Triangulating Value and Incorporating ESG

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Presentation Overview

- Bio and personal Story
- Brief look at Cove Street's investment process
- Dive into the different method of valuation (w/examples)
- Discussion of decision making and incorporating ESG
- Key takeaways
- Q&A

Presenter Biography

- **Ben Claremon**

Ben Claremon joined Cove Street in 2011 as a research analyst. He also serves as a Co-Portfolio Manager for our Classic Value | Small Cap Plus strategy. Previously he worked as an equity analyst on both the long and the short side for hedge funds Blue Ram Capital and Right Wall Capital in New York, and interned at West Coast Asset Management in Santa Barbara. Prior to that, he spent four years with a family commercial real estate finance and management business. Mr. Claremon was also the proprietor of the value investing blog, The Inoculated Investor. His background includes an MBA from the UCLA Anderson School of Management and a BS in Economics from the University of Pennsylvania’s Wharton School.

Personal Story

- Grew up in Arizona
  - The son of a writer and a hypnotherapist
  - As far away from Wall Street as you can imagine
- Straddled two worlds
  - Southern Arizona border life
  - New York City (Bronx) family real estate business
- Went to Wharton School at UPenn to study real estate
  - Path was set at 14 years old
  - Myopic view of college– get in, get out; means to an end
  - In hindsight: should have focused on finance/accounting
  - Advice: take advantage of classes outside your core competency!

Personal Story (cont.)

- Worked in real estate for 5 years
  - Working for your family = "interesting"
  - Didn't love the property management business
  - Fell in love with investing thanks to Ben Graham's *The Intelligent Investor*
- Decided to try to get a job on the buy-side
  - Lucky enough to get a job with start-up hedge fund in NY
  - Financial crisis was a lot of fun (but learned a lot)
  - Interned at another hedge fund before business school
- Moved to L.A. to go to UCLA Anderson
  - Focus was on accounting and finance
  - Was part of the Student Investment Fund (SIF)
  - Co-founded Anderson Investment Association
  - Interned at West Coast Asset Management

Personal Story (cont.)

- Started an investment blog to stay in the game
  - The Inoculated Investor
  - Annual trek to Omaha for the BRK meeting
  - Started up the 10-K Club of SoCal
- Cove Street founder discovered me through the blog
  - Hired as 1 of 2 analysts in 2011
  - The rest is history
    - Almost 10 years at CSC
    - Co-PM of the Small Cap PLUS strategy
    - Frequent guest on podcasts
- Keys to success
  - Persistence
  - Willingness to do things others aren't
  - Loving the process of investing
  - Finding ways to distinguish yourself from others

Cove Street Capital…at a glance

- Cove Street Capital ("CSC") is an LA-based, SEC-registered investment adviser founded in 2011
  - 100% employee owned
  - ~$750 million under management
- Concentrated, Small/SMID Cap value focus
  - Business, Value, People
- Talent-dense analytical team
  - Jeff Bronchick, CFA
  - Eugene Robin, CFA
  - Ben Claremon
    - Principal and Portfolio Manager
  - Andrew Leaf
- http://covestreetcapital.com/

Investment Philosophy

- Classic fundamental, research-driven value investing
- Concentrate on best ideas
- Think and act long-term
  - Mathematics of compounding
  - Less is more
- Key investment questions:
  - Is this a high return company that is getting more valuable each day?
  - Is this company run by honest people who understand capital allocation?
  - Is the stock undervalued based on conservative assumptions about the future?

4-Step Investment Process

- Generating Ideas
  - Screen for both good businesses & cheap stocks
  - Screen for behavioral anomalies/companies in transition
  - Collective investment experience/contact network/out of office experiences/management meetings
- Qualify
  - CSC Capital IQ-linked analytic spreadsheet
  - Company quality
    - Buffett stock—good business at a reasonable price?
    - Graham stock—cheap security that provides a large enough margin of safety?

4-Step Investment Process (cont.)

- Deep dive
  - Team tackle by generalists: 2 long, 1 short
  - **Triangulate intrinsic value**
    - **DCF, SOTP, multiples analysis**
    - Sustainable competitive advantage?
  - C-PEST analysis—Climate, political, economic, social, technological risks

- Decision
  - Full or half position?
  - Margin of safety
  - Sufficient risk-adjusted upside
  - Establish sell discipline

Why is valuation so important to YOU?

- As an investor, all you can control is:
  - Your due diligence process
  - The price you pay
- Academic research says "valuation really matters when it comes to future returns"
- Core skill of being an equity analyst
- Allows you to employ creativity
- Building consistency is key to a good process

Investing Topics to Cover

- How Cove Street values companies
- How valuation impacts investment decisions and position sizing
- Incorporating ESG into decision making

Key Valuation Techniques

- DCF
- Historical Multiples Analysis
- SOTP
- Private Market Value
- TRIANGULATE!!
  - You want multiple metrics that suggest that the stock is trading below intrinsic value
    - But no bell goes off when you hit a stock's intrinsic value

Discounted Cash Flow Analysis (DCF)

- The value of ANY company is equal to the present value of future cash flows
  - The difficulty is properly understanding what the future will look like
  - This is why you have to perform deep diligence on the business:
    - Competitive advantage
    - Total addressable market
    - Incremental returns on capital
    - Margin/return enhancement opportunities
    - Capital allocation avenues
  - Garbage in= garbage out
    - Any stock can be cheap or expensive based on assumptions
  - Multiples are simply short hands for a DCF

DCF (cont.)

- Cove Street's Conservative DCF Assumptions
  - Risk free rate = 5%
    - Far higher than current 30 Year UST
    - Think of WACC as a minimum level of return you would accept as an equity investor
      - Long term market returns of 6-7% so acceptable WACC > market returns
      - We are not alone– Joel Greenblatt:
        - https://www.theinvestorspodcast.com/episodes/common-sense-investing-w-joel-greenblatt/
  - Terminal growth rate = 0%
  - Modest growth expectations years 5 to 10

DCF (cont.)

- DCF Example: Western Union (WU)
  - Stock Price: $24.45

NOPAT Discounted Cash Flow

Weighted Cost of Capital	8.1%		
NOPAT Growth CAGR (Yr 1-5)	4.2%		
NOPAT Growth CAGR (Yr 6-10)	2.0%		
Investment Growth CAGR (Yr 1-5)	3.4%		
Investment Growth (Yr 6-10)	2.0%		
Value of $1 at Cost of Cap	12.3		
Perpetuity Factor PV	5.63		
Present Value of FCF	$6,765	*47%*	
Present Value of NOPAT at Perpetuity	$7,583	*53%*	
Implied Enterprise Value	$14,348		
- EVA Debt	$2,106		
+ Other (including unfunded pension)	29.9		
Implied Equity Value	$12,272		
Shares Outst.	415.2	*Roll Fwd*	*(adjust for stock options)*
Intrinsic Value per Share	**29.56**	***30.14***	
Implied P/E	15.7x	*15.0x*	
Implied EV / EBITDA	11.8x	*11.2x*	

	WACC						
Nopat Growth		6.6%	7.1%	7.6%	8.1%	8.6%	9.1%	9.6%
	-5.0%	$ 28.87	$ 26.48	$ 24.40	$ 22.58	$ 20.96	$ 19.53	$ 18.25
	-4.0%	$ 30.07	$ 27.56	$ 25.38	$ 23.46	$ 21.78	$ 20.27	$ 18.93
	-3.0%	$ 31.31	$ 28.68	$ 26.39	$ 24.39	$ 22.62	$ 21.05	$ 19.64
	-2.0%	$ 32.60	$ 29.84	$ 27.44	$ 25.35	$ 23.49	$ 21.85	$ 20.38
	-1.0%	$ 33.95	$ 31.05	$ 28.54	$ 26.34	$ 24.40	$ 22.68	$ 21.14
	0.0%	$ 35.34	$ 32.30	$ 29.67	$ 27.37	$ 25.35	$ 23.55	$ 21.94
	1.0%	$ 36.79	$ 33.61	$ 30.85	$ 28.45	$ 26.32	$ 24.44	$ 22.76
	2.0%	$ 38.29	$ 34.96	$ 32.08	$ 29.56	$ 27.34	$ 25.37	$ 23.61
	3.0%	$ 39.84	$ 36.36	$ 33.34	$ 30.71	$ 28.39	$ 26.33	$ 24.50
	4.0%	$ 41.46	$ 37.81	$ 34.66	$ 31.90	$ 29.48	$ 27.33	$ 25.41
	5.0%	$ 43.13	$ 39.32	$ 36.02	$ 33.14	$ 30.61	$ 28.36	$ 26.36
	6.0%	$ 44.87	$ 40.88	$ 37.43	$ 34.43	$ 31.78	$ 29.44	$ 27.35
	7.0%	$ 46.67	$ 42.50	$ 38.90	$ 35.75	$ 32.99	$ 30.54	$ 28.36
	8.0%	$ 48.53	$ 44.18	$ 40.41	$ 37.13	$ 34.25	$ 31.69	$ 29.42
	9.0%	$ 50.46	$ 45.91	$ 41.98	$ 38.55	$ 35.54	$ 32.88	$ 30.51
	10.0%	$ 52.46	$ 47.71	$ 43.61	$ 40.03	$ 36.89	$ 34.11	$ 31.64
	11.0%	$ 54.53	$ 49.57	$ 45.29	$ 41.55	$ 38.28	$ 35.38	$ 32.80

		287	652	1017	1382	1747	2112	2477	2842	3207	3572
	Dec-20	Dec-21	Dec-22	Dec-23	Dec-24	Dec-25	Dec-26	Dec-27	Dec-28	Dec-29	Dec-30
NOPAT	993.1	1,122.8	1,142.3	1,163.9	1,191.6	1,219.9	1,244.3	1,269.2	1,294.5	1,320.4	1,346.8
- Inc. In Capital		371.2	198.3	179.1	188.2	197.6	149.3	152.2	155.3	158.4	161.6
= Free Cashflow		751.5	944.0	984.8	1,003.4	1,022.2	1,095.0	1,116.9	1,139.2	1,162.0	1,185.3
Cross-Check: CFFO - Capex	*841.0*	*959.3*	*955.5*	*1,000.1*	*1,022.6*	*1,045.6*	*1,069.0*	*1,092.8*	*1,117.1*	*1,141.8*	
Roll Fwd Discounted FCF		$707	$821	$792	$746	$703	$697	$657	$620	$585	$552
NOPAT growth		*13.1%*	*1.7%*	*1.9%*	*2.4%*	*2.4%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*
Total Capital Employed	6,328.6	6,699.8	6,898.2	7,077.3	7,265.5	7,463.1	7,612.4	7,764.6	7,919.9	8,078.3	8,239.9
Growth		*5.9%*	*3.0%*	*2.6%*	*2.7%*	*2.7%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*	*2.0%*

Historical Multiples

- Use Capital IQ to determine the standard deviation adjusted average multiples for every company
  - 5, 10, 15 year average if available
- Apply the chosen multiple to 3 year out EV/EBITDA, P/E, EV/Sales multiples
  - Include cash generated over that period (for EV-based calcs) to determine the value in 3 years
- WU Multiples

1/11/05 to 1/11/21	
STDEV Adjusted AVG EV/EBITDA	8.21x
STDEV Adjusted AVG P/E	12.95x
STDEV Adjusted AVG P/BV	16.02x
STDEV Adjusted AVG EV/Rev	2.21x
1/11/11 to 1/11/21	
STDEV Adjusted AVG EV/EBITDA	7.95x
STDEV Adjusted AVG P/E	11.20x
STDEV Adjusted AVG P/BV	11.05x
STDEV Adjusted AVG EV/Rev	2.07x
1/11/16 to 1/11/21	
STDEV Adjusted AVG EV/EBITDA	8.25x
STDEV Adjusted AVG P/E	11.14x
STDEV Adjusted AVG P/BV	9.72x
STDEV Adjusted AVG EV/Rev	2.06x

Historical Multiples (cont.)

- WU Multiple Analysis:

EBITDA ANALYSIS

Multiple Choice:	5 YR STDEV AVG		
FY to use for base:	FY2023	**Cash Generated (21-23)**	$2,531.9
Current Debt =	1639.1	Per Share	$6.11
EBITDA step % =	5%	Total Value	$33.11
Multiple step % =	15%	% Upside	*35.4%*

FY2023 EBITDA	5.9x	7.0x	8.2x	9.4x	10.9x
$ 1,228.31	$ 13.60	$ 16.70	$ 20.34	$ 23.98	$ 28.17
$ 1,292.96	$ 14.52	$ 17.78	$ 21.62	$ 25.45	$ 29.86
$ 1,361.01	$ 15.50	$ 18.93	$ 22.96	$ 27.00	$ 31.64
$ 1,429.06	$ 16.47	$ 20.07	$ 24.31	$ 28.55	$ 33.42
$ 1,500.51	$ 17.49	$ 21.27	$ 25.72	$ 30.17	$ 35.29

EPS ANALYSIS

Multiple Choice:	5 YR STDEV AVG
FY to use for base:	FY2023
EPS step % =	5%
Multiple step % =	15%

FY2023 EPS	8.1x	9.5x	11.1x	12.8x	14.7x
$ 2.02	$ 16.25	$ 19.11	$ 22.49	$ 25.86	$ 29.74
$ 2.12	$ 17.10	$ 20.12	$ 23.67	$ 27.22	$ 31.30
$ 2.24	$ 18.00	$ 21.18	$ 24.91	$ 28.65	$ 32.95
$ 2.35	$ 18.90	$ 22.24	$ 26.16	$ 30.08	$ 34.60
$ 2.47	$ 19.85	$ 23.35	$ 27.47	$ 31.59	$ 36.33

Sum-of-the-parts (SOTP)

- If company has multiple segments:
  - Find public comps for each of the segments
    - Apply those multiples to the various segments
    - Can use precedential transactions as well
    - Add discount or premium based on business quality vs. peers
    - Be very careful if there are no/few perfect comps; beware inflated multiples
    - Sum up the various parts, subtract debt => equity value
- LUMN Example

Valuation Overview

$ in billions, except per share amounts

	1Q20 LTM Adj. EBITDA [1],[2]	Multiple Low	Multiple High	Implied EV Low	Implied EV High
Level 3	$ 3	10.0x	12.0x	$ 29	$ 35
CenturyLink	6	5.0x	6.0x	31	37
Consolidated	**$ 9**	**6.6x**	**7.9x**	**$ 60**	**$ 72**

	Low	High
Implied EV	$ 60	$ 72
- Net Debt [3]	*($33)*	
Equity Value	$ 26	$ 38
÷ Shares Out. [4]	*1.1*	
Share Price	**$ 24**	**$ 35**

Using Level 3 as a proxy for fiber assets based on publicly disclosed financial results

Historical multiples for Level 3 and remaining CenturyLink entities yield a range of Enterprise values significantly higher than current market value

Private Market Value

- What would this company be worth if it were sold today?
- Look for precedential transactions
  - Either apply those multiples to segments or whole company
  - Add discount or premium based on business quality vs. peer
  - Understand where you are in the cycle and when the deals were completed
  - Again, be very careful if there are no/few perfect comps; beware inflated multiples
  - Understand differences that stem from:
    - Margins
    - Returns
    - Growth profile
    - Geographic exposures
    - Where the stock is traded
    - Size and scale
    - Strategic vs. private equity acquirer

Combining Techniques

- Triangulate value
  - Again, what you want is multiple metrics that suggest undervaluation
  - If one doesn't scream cheap=> not necessarily a deal breaker
  - Make sure you are consistent in your assumptions across techniques
- Use the DCF to test your assumptions:
  - What is the current stock price implying about growth/margins?
    - Is that reasonable or unreasonable?
- Too conservative => you miss opportunities
  - Too bullish => you LOSE money
  - First rule is don't lose money
- Demand a sufficient margin of safety for the risk you are taking
- Develop a contrarian thesis on why the market is wrong at the current valuation

Decision Making

- Do you overweight the stock that trades at the largest discount?
- Do you overweight the stock with the least downside?
- Business + Value + People align => overweight
  - Just Business + Value => deal breaker
  - Just Value => not as interesting
  - People + Value OR People + Business => OK to invest @ half position size
- But wait, how does ESG fit?
  - There is no good E & S without good G
    - Everything starts with good corporate governance
    - Good management teams anticipate changes and invest for the long run
    - Focus on E&S comes from the top but has to be part of the culture

10 Questions on the E of ESG

- If you see a lot of yeses that is not a good sign
  - Cheap valuation may not be enough to protect you from these issues
  - You may question the longevity of the company or the returns
  - You may wonder if management has done enough
    - Capital allocation?
    - Risk management?
  - No hard and fast rules exactly—this is a red flag analysis
  - ESG is a hot space so BEWARE greenwashing

	Yes =1
Sustainability Questions (C-PEST Analysis)	**No = 0**
Company impacted by warming temperatures (either products or facilities)	0
Company impacted by rising seas (either products or facilities)	0
Questions about product relevance in a more sustainable future	1
Production not feasible or economic without subsidies or if the company paid the true environmental costs	1
Business only exists in its current form due to lack of regulation	1
Long supply chain that requires quick and cheap shipping from around the world	1
Generally a polluting/dirty company or industry	1
Company has never run a carbon footprint analysis or an environmental impact assessment	0
No ability or willingness to make products more sustainable or circular	0
Inevitable social change that moves people away from the company's products/services	1
Total Score	6

Key Takeaways

- You can become a buy-side analyst even if you don’t take a “traditional” path
- Find a way to distinguish yourself from others to stand out
- Valuing companies is an imperfect science so be conservative and use multiple methodologies
- ESG is an important thing to consider—start with governance and move from there

Q&A

- Any questions? Comments? Feedback?
- Contact :
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