ValueWalk Interview

November 2015

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First off, could you tell our readers a little about Broyhill Asset Management and the firm's investment strategy?

Sure. Broyhill is a boutique investment firm, established as a family office and guided by a disciplined value orientation. Our family office foundation provides the security of a stable capital base located in Lenoir, North Carolina. The advantage of being located in the foothills of the Blue Ridge Mountains is that we are outside of the fray. It's pretty quiet here and the rumor mill just doesn't churn as loudly. Removed from the noise, we are able to climb the mountain and survey the investment landscape with a rational, long-term perspective.

We construct concentrated equity portfolios for like-minded investors. We provide our partners with complete transparency by offering separately managed accounts for each investor. The investment strategies we endorse for our investors are consistent with those developed and deployed for ourselves. Some of our partners look to us solely for stock selection. In this case, we leverage the same internal research, which drives stock selection for BMC Fund, to construct similar portfolios for investors[1]. Others look to us for a more holistic approach to their wealth. In this case, we can construct a broader portfolio which may include allocations to external managers, again leveraging those capabilities and relationships developed over decades. In both cases, we place great emphasis on capital preservation and remain invested alongside of our clients.

How do you go about looking for an investment (both long and short) at Broyhill; what's your investing process?

Promising investments can come from anywhere. There are no patents on investment ideas. The only common factor in our search for fifty cent dollars is the thrill of the hunt. We read voraciously, attend conferences, talk to business owners, and often share our thinking with like-minded investors. We benefit from an expansive industry network but are just as likely to fish for bargains in more conventional ponds: industry publications, regulatory filings, corporate actions, quarterly letters, etc. We are generalists turning over a lot of rocks to find those few gems that meet our requirements for investment. The examples which follow should provide a sense for how we do this.

When you've found a potential position what makes you say, "Yes, we want to take a position" or "No, we don't?" What kind of margin of safety are you looking for?

Our preference is for high quality businesses that are easily understood. This alone eliminates the majority of investment alternatives, allowing us to focus our resources on understanding simple businesses without distraction from the noise outside of our circle.

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[1] Chris is the President and Chief Investment Officer of Broyhill Asset Management and Vice President and Chief Investment Officer of BMC Fund, Inc. BMC Fund. is a closed-end, diversified investment company registered under the Investment Company Act of 1940, as amended. The fund was created in 1981 and remains the primary wealth vehicle for the Broyhill Family. It is not publicly traded on any markets.

Inside our circle, we read pertinent books, publications, company filings, transcripts, industry periodicals and journals to deepen our understanding. Occasionally, something will catch our attention and at that point, we dig in and tune everything else out. Most investments won't meet our requirements and as a result we will pass. Others won't offer a sufficient discount to intrinsic value so we will wait.

We only need a few good ideas every now and then to construct a portfolio in this manner. Rather than lower our standards and allow unexceptional ideas to creep into the portfolio, we'll go back to scanning the markets and turning over rocks until something turns up. When it does, we'll drill down again until the thesis is rejected or we make an investment.

How much concentration are you prepared to take in the portfolio?

Research has demonstrated that the average fund manager has historically underperformed a low-cost index fund after fees and expenses.

This should not come as a surprise considering that the average fund holds over 100 stock positions today and turns over nearly the entire portfolio on an annual basis. Rather than strive for long term excellence, most institutions have become closet indexers in order to avoid the risk of falling in the bottom quartile of their peer group in the short term.

Clearly, just being different from the benchmark isn't, by itself, a recipe for outperformance. Successful investing requires that you have a different view from consensus – but that view also needs to be right.

Closet indexing is far more comfortable than being wrong but it is certain to produce subpar returns. Conversely, we recognize and fully accept that our own process may not be the best way to stay at the top of the pack in any given year, but the evidence suggests that it produces a portfolio better able to avoid permanent capital loss and increases the probability of success over the long term.

Generally speaking, we are looking for investments that have the potential to double over three to five years with a low probability of loss. These things don't come along every day so we concentrate our capital in our best ideas, and are willing to trade short-term underperformance for long-term success.

We believe that exceptional returns are created by concentrated portfolios, as excellent ideas are few and far between. The idea that you should own a little bit of everything is a recipe for mediocrity. We work exceptionally hard to ensure that our largest positions offer the most attractive returns on a risk-adjusted basis. At the moment, our top ten positions represent roughly two thirds of our equity exposure.

Still, diversification across the portfolio - even in a concentrated strategy - is critical, as our "best" ideas can sometimes prove wrong. So we strive to generate consistent returns by never allowing one view, no matter how high our conviction, to dominate the risk of the overall portfolio.

When considering potential investments, careful consideration is given to the investment's own intrinsic value and expected return, as well as to the sensitivity to other investments already in the portfolio.

In Broyhill's Q1 letter, you mentioned that you'd taken a look at the oil industry but had struggled to find any opportunities that were worth taking. Nearly six months on, has your view changed? Are you finding opportunities in the sector now?

Given our preference for quality, we generally have little interest in commodity businesses where product pricing is outside of management's control. Of course there are exceptions to every rule and we discussed two of these exceptions in our 2013 Annual Letter. In both cases, inefficiency in our nation's infrastructure, rather than a speculation on energy prices, created opportunities for investment. And in both instances, we capitalized on an overreaction to short-term developments which had little impact on intrinsic value.

We purchased shares of Kinder Morgan (KMI) in early 2014 as the stock overreacted to several negative research reports and a surge in short interest. We sold our investment in KMI later that year after the market rewarded Mr. Kinder's demonstration of financial engineering via the purchase of its two Limited Partnerships. In 2013, we purchased shares of Northern Tier (NTI) amidst heavy retail selling in response to a reduced distribution, a large secondary offering and an unexpected fire at its only refinery (as opposed to those planned backyard fires often seen in the South this time of year). We reluctantly sold our investment in NTI last quarter, after Western Refining announced its intent to acquire all of the publically traded units it didn't already own.

After monetizing two of our best performers in recent years, we learned that in the energy sector, the third time is emphatically not a charm. Commodity businesses have an impressive history of value destruction and our third investment in the sector lived up to this reputation. To put it bluntly, we misjudged the height of the barriers to entry in the industry and underestimated the probability of "lower for longer" in the energy sector.

As a young analyst at JPMorgan, I vividly recall our energy team (along with most of Wall Street) assuming $18 per barrel for "normalized" oil prices in their earnings models. I realize this sounds like a story your grandfather might tell you, but this was only fifteen years ago. And it took nearly a decade for those anchored estimates to come up toward $50 even as oil rocketed past $150 on the heels of surging Chinese commodity demand. Fast forward to today: Chinese demand for ghost cities appears to be past its peak; domestic oil supply has far surpassed our wildest dreams; and the world's fastest production car does not use a single drop of oil.[2] Against this backdrop, the forward curve assumes $60 "normal" oil today vs $80 one year ago. This may have appeared conservative with oil trading north of $100. Will it appear conservative if oil falls to $30 or back to the "old normal" of $18 per barrel?

We don't know what the right price is. Or perhaps more accurately, we can't know. And the more rocks we turned over in the energy sector, the more our confidence dwindled. These stocks are cheap *if you assume that the recent past is a decent proxy for normal oil prices.* But the industry has a long haul ahead of it if you widen your lens, consider the potential for recency bias, and reflect on the long term history of oil prices. With no edge in forecasting commodity prices, we've put energy in the "too hard" pile, but not before updating our checklist with a few lessons learned. Pain plus reflection equals progress. We must admit that we were wrong in order to learn from our mistakes.

[2] *The new Tesla Model S P90D, accelerates faster than sports cars from Ferrari, Lamborghini and Bugatti, according to [Motor Trend](#).*

You mentioned in Broyhill's Q1 letter that the firm was looking at Ally Financial based on the subprime auto lending industry's fundamentals. Do you still like the look of this company/sector?

Subprime auto lending isn't of particular interest to us. For that matter, neither is auto lending or banking in general. Broadly speaking, we have little interest in the great majority of financial businesses (our large investment in Oaktree, the obvious exception). Banks can appear to be high quality institutions at specific points in time, but give them enough rope and they eventually go bust.

Historically, ten years has been enough rope although the periods between crises appear to have shortened of late, so the next bust may not be that far off. Either way you cut it, if you put a zero at the end of a long, consistent stream of double-digit annual returns, your ending value is still zero. Something about that doesn't sit well with us.

So how is Ally Financial (ALLY) different? To us, ALLY looks very similar to CIT Group (CIT) after it emerged from bankruptcy. CIT exited from bankruptcy in December 2009 with a clean slate, yet a number of temporary factors resulted in a large valuation discrepancy relative to peers: written agreements with the Federal Reserve limited the company's capital allocation options; high cost debt suppressed normalized earnings power; short-term book value growth was diminished by debt repayments and refinancing; and investors looked past a significant tax shield against future earnings in the form of NOLs.

The overarching issue for CIT was its funding model. As the regulatory shackles were removed, management was able to move away from high cost debt and use the bank as the primary funding for new business. The stock subsequently rerated from 0.7x book value to 1.1 – 1.2x book value over two years.

ALLY was majority owned by the US government until November 2013, but still trades at a discount to book value today. Like CIT, current earnings are depressed by high cost financing and a suboptimal capital structure. Similarly, as ALLY optimizes its balance sheet, near-term book growth will moderate. However, looking out past a few quarters, all of these near-term challenges start to drive long-term value creation.

The company is expanding its use of deposit funding at Ally Bank and working with regulators to refinance the remaining preferred securities from its capital structure. Management has made substantial progress optimizing the balance sheet to date, but eliminating the Series G preferred would be a big win. They are in an active dialogue with the Fed regarding Series G right now with the objective of initiating a dividend and share buyback program next year.

Bank assets represented more than two thirds of ALLY's balance sheet at quarter-end. This should trend closer to three quarters in the near term with upside potential closer to 90% over time. Let's think about this for a moment. ALLY had over $21 billion in long-term debt on its balance sheet as of quarter end with a 4.9% average cost of funding. If management successfully moves towards a deposit-based funding model – with an average cost of funding of 1.1% - the potential savings on this stack alone is roughly $800 million. To put this number in perspective, consider that consensus estimates for FY15 net income are around $1 billion.

Balance sheet optimization at ALLY is only a matter of time. And we have all of the time in the world for ALLY's earnings power to shine through. If Mr. Market is slow to recognize this shift, I can assure you that Mr. Jeff Brown, ALLY CEO, will act quickly to highlight the value we see today. He's done just fine with one hand tied behind his back since emerging from bankruptcy. Imagine what he can do with both hands once the capital allocation handcuffs come off with Series G. As he noted on this week's earnings call, "I would love to be buying back shares. Given where tangible book sits, this is really Finance 101." And given where the stock sits in relation to tangible book, we are not paying anything today for the optionally embedded under the Ally Bank umbrella which posted $1.8 billion in deposit growth for the quarter, up 15% year-over year. What's in your wallet?

You've also expressed an interest in Seaworld after the company's recent troubles. What do you think the market is missing here and what attracted you to Seaworld in the first place?

We've been following the theme park industry since Six Flags (SIX) filed for bankruptcy during the crisis. We don't own SIX but we owned Cedar Fair (FUN) for several years (we liquidated our position last quarter as the stock approached our estimate of fair value). FUN ran up roughly 5x from levels where Apollo attempted to take it private during the crisis. There's plenty of money to be made in simple businesses. Private equity's attraction to the industry is easy to understand – the businesses are recession resilient and throw off tremendous cash flow through the cycle. It's a mature business, but zero supply growth and good consumer value provide owners with plenty of pricing power.

We've followed SeaWorld (SEAS) since Blackstone took the company public in April 2013. At the time, expectations were overly optimistic, and the stock's valuation reflected that optimism. The consensus assumed that attendance and pricing would rebound and margins would normalize. Instead, the company was faced with a series of challenges which drove a large gap between expectations and reality. Today, the gap between expectations and reality has turned in our favor – we think the stock's current valuation overly discounts these challenges.

The market believes that consumer tastes have evolved and that Blackfish has permanently impaired the SeaWorld brand. This is an emotionally charged issue which makes it difficult for investors to think rationally. We believe that the average American still enjoys going to the zoo or the aquarium and the empirical evidence supports this assumption. Zoos have been around for a very long time. They provide an educational experience that is impossible to get anywhere else. Seaworld serves a similar role.

The competitive environment is another source of investor concern. The market believes that SeaWorld cannot compete with Disney and Universal. We don't disagree. We just don't think they need to compete at all. SeaWorld has successfully existed in the same markets as Disney for decades. They haven't survived by competing head on. Instead, they've survived by playing their own game and offering a totally unique experience for families. We think Disney and Universal actually benefit SeaWorld to some extent via robust passenger traffic into Orlando and plenty of cover in terms of ticket pricing.

This gap between expectations and reality has resulted in irrational pricing. The market is currently valuing SEAS at a trough multiple on trough earnings. We think that's a mistake. It's pretty short sighted to assume sentiment will always be this depressed. And we think we have plenty of downside protection in other assets like Busch Gardens and with the stock trading near levels where it was taken private. This is a good business suffering from temporary challenges. Despite the stock's double-digit gain year-to-date, sentiment remains very depressed.

And finally, you mentioned in your August letter that Broyhill is buying mispriced options to generate short-term returns. What was your thesis behind this trade and how does it fit into your value mandate? Do you frequently use derivatives to boost short-term returns?

I wouldn't say that we *frequently* use derivatives to boost short-term returns. But we don't think the words "options" and "value" are mutually exclusive. And to be clear, the single largest driver of our returns has been, and will generally be, driven by direct investments in individual securities.

We are fundamental investors and we tend to worry more than most. As a result, we are willing to trade some upside during good times for the ability to sleep better at night. Holding cash in the absence of compelling opportunities helps us sleep. At the right price, and under certain conditions, hedging a portion of our risk through the purchase of put options helps us sleep even better. This was certainly the case last quarter as our declines were limited to a fraction of the losses experienced by stock indices. More importantly, while many investors were paralyzed by short term fear and rapid price declines, we were positioned to buy more of the businesses we own at better prices, and as a result, we recouped our unrealized losses more quickly.

The *occasional* use of options in this manner serves to reduce our risk, rather than boost short-term returns. Our use of options is not unlike our other value-driven investments. We aim to buy low and sell high. Occasionally, spikes in volatility allow us to sell high and collect rich premiums which give us the right to buy companies we'd like to own at lower prices. And since we typically have plenty of cash on hand, these positions are always fully collateralized. Again, we view this is as an inherently lower risk proposition than owning stock outright.

We don't use leverage but we are more than happy to enhance the return on our cash while waiting for lower prices and a wider margin of safety. In August, for example, volatility spiked to levels last seen in the wake of Lehman's collapse. In response, we sold options to increase our exposure to several core holdings in the portfolio earning returns on our cash approaching double-digits over the course of a few weeks. With the overall market barely correcting 10%, selling options with the VIX at 50 appeared to be a better risk/reward than buying stock outright.

In addition to put selling, we will occasionally use options to exit positions by writing covered calls at strike prices near intrinsic value. This is less common for us as the premium rarely offsets the downside risk of holding onto a fully valued position. That said, the premium can serve to partially offset declines in market value when markets are falling. More importantly, in both cases, we are being paid to do something we would do anyway.

Thanks for your thoughtful questions. If my rambling resonated with a few of your readers, they can subscribe to our research and updates here or ping us directly at info@broyhillasset.com. We are always happy to talk shop with like-minded folks. We learn a lot by listening to different perspectives so feel free to share with us. All knowledge is cumulative so seemingly small tidbits can pay large dividends over the years.

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