ValueInvestor INSIGHT
The Leading Authority on Value Investing
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Investing in Crisis

Warren Buffett captures an essential truth about investing when he says, "It's only when the tide goes out that you learn who's been swimming naked." The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they're navigating the roiling seas.

INVESTOR INSIGHT

Peter Keefe
Avenir Corporation

When Philosophy is Tested

Avenir Corp.'s Peter Keefe has built a remarkable track record investing in "compounders" that are exactly the types of companies investors tend to gravitate towards when they upgrade the quality of their portfolios in a sharp market downturn. Here he describes his process and mindset through the current crisis and where he turned to upgrade his own portfolio as the market churned.

How, for want of a better word, would you say you were "prepared" for what unfolded in the equity markets last month?

Peter Keefe: Even though Warren Buffett encourages us to think about the unimaginable, we never thought about businesses being shut down for extended periods of time. What we do think about, though, is paying the right price for the value we believe we're getting in return. That meant that cash had been organically building in our portfolio throughout 2019 and we entered the new year with a cash level in the teens. We'd sold a few things, and while there were plenty of businesses we were interested in to reinvest the proceeds, the multiples we had to pay still implied modest returns even if everything went right. Cash building was not strategic or tactical, just a fallout from a simple investment process.

I bear in mind something that Brad Singer, formerly the CFO at both American Tower and Discovery Communications, once said to me. I had asked him what was the biggest single destroyer of capital that he'd seen as an investor and an operator and he answered quickly with "management boredom." With that in mind, I've always tried to make sure that if I couldn't put capital to work at what I considered to be outstanding rates of return, I would sit on my hands. That's what we were doing.

Then the world comes unglued and our response was to keep doing what we always try to do, invest in outstanding businesses run by ethical and skilled managers and that are capitalized in a manner that will allow them to survive long periods of hardship. These are times when your philosophy gets tested. The market's going down 5%, 6%, 7% a day and the expectations of the virus's toll are increasingly dire. Philosophy can go out the window in an environment like that – understandably, by the way.

But as an investor, if you ignore the proximate cause of the market decline, it's just another 35% decline and we've been through many of those. You have to react the same way you always do. If the businesses you want to buy have unassailable – I call them "five-year" – balance sheets, if they have durable cash flows that may be interrupted but likely to resume and compound as before, and the price gets right, you buy them. It didn't last long – if you blinked, you missed it – but we put some capital to work at sharply lower prices. Certainly not as much as we would have liked to.

You're a long-time owner of American Tower [AMT], and even its stock went crazy last month – from $250 on March 4th, to less than $175 on March 23rd, to hitting an all-time high of $260 two weeks later. How did you respond to all that?

PK: Go figure. I should have mentioned on the subject of preparation that we have been around long enough to understand that exogenous shocks happen. As a result we try to minimize our exposure to the unknowable and concentrate on investing in businesses that aren't yoked to an unpredictable global economy or political landscape. American Tower is a great example. As mobile bandwidth consumption grows, which is a pretty powerful tailwind, so too will AMT's earnings. That's unlikely to be fundamentally altered by the pandemic. Its revenues going out five or six years are largely contractual, with credit-worthy counterparties. The credit-worthiness of the counterparties has even arguably improved in the last 60 days with T-Mobile's acquisition of Sprint.

This is the type of business we love, bond-like almost, with increasing coupons that are known and persistent. If we don't already own it, we want to be up to speed on it and ready to buy it at the right price. In any event, when something like this goes down 30% in less than three weeks, we're very likely to be a buyer. That was the case with American Tower.

Walk through your updated investment case for auto-auction company Copart [CPRT] in light of recent events.

PK: The company's basic business is auctioning totaled automobiles for insurance companies. A car is in an accident, the body shop says it will cost $15,000 to fix it, but the insurer says it's only worth $13,000. The insurance company declares it a total loss, pays out the $13,000 to the policyholder and then turns to Copart to get as much for the totaled car as possible.

To give some background, the company was started in 1982 by Willis Johnson, who is still the Executive Chairman. He was a kid from rural Oklahoma who came back from Vietnam and started a salvage business where he'd buy junked cars and people would come in and literally pull parts off the cars and pay him a couple bucks for each one they wanted. From that the business has evolved and Copart is now the #1 player in what is essentially a U.S. duopoly with IAA [IAA], which was spun off last year by KAR Auction Services. The company has 200 salvage yards located primarily in metropolitan areas across the country. Since 2003, all of the auctions have been online only.

We love the business and think it has systemic advantages that give it an inherent and lasting advantage over any competitor. That's primarily due to the fact that the company has spent 40 years acquiring real estate around the United States – paid for in cash often decades ago when the land was far less expensive – in metropolitan areas where there are more accidents. That makes it easier and cheaper for insurance companies to offload the wrecked cars. With a growing inventory base, the company was able to develop, again over 40 years, the biggest network of buyers, which is now international. The more buyers, the more liquidity, the better the prices at auction. That then attracts more inventory from insurers – it's a virtuous circle.

Like eBay or Amazon, they've created a whole ecosystem that lives off their auctions. It doesn't take a lot of capital to run the business and operating margins are extraordinarily high – exceeding Microsoft's, in fact. People when they first hear about it say, "What, you're investing in a junkyard?" But this is more a technology business than anything else.

Are there any secular industry trends working in the company's favor, or against it, today?

PK: One significant positive is that automobiles are deemed totaled much more frequently than they used to. Half of the value of an automobile is now in the electronics – computers, sensors, optical cameras – much of which is located in places that often get hit. A bumper for a 2000 Ford F-150 might cost $300 to replace, while the one on a new F-150 might go for $1,700. That results in newer vehicles getting totaled with much greater frequency,

INVESTMENT SNAPSHOT

Copart
(Nasdaq: CPRT)

Business: Operator of an online auction platform that connects primarily insurance-company sellers of "totaled" automobiles with a large and liquid global network of potential buyers.

Share Information (@4/29/20):

Price	**83.01**
52-Week Range	55.69 – 104.88
Dividend Yield	0.0%
Market Cap	$18.85 billion

Financials (TTM):

Revenue	$2.23 billion
Operating Profit Margin	36.6%
Net Profit Margin	32.9%

Valuation Metrics
(@4/29/20):

	CPRT	S&P 500
P/E (TTM)	22.4	22.5
Forward P/E (Est.)	24.6	21.0

Largest Institutional Owners
(@12/31/19 or latest filing):

Company	% Owned
Vanguard Group	10.1%
BlackRock	4.9%
State Street	3.7%
Principal Global Inv	2.8%
Brown Brothers Harriman	2.8%

Short Interest (as of 4/15/20):

Shares Short/Float	2.6%

CPRT PRICE HISTORY

THE BOTTOM LINE

The company has inherent competitive strengths that combined with a resilient income statement and balance sheet should allow it to come out of the current crisis as strong as ever, says Peter Keefe. He believes the current market cap is justified by pre-coronavirus free cash flow and that dramatic growth potential overseas is a free option on the upside.

Sources: Company reports, other publicly available information

and also in cars being totaled that are still perfectly driveable. There are people bidding on these automobiles not just for the parts or metal value, but because they can sell them in vast quantities overseas where they're fixed up enough, if at all, to meet maybe less-strict inspection regulations. That all has created even more liquidity, making the ecosystem more valuable.

How is the business affected by today's economic challenges?

PK: We never thought about miles driven collapsing by perhaps 40%, but that's clearly an issue for them. The way we're approaching it in general is that we have to be confident the businesses we own can survive at least two years of hell. We think that's the case here and more. A lot of the costs are variable. They have about $1 billion in total debt, having drawn down their $800 million or so revolver they haven't had to use, so on a net basis for now there's only a couple hundred million in debt. Eventually we think people will start driving again and that Copart's business won't at all come out of this any weaker as a result.

The shares at a recent $83 are about 20% off their February high. How are you looking at potential upside?

PK: Pre-coronavirus we had penciled out $2.80 per share for free cash flow this year, and expected that to continue to grow over the next few years at a 10%-plus pace. If you take our pre-pandemic level of cash flow as something they can get back to with some delay, you could justify a 25x multiple on that, which gets you to above where the stock traded for much of March and April.

The main kicker on the upside is the potential we see from the company continuing to take its business model to other parts of the world, particularly Western Europe. They've been successful in the U.K. and are starting to really pick up the pace in Germany, where they're essentially creating a market. Western Europe's market is roughly the same size as the U.S. in terms of people and car park, and we don't think it's inconceivable that Copart's operations there one day are as big as they are now in the U.S. They're not making any money to speak of at it now, but at today's share price you're not paying anything for it either.

We have owned this since 2018 and have added modestly to the position this year. We realize we're likely facing at least a couple quarters of significantly reduced earnings, but it's a great business with great management with a lot of optionality for growth. We have to be willing to look "across the valley," but we're more than comfortable doing that here. We hope we get the opportunity to buy more at even better prices.

Are you at the point yet of worrying about lasting impacts of the monetary and fiscal responses to today's crisis?

PK: It colors the background, but not so much our specific decisions to buy or sell anything. During the financial crisis, especially with the bailouts of banks and auto companies, there was a lot of talk at the time about the risks of moral hazard. Have you heard about that at all in the past six weeks? We've become acculturated to spraying money on any financial catastrophe – that's the accepted response. I can't imagine that isn't ultimately without consequences.

If we're heading to $25 trillion of federal debt in the U.S., that just makes me rub my eyes. You may remember in Hemingway's *The Sun Also Rises*, one character asks another how he went broke and the answer is "Two ways. Gradually, then suddenly." That's a metaphor for how these things are likely to end.

I don't know if there's a debt bubble or not, but if there is, one could imagine the ultimate outcome might be higher interest rates and higher inflation. So to us that argues to not be invested in businesses that would be significantly harmed by higher interest rates and higher inflation. More generally, we're looking for even an added layer of protection between our companies and the vagaries of the general economy. You don't want to be reliant on a robust economy to underpin your investment strategy.

How would you describe your mood through all this?

PK: Speaking just as an investor, if you understand your businesses and know what they're worth, you don't lose a lot of sleep when the market cracks. You have to have a bit of a predatory instinct, wired emotionally not to be paralyzed and think the world's ending, but instead be ready to pounce when the hunting is easier.

We have no prediction as to when the virus burns out or whether there are going to be secondary or derivative effects, which there likely will. We know it's going to be bad and our businesses better be ready for a couple of years of difficulty. But any opportunity to deploy capital at highly advantageous prices is exciting news. If you're an investor and you don't like it when stocks go down, you're not a value investor. VII