

People Watching

Avenir Corp.'s strategy of buying great businesses well and holding them tight seems deceptively simple. "Easy to understand, hard to do," says Peter Keefe.

INVESTOR INSIGHT



James Rooney (l), Peter Keefe (r)
Avenir Corporation

Investment Focus: Seek "franchise" businesses with superior management, to buy when they infrequently go on sale and to hold as they compound value over time.

Having too often sold into the share-price strength of companies that turned out to compound value far into the future, Avenir Corporation's Peter Keefe now resists the temptation to prune winning holdings. "We've concluded, as Mae West said, that too much of a good thing can be wonderful."

This penchant to let winners ride has served Avenir investors exceedingly well. Since 1990 the firm's composite portfolio has earned a net annualized 13.3%, vs. 9.6% for the S&P 500.

Putting as much emphasis on the jockey as on the horse in target companies, Keefe and co-portfolio manager James Rooney are finding opportunity today in such areas as used cars, specialty insurance, discount retail and family restaurants.

Inside this Issue

FEATURES

Investor Insight: Avenir

Going long on expected compounding machines, which today include CarMax, Dollar Tree, Microsoft, Denny's and Markel.

Investor Insight: Healthcare

Parsing risk/reward in the high-profile sector and seeing upside in Boston Scientific, Alkermes, Cigna, Envision and Allergan.

Uncovering Value: D. R. Horton

Betting on a company and industry evolution with a potentially large payoff for shareholders.

Uncovering Value: NCI

Might the company's clear lack of cachet be obscuring important cyclical and secular upside?

Editor's Letter

On why Warren Buffett won his index vs. hedge fund bet.

INVESTMENT HIGHLIGHTS

| INVESTMENT SNAPSHOTS |
|--------------------------------------|
| Alkermes |
| Allergan |
| Boston Scientific |
| CarMax |
| Cigna |
| D.R. Horton |
| Denny's |
| Dollar Tree |
| Envision Healthcare |
| Markel |
| NCI Building Systems |

Other companies in this issue:

[AbbVie](#), [Amazon](#), [American Tower](#), [Amgen](#), [Biogen](#), [Cardiovascular Systems](#), [Gilead Sciences](#), [HCA Healthcare](#), [Internap](#), [Medtronic](#), [Microsoft](#), [Novartis](#), [O'Reilly Automotive](#), [Pioneer Natural Resources](#), [Regeneron](#)

Investing in Healthcare



Matthew Kamm
Artisan Partners



Connor Browne
Thornburg Inv.



Jeff Jonas
Gabelli & Co.



Robert Klaber
Parnassus Inv.



Varun Singh
Westwood Mgmt.

If uncertainty fosters investment opportunity, the current machinations in Washington over healthcare regulation signal that a closer look at the disparate legion of healthcare providers could be in order. The sector in May of this year passed financials to become the second-largest in the S&P 500 index by market value, but on the back of strong

sector earnings results it is currently trading at a valuation discount to the index – only the third time that's happened in the past 25 years.

In this special report, we call on five portfolio managers with deep experience investing in healthcare to help parse the opportunities and risks in the high-profile sector today.

Investor Insight: Avenir

Peter Keefe and James Rooney of Avenir Corp. explain how they handle the most important but difficult thing they have to do as investors, what key company trait they think the market doesn't adequately value, why they can be slow in both building and trimming positions, and why they see unappreciated value in CarMax, Dollar Tree, Denny's and Market.

Targeting superior "franchise" businesses, as you do, would appear to be a crowded trade. How does one do it well?

James Rooney: The basic approach is pretty widely pursued by investors on both the value and growth/momentum sides. Everyone wants to buy great businesses. The harder part is making distinctions about the long-term sustainability of the franchises and focusing on those with unique competitive advantages that allow them to return above-average returns on capital over long periods of time.

That advantage may come, say, from the distribution network of a retailer like Dollar Tree [DLTR]. It could be the long-term contracts underlying scarce wireless-tower sites in the case of American Tower [AMT]. It could be an extraordinarily strong reserve position in the most prolific basin in the U.S. in the case of Pioneer Natural Resources [PXD]. We like to say we're focused on understanding the knowable while trying to insulate ourselves as best we can from the unknowable. That gives us appreciation for businesses with cash flows and returns on capital that are predictable through thick and thin.

Peter Keefe: The longer I'm at this the more convinced I am of the importance of being able to judge people – there are more great businesses than there are great managers. I'd argue that one of Warren Buffett's great advantages as an investor is his ability to size people up quickly and accurately. But while assessing management is perhaps the most important thing we do, it may also be the most difficult. It doesn't lend itself to spreadsheet analysis.

How do you do judge people?

PK: It's more art than science. We start by looking at executive compensation, including how they're paid, how much

they're paid, and the metrics upon which their pay is based. We look for indicators that they feel an obligation to share the risks of the owners of the business, people who bought shares with after-tax dollars as opposed to being given a fistful of lottery tickets in the form of options as compensation. The metrics for their bonus plans should be oriented toward shareholder value creation – things like free cash flow per share or, for financials, growth in

ON READING PEOPLE:

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book value per share. It's one thing for us as investors to speak about EBITDA and multiples of EBITDA in valuation, but it's scary when management is compensated based on a metric like that. It implies capital is free and promotes growth for growth's sake, which we detest.

We put a high premium on visiting management and looking them in the eye. We can ask deeper, more probing questions, and even if they say the same things you've heard on a call or at a conference, how they react in answering is often telling. We tend to get two reactions. Sometimes they light up and consider us a breath of fresh air because we want to be a long-term partner and part of the permanent capital base. Other times the reaction is suspicion, that we're asking too many hard questions and trying to knock them off the script. A few times – we took this as a compliment – we were mistaken for short sellers because we kept wanting to talk about risks and how they would respond to them. If they aren't willing to engage at that level and

just want to go over management happy talk, we're not interested.

JR: A big topic of conversation is always capital allocation. We're looking for the discipline to only invest for a return on a risk-adjusted basis that is very attractive and consistent with historical levels. Not having a clear basis for making decisions, or using rules like, "We're looking to earn 200 basis points above our cost of capital," are obvious red flags.

Equally important is asking what they plan to do with money they can't reinvest at attractive rates. The best answer to us starts with weighing any opportunity against repurchasing shares. Do they have an intelligent read on intrinsic value and will they consistently buy back shares at attractive discounts to that intrinsic value? That's another key way to determine whether they are thinking like owners.

PK: We think management's reinvestment acumen is something Wall Street doesn't adequately value. Most investors develop linear earnings models to arrive at price targets, but because the view is usually so short term, they're more likely to miss the extent to which smart capital allocators can create real compound value over five, ten, fifteen or more years. Jim Taiclet [Chairman and CEO of American Tower] is thinking that far down the road. He's the type of manager who we think creates the most shareholder value over time.

Apart from wanting great businesses with great managers, your third criterion is to invest at a significant discount to your estimate of intrinsic value. How does that exist in these types of companies?

JR: It's been less the case lately, but markets wax and wane. Oil prices go down and E&P stocks like Pioneer go down. There's a telecom merger so tower stocks

like American Tower go down. Restaurant sales or retail sales vacillate, affecting the stocks of companies like Denny's [DENN] or Dollar Tree. If the underlying asset value, or brand, or business model, or distribution network isn't impaired, we can have an opportunity to buy a great business at a discount.

PK: We first started to get interested in Microsoft [MSFT] in the summer of 2013. The consumer Windows business was under pressure as PC shipments fell. The market didn't like the Nokia acquisition. The market didn't like the CEO. There were plenty of reasons to be down on Microsoft. But on the enterprise side of the business we saw significant growth building off a vast, entrenched installed base of products and services, many of which were going to get stickier as they migrated to the cloud. This side of the business was growing at a double-digit rate and generating maybe \$1.75 per share in free cash flow. After netting out cash, we were only paying in the mid-\$20s for a business of that quality while getting the rest for free.

Looking at it now, the enterprise side of the business has nearly doubled. The consumer business is doing well. And they clearly have a gifted CEO, who has terrific capital-allocation skills and has refocused the company on its strengths. We think the opportunity today is better than ever. Businesses migrating to the cloud have an easier path with Microsoft and its Azure services. You're going Microsoft to Microsoft. That's a big advantage for the incumbent who has been in the business of managing enterprise IT for four decades.

We're a bit surprised to hear you mention Pioneer Natural Resources as a superior business. Elaborate on that.

JR: It is rare for us to own something with direct commodity exposure, but we consider Pioneer a superior business because of the quality of its reserves and the capital discipline of its management. That makes it a franchise business. The primary reserve position is in the Permian basin, where it can drill with 30% returns on

capital at oil prices where most peers are shutting down production. The production costs on its horizontal wells are so low that the company can grow north of 15% a year for a very long time, funded out of cash flow and while maintaining a net debt coverage of less than one. That's unique. As for capital discipline, we've owned Pioneer stock for more than ten years, through commodity cycles, and admire management's skill in allocating capital regardless of the environment.

ON AMAZON:

We have a small position and actually can't think of a business model that is more likely to be intact in 20 years.

PK: You won't see classic cyclicals in our portfolio, but all of our businesses, in one form or another, can be affected by economic cycles. But if you have a franchise, it expresses itself in the ability to continue to generate good returns on capital through those cycles. If you can't do that, you don't have a franchise.

We're guessing it's not so easy for you to find new ideas in today's market.

PK: It's safe to say that there aren't a lot of compounders out there that could be classified as undiscovered. We criticize management for reinvesting at rates of return that are dilutive to their historic returns, so it's a bit daunting for us to buy businesses trading at earnings yields of 4-5%, a level that doesn't seem to incorporate the chance of much, if anything, going wrong.

We've taken what for us is a small position in Amazon [AMZN]. We actually can't think of a business model that is more likely to be intact in 20 years, and in Jeff Bezos we believe we have a CEO who is clearly aligned with shareholders and who brings a lot of optionality as he looks to disintermediate who-knows-what businesses in the future. That said, valuing the

company with a traditional discounted-cash-flow model is challenging. We've arrived at a rough valuation for the Amazon Web Services cloud business, which with unheroic assumptions leads us to believe we're paying no more than fair value for the retail business. Given we're also getting optionality on management's skill, we're willing to own a small position.

JR: We want to own 10 to 15 great businesses at a time and a full position at cost is usually 5-7%. But the initial position size reflects our conviction level at a given valuation. At a better price, we would have bought a lot more Amazon. But when we're still refining our estimate of intrinsic value, or the range of potential values is wide, or we've given a little on the discount to intrinsic value, we'll take a smaller position. The market will behave erratically and at some point in the future we'll likely be able to buy more. It often takes us a year or two to get fully invested.

Are you sitting on a lot of cash?

PK: Today we're around 10% cash in mature portfolios, while if you invested yesterday it would probably be more like 30%. That's not a strategic or tactical position, it simply falls out from the investment process. When valuations are high, we wind up with more cash. When valuations are low, we wind up with less.

Some of our biggest mistakes have been in selling down positions in great businesses when we thought they were fairly valued, or even a bit overvalued. Over the 20 years we owned it, every sale we made of Micros Systems [bought out by Oracle in 2014] turned out to be a mistake. When we've trimmed American Tower, it's been a mistake. In our experience, compounders tend to keep compounding, so we're slow to sell unless something in the business or company has fundamentally changed or if the valuation has just become extreme.

Many of our investors are in taxable accounts and we're cognizant of the fact that selling a compounder and absorbing the tax hit means we have to be able to reinvest the freed-up cash at a quite a bit

higher expected return than what we were earning. That further discourages us from selling. On top of that, if we sell an American Tower or a Markel [MKL], we're by definition reducing the quality of our portfolio. That's not something we want to do, especially at this point in the market cycle.

You do sell from time to time. Can you give some fairly recent examples?

JR: Two positions we sold in the past year or so were Ross Stores [ROST], the off-price retailer, and Equinix [EQIX], which operates datacenters. Each is a terrific business, with unique strengths and capable management, but the valuations got to the point where it was prudent to sell. Datacenters are hotter than ever, but the tumult in retail may give us another crack at Ross Stores. We think the prospects for off-price retailers remain intact and the industry is less likely to get disintermediated by Amazon. With share prices down, stocks like Ross are on our radar screen.

PK: One additional point on Equinix: They weren't hiding it, but there is north of \$2 per share in stock-based executive compensation that the company and most analysts add back to arrive at free cash flow. At a 20x multiple, that was \$40 in share value that doesn't really exist, given our view that equity is real compensation and should not be added back to arrive at "adjusted" earnings or cash flow. With the stock already pricey, that made it even more so, prompting us to exit the position.

JR: Another name that illustrates our process is AutoZone [AZO]. After taking a position and learning more about after-market auto parts, we concluded we owned the wrong company in the sector. We like the business in general, but think O'Reilly Automotive [ORLY] has the better distribution network and better business model. In this case we have exited our AutoZone position, and as O'Reilly's stock has come down with the rest of the sector we're paying very close attention. In general, if we're comfortable with the race, we have no problem switching horses.

Four years ago [VII, July 31, 2013], you made the case for Internap [INAP], which had a legacy technology business in decline but a rising datacenter business you thought would compensate. It hasn't worked out so well. Any lessons there?

PK: I talked earlier about how hard it is to assess management, and I'd go so far as to say that all of our mistakes over time have been at least partly related to misjudging

ON SELLING:

If we sell an American Tower or a Markel, we're reducing the quality of our portfolio – not something we want to do.

management or the board. That was the case here. We believe the board looked to sell the company early in 2015, an effort that produced no acceptable offers. Possibly due to disagreement over the sales process, the CEO was replaced. A new CEO came in, apparently to supervise a second effort to sell, with the same result both with respect to the sale and to the CEO. The botched sales processes, complicated by a clumsy activist campaign, understandably destabilized operations and the sales force, leaving the company at risk of breaking financial covenants.

We now have a third CEO, Peter Aquino, and think the third time is a charm. He's imposing financial, organizational and sales discipline that had gone out the window during the prolonged sales processes. We participated in a recapitalization of the company earlier this year, so the balance sheet is not an issue. We also introduced to the company an alumnus of Micros Systems who is a first-class capital allocator and operator, and he's now on the board. The share price has rebounded, but we think the business is potentially worth far more than its quoted value [recently \$3.85 per share]. We're not proud of what's happened with the investment so far, but the thesis around cloud services is

exactly the same, and after the chaos we think it's about to take hold. Stay tuned.

Describe the franchise aspects that attract you to CarMax [KMX].

JR: Many have tried, but no one has been able to replicate CarMax's model of selling high-quality used vehicles at fixed prices across all brands and models in one location. They appraise, acquire and refurbish cars and have them on the lot, in scale, within 20 to 30 days. They might not have the cheapest price out there, but they typically have the largest inventory offered at fair prices with no haggling. They are true retailers, with expertise in supply chain, logistics, pricing and branding that has proven very difficult for dealers to match. It's a unique retail franchise.

PK: This is one of our best long-term investments, but I can't think of a stock with this size market cap that fluctuates around earnings more than this one. There's concern about credit quality, the composition of creditors, new-car sales, used-car sales, new-car prices, used-car prices. We engage in none of that. They've invented a better mousetrap with white space on the map to expand for a decade. If you don't overpay for that, that's all you need to know.

What are the key concerns today?

JR: One big one is the extent to which a slowdown in U.S. new-car sales impacts the sale of used cars and used-car prices. What often gets missed is that while the volume of used cars sold in any period will fluctuate, the profit per car has remained fairly consistent for CarMax because of its discipline in buying inventory and pricing to the consumer. That mitigates cyclical ups and downs you might otherwise see.

Another concern weighing on the entire sector is exposure to subprime loans. Here we recognize the general risk, but based on our experience with CarMax have no reason to believe it has compromised or will compromise on its lending standards.

There is also a lot of talk about changes in the automobile industry with respect to

autonomous driving and ride sharing. Our view over even the long term is that CarMax will remain relevant to the consumer wherever it operates. We're not counting on it to dominate the used-car business or on the used-car business to grow rapidly, we just expect the company to continue to steadily increase its share of a highly fragmented business.

Talk about the extent of the "white space on the map" for growth?

JR: The company is only present in about 70% of its addressable markets. It just re-

cently entered the San Francisco market, for example, and we believe it can continue to add 12-15 stores per year overall for the foreseeable future, off a current base of 176. As stores mature, repeat buyers increase, further enhancing the brand in local markets. That drives same-store sales as well.

How are you looking at valuation with the shares at recent \$66.75?

JR: We expect the company to earn around \$4.75 per share in free cash flow in 2018, so the forward multiple on that is around

14x. We don't think that's aggressive at all for a company that we expect to grow by roughly 10% per year on the top line and closer to 14% annually on the bottom line, after factoring in share repurchases using excess cash flow.

Even without any multiple expansion, we're content with that kind of return in this market. And if history is any guide, we'll likely have plenty of opportunity to buy more at a better valuation next time the market blows particularly cold on the stock, as it inevitably will.

From one retailer to another, describe your broader investment case for discounter Dollar Tree.

JR: We first got involved with Dollar Tree in early 2014 after getting comfortable with the premise behind its model: Task vendors to provide high-quality merchandise for an average per-unit cost of 65 cents, that the company can sell quickly for \$1. There's a treasure-hunt aspect to visiting the stores, bringing customers – who expect on average to spend \$5 per visit but end up spending around \$8 – back frequently. With state-of-the-art sourcing and distribution that are extremely difficult to replicate, the company has consistently generated 20%-plus returns on capital. It's also important to note the defensiveness of the business: earnings grew in 2008, 2009 and 2010 as its customer base expanded through the financial crisis.

The story here has been complicated by the acquisition of Family Dollar in 2015. While the name is similar, the business models differ in that Family Dollar is more of a discount convenience store, without the same everything-is-\$1 pricing strategy. Sourcing, logistics and distribution are equally important, however, and that's where Dollar Tree management expects to make a significant difference as it continues to integrate what had arguably been an undermanaged family-controlled business.

Isn't one drag on the stock the fact that the integration effort so far isn't showing big results?

INVESTMENT SNAPSHOT

CarMax
(NYSE: KMX)

Business: Retail sale and financing of used passenger cars and trucks, sold with a "no-haggle" approach through some 175 owned and operated superstores in 39 states.

Share Information (@7/28/17):

| | |
|----------------|-----------------|
| Price | 66.79 |
| 52-Week Range | 47.50 – 69.11 |
| Dividend Yield | 0.0% |
| Market Cap | \$12.24 billion |

Financials (TTM):

| | |
|-------------------------|-----------------|
| Revenue | \$17.08 billion |
| Operating Profit Margin | 6.6% |
| Net Profit Margin | 3.9% |

Valuation Metrics

(@7/28/17):

| | KMX | S&P 500 |
|--------------------|------------|--------------------|
| P/E (TTM) | 19.2 | 23.9 |
| Forward P/E (Est.) | 16.8 | 18.9 |

Largest Institutional Owners

(@3/31/17):

| Company | % Owned |
|---------------------------|----------------|
| Vanguard Group | 9.5% |
| Primecap Mgmt | 8.9% |
| Ruane, Cunniff & Goldfarb | 5.2% |
| Baillie Gifford & Co | 4.8% |
| Principal Global Inv | 4.5% |

Short Interest (as of 7/14/17):

| | |
|--------------------|-------|
| Shares Short/Float | 14.0% |
|--------------------|-------|

KMX PRICE HISTORY



THE BOTTOM LINE

While its share price fluctuates due to a variety of factors, Peter Keefe argues that what really matters is that the company has "invented a better mousetrap with white space on the map to expand for a decade." Assuming no multiple expansion, he expects share value to compound at a rate comparable to the 14% clip at which he expects EPS to grow.

Sources: Company reports, other publicly available information

JR: Yes, it's fair to say it has taken them longer than many on Wall Street thought it would to successfully improve operations at Family Dollar. One analyst report out earlier this month argued the company should just admit they made a mistake and spin Family Dollar back out. We're quite a bit less concerned by that than others.

The changes required at Family Dollar run deep – from culture, to sourcing, to distribution, to merchandising, to marketing, to overall store formats. Those are not easy or quick fixes and Dollar Tree management never said they would be. One quick thing they did do was rebrand 300 or so of the acquired stores to be Dollar Trees, but there's still much to do behind the scenes that takes time. We believe Dollar Tree's management is more than up to the task. If they can get Family Dollar back to Family Dollar's historical margins, the acquisition will work out well. If they get it to margins comparable to their own and to direct competitor Dollar General, it's going to be a homerun.

PK: To get on my soapbox here about Wall Street, we respect that Dollar Tree management hasn't been overly concerned with meeting others' quarterly expectations or in detailing everything they're doing. They are more concerned with doing the job right, with as little disruption to the current operations as possible.

After the acquisition, management declined to give guidance on the following quarter because they didn't feel comfortable doing so in such a fluid situation. One exasperated analyst piped up and asked, "So how can the investment community be expected to forecast profitability?" The stock tanked after the call and we're thinking, "Inefficient markets live because analysts probably making \$1 million a year don't know how to make estimates without being led by the nose by the investor-relations department."

Assuming eventual success in integrating the two companies, how attractive do you consider the shares at their recent price of just under \$72?

JR: As they improve operations at Family Dollar, overall margins should also improve and they are likely to get to a basic model of some same-store-sales growth, square footage growth at both banners, a bit of operating leverage, and using free cash flow to pay down acquisition debt and repurchase shares. In our base case we're expecting revenues to grow a bit over 6% per year on average over the next five years. If Family Dollar EBIT margins get back to the 7.5% or so of five years ago, all that would translate into 9-10% annual growth in free cash flow. For that today we're paying only 12.3x the \$5.85

per share in free cash flow we expect the company to earn this year.

PK: Imputing something closer to Dollar General margins onto Family Dollar gets our estimate north of \$10 per share in free cash flow here in four to five years. There aren't too many places in this market where we're able to buy \$10 of out-year free cash flow for \$72. It's uncommon to see a public company make an acquisition of this size of a fixer-upper. But they're thinking and acting like a private owner would, which is exactly what we want them to do.

INVESTMENT SNAPSHOT

Dollar Tree
(Nasdaq: DLTR)

Business: Largest U.S. operator of discount variety stores meant to offer customers a combination of convenience and value under the Dollar Tree and Family Dollar brands.

Share Information (@7/28/17):

| | |
|----------------|-----------------|
| Price | 71.80 |
| 52-Week Range | 65.63 - 99.93 |
| Dividend Yield | 0.0% |
| Market Cap | \$16.99 billion |

Financials (TTM):

| | |
|-------------------------|-----------------|
| Revenue | \$20.92 billion |
| Operating Profit Margin | 8.0% |
| Net Profit Margin | 4.1% |

Valuation Metrics

(@7/28/17):

| | DLTR | S&P 500 |
|--------------------|-------------|--------------------|
| P/E (TTM) | 19.7 | 23.9 |
| Forward P/E (Est.) | 14.3 | 18.9 |

Largest Institutional Owners

(@3/31/17):

| Company | % Owned |
|--------------------------|----------------|
| Vanguard Group | 9.1% |
| Fidelity Mgmt & Research | 4.7% |
| BlackRock | 4.3% |
| State Street | 4.2% |
| Lone Pine Capital | 2.8% |

Short Interest (as of 7/14/17):

| | |
|--------------------|------|
| Shares Short/Float | 2.3% |
|--------------------|------|

DLTR PRICE HISTORY



THE BOTTOM LINE

Short-sighted investor impatience over its 2015 acquisition of Family Dollar is obscuring the company's positive growth profile and its ability to generate incremental free cash flow, says James Rooney. He expects over time that the current 12.3x multiple of estimated 2017 free cash flow at which the shares trade will be proven a considerable bargain.

Sources: Company reports, other publicly available information

You made the case for Denny's [DENN] five years ago [VII, July 31, 2012], as it pursued what you called a multiyear operational and balance sheet overhaul. With that seemingly done, why are you still high on the stock?

JR: The overhaul has worked well. They reengineered and modernized the menu, while remaining true to their roots as "America's diner," where you can get everything from pancakes to a burger to a decent steak. They introduced a value menu in response to the last recession, which has been successful and should help them in the next one. All company-owned restaurants have been remodeled, and by the end of next year 75% of the franchised restaurants will have been done as well. So far the remodels are delivering a sales uplift of roughly 6% on average per unit.

To reengineer the business model, the company has been selling company-owned restaurants to franchisees, so that close to 90% of the 1,730 stores are franchised. That allowed them to pay down debt through 2014, at which point they could relever somewhat as lenders got comfortable with the new operating profile. The balance sheet is now levered at 2.6x net debt to EBITDA, which we believe is reasonable and where they plan to keep it.

Also positive for shareholders has been a concerted effort by management to buy back stock. The absolute level of free cash flow is up by roughly 17% over the past five years, but because the share count is down 23%, free cash flow per share is up by close to 50%. That is partly why the stock is up. [Note: Denny's shares, at \$4.50 five years ago, now trade at \$11.40.]

The story now is pretty straightforward. The business model generates significant free cash flow, which management can allocate to growing the store base through new franchisees as well as new-store development. What's left over in free cash flow is allocated to share repurchases. It's a great model that we expect to continue to compound free cash flow.

PK: This is an aside, but you might be surprised to hear that Denny's has a decent

social-media presence – much of it around clever repartee with competitors – that has actually caught the attention of a lot of young kids. You wouldn't expect that from a company most known for its early-bird specials for seniors, but we think it says something about management's ability to leverage historic strengths while also being relevant to today.

What upside do you see in the stock from today's price?

JR: Assuming free cash flow per share can compound at a mid- to high-single-digit

rate, looking a few years out we expect the company to be earning at least \$1.10 to \$1.20 per share in free cash flow. Based on our discounted-cash-flow model, we think the shares today are worth \$15 per share.

You own more than 10% of the shares outstanding. Does that cause any issues with liquidity or otherwise?

PK: We believe this is a compounder, so we're not particularly worried about an exit or liquidity. I've heard it said how if you have a position that in any way is keeping you up at night, you shouldn't

INVESTMENT SNAPSHOT

Denny's
(Nasdaq: DENN)

Business: Owns, operates, franchises and licenses full-service, moderate-priced family restaurants under the Denny's brand name at more than 1,700 locations worldwide.

Share Information (@7/28/17):

| | |
|----------------|-----------------|
| Price | 11.40 |
| 52-Week Range | 10.02 - 14.25 |
| Dividend Yield | 0.0% |
| Market Cap | \$796.4 million |

Financials (TTM):

| | |
|-------------------------|-----------------|
| Revenue | \$510.2 million |
| Operating Profit Margin | 13.9% |
| Net Profit Margin | 3.5% |

Valuation Metrics

(@7/28/17):

| | DENN | S&P 500 |
|--------------------|-------------|--------------------|
| P/E (TTM) | 50.4 | 23.9 |
| Forward P/E (Est.) | 17.8 | 18.9 |

Largest Institutional Owners

(@3/31/17):

| Company | % Owned |
|----------------|----------------|
| T. Rowe Price | 10.9% |
| Avenir Corp | 10.4% |
| Wells Capital | 6.9% |
| BlackRock | 6.1% |
| Vanguard Group | 5.2% |

Short Interest (as of 7/14/17):

| | |
|--------------------|------|
| Shares Short/Float | 3.8% |
|--------------------|------|

DENN PRICE HISTORY



THE BOTTOM LINE

Having nearly completed a successful multiyear operational and balance sheet overhaul, the company is now poised to compound per-share free cash flow through prudent new-store development and stock buybacks, says James Rooney. Assuming mid- to high-single-digit annual growth in free cash flow, he pegs the shares' fair value at around \$15.

Sources: Company reports, other publicly available information

own it. That's not an issue here. We own a lot of Denny's and wish we owned more. For the business, the management and the valuation, it checks all the boxes for us.

Markel is certainly a name well known to value investors. Why is it a long-time core holding of yours?

PK: Anybody can be in the specialty-insurance and reinsurance businesses, as Markel is, and it sometimes seems like everybody is. It's a financial-services business where you're allocating capital on a risk basis. Banks make judgments about loans. Investment managers make judgements about investments. Markel makes judgements about insurance risks. There's nothing inherently superior about the property/casualty insurance model. But there is something inherently superior about a management team that over a very long period of time has the discipline to walk away from underpriced business, which is clearly the case at Markel. The underwriting record over time has been very good and they reserve very conservatively for future claims. A lot of good comes from that. In addition, a number of Markel's recently acquired businesses have reduced underwriting exposure and have a service-or fee-based model, further distancing the company from commodity-like markets.

That discipline not only illustrates that management resists the pleadings of analysts who want another penny per share in short-term earnings, but it also winds up deferring huge amounts of taxable income. If it turns out you've reserved \$1,000 more than you needed to, by the time you take that into income it may have been earning investment returns for years. We think that's an underappreciated aspect of underwriting discipline: Pay less tax today, and on that same amount down the road you've been earning income in the interim.

A result of underwriting discipline at Markel has been a lot of excess capital that has been capably managed by Tom Gayner [VII, April 29, 2016], now the co-CEO, who invests in fixed income and equity securities as well as, through Markel Ventures, private businesses. The combi-

nation of insurance underwriting and investing has driven an 11% compound annual growth in book value over the past decade. We see no reason why that can't continue.

Talk more about Markel Ventures. Do you consider it an unmitigated success?

PK: It has absolutely been a source of value and we consider it an important additional outlet for potential investment. With whole companies, you control the compensation and the cash flows, which you can redeploy from subsidiary to subsid-

iary on a tax-advantaged basis. Last year the Ventures businesses on \$1.2 billion in revenue earned \$165 million in EBITDA, a revenue and profit stream we believe is worth significantly more than the just over \$1 billion invested in it to date. We expect Ventures over time to continue to become a more prominent part of the business.

Are there insurance pricing cycles to worry about with Markel at the moment?

PK: Prices have been trending downward for more than a year, but in general the cycles haven't been as volatile as they used

INVESTMENT SNAPSHOT

Markel
(NYSE: MKL)

Business: Sales and underwriting of insurance and reinsurance, including lines focused on general and professional liability, property, marine and energy, and workers' comp.

Share Information (@7/28/17):

| | |
|----------------|-------------------|
| Price | 1061.56 |
| 52-Week Range | 811.05 - 1,068.18 |
| Dividend Yield | 0.0% |
| Market Cap | \$14.80 billion |

Financials (TTM):

| | |
|-------------------------|----------------|
| Revenue | \$5.65 billion |
| Operating Profit Margin | 12.5% |
| Net Profit Margin | 6.5% |

Valuation Metrics

(@7/28/17):

| | MKL | S&P 500 |
|--------------------|------------|--------------------|
| P/E (TTM) | 44.2 | 23.9 |
| Forward P/E (Est.) | 37.2 | 18.9 |

Largest Institutional Owners

(@3/31/17):

| Company | % Owned |
|----------------------|----------------|
| Vanguard Group | 7.9% |
| BlackRock | 4.7% |
| Principal Global Inv | 4.5% |
| Atlanta Capital Mgmt | 4.3% |
| Baillie Gifford & Co | 4.0% |

Short Interest (as of 7/14/17):

| | |
|--------------------|------|
| Shares Short/Float | 1.5% |
|--------------------|------|

MKL PRICE HISTORY



THE BOTTOM LINE

Peter Keefe believes the company's underwriting discipline combined with its investment prowess creates a "virtuous cycle" that can continue to generate long-term compound annual book-value growth in excess of 10%. Barring a significant change in the interest-rate environment, he would expect share value to compound at a comparable rate.

Sources: Company reports, other publicly available information

to be. It's idle speculation on my part, but maybe in a digital age price discovery is easier and more rapid, dampening rate volatility. (Of course, that goes out the window when you're pricing an unusual, one-time or exotic risk – that is pure art.) But none of that is key to our judgement on the company. Insurance is a necessary commodity, some of it is going to get written by Markel, and we believe it will be written well. That should continue to create the virtuous cycle of excess capital that drives the business model.

The shares, now near \$1,060, don't appear cheap at 1.7x book value.

PK: The valuation is at the high end for property/casualty insurers. It's not quite as expensive as it looks, however, because the value of Markel Ventures for GAAP-accounting reasons is not fully reflected in book value. Also, there is no reason why Markel can't trade at twice book in this interest-rate environment.

We're content holding the stock at today's valuation and expect our returns at least to compound along with book value at a low double-digit rate. As for risks, a rise in interest rates would hit book value in the short term as the large bond portfolio declines, but as premium dollars get reinvested at higher rates, we'd expect that impact to prove temporary.

There is also upside optionality on further acquisitions, in insurance or otherwise through Markel Ventures. The company just announced more than \$1.1 billion in acquisitions – \$900 million for insurance-services provider State National, which has limited underwriting exposure and a fee-based model, and over \$200 million for a majority stake in Costa Farms, which claims to be the world's largest grower of ornamental plants. One of the benefits of having a hugely liquid balance sheet with premium dollars coming in every month is that when Mr. Markel has a tantrum – and he will – you're in an opportune position.

We often ask investors if the prevalence of passive investing has at all impacted how they ply their trade. Has it yours?

PK: The fact that passive investors tend to be agnostic when it comes to corporate governance is a concern. Investors should be a check on wayward governance, especially when it comes to compensation. I worry that that role isn't being adequately played, which may ultimately have unpleasant consequences for shareholders.

While this is more of a sense than anything else, I also think share prices are increasingly distorted by the collective buying and selling of ETFs. As more and more trading happens without any thought about valuation, price discovery has to be somewhat less efficient. Ultimately that should be a good thing for value investors, but in a broadly rising market it can make it difficult to find things to do. I have no idea when, but a reckoning will come and people will run away in blind panic. Then we'll have more than enough to do. **VII**