

INTERVIEW

«The Stage is Being Set Where Value Can Outperform Growth Again»

New York-based value boutique Tweedy, Browne has been in the business of finding undervalued stocks for more than 100 years. In an in-depth interview, members of the investment team talk about their current picks. **By Mark Dittli**

The past years have been tough for value investors. Growth stocks from the U.S. technology sector were all the rage, with investment money flowing into mega cap stocks like Amazon, Apple, Netflix or Tesla. Valuations didn't matter in an environment with ever lower interest rates.

But now the tide may be turning. Expectations of a strong economic recovery after the pandemic are pushing up interest rates in America. Equities from cyclical sectors have gained the upper hand since the late summer of 2020 – and this means that the value style is seeing a renaissance.

New York-based value boutique Tweedy, Browne is one of the veterans in the field. The firm has been in the business of identifying undervalued securities for more than 100 years, having worked with and for value icons such as Benjamin Graham, Walter Schloss and Warren Buffett.

Five members of the investment team of Tweedy, Browne – Thomas Shrager, Robert Wyckoff, Jay Hill, Roger de Bree and Andrew Ewert – sat down with The Market for an in-depth conversation. They agreed to talk about individual names such as Intel, Alibaba, Fresenius or Roche, but they emphasize that their views on particular securities should not be relied on to make an investment decision and should not be considered a recommendation to buy or sell or an offer for any of the securities referenced.

Do you see the beginning of a new cycle for value investors?

Robert Wyckoff: The green shoots for value began to spring up last November in earnest, when the vaccine news came out by Pfizer and Moderna. Forgive the pun, but that was a shot in the arm for those of us who were looking beyond Covid and saw the prospects of a strong economic recovery.



«A shift to value should favor Europe and Japan»: Bob Wyckoff.

And this recovery favors value stocks?

Wyckoff: Yes. We've been in a bifurcated market in the past several years. It was all about big tech versus everything else. Now with the expected economic recovery, earnings momentum will shift to the more cyclical stocks which you tend to find in the value segments of the market. Also, in a strong economic recovery, coupled with disrupted supply lines, we could see the return of inflation. Inflationary expectations seem to be on the rise, and long term bond yields are trending up. This favors value stocks as opposed to the longer duration growth stocks. So when you put it all together – a strong economic recovery, rising interest rates, and generally more attractive valuations among cyclicals –, this tells us the stage is being set where value can outperform growth.

That would also mean an end of the outperformance of U.S. stocks?

Wyckoff: A shift to value should favor Europe, which is less about big tech, and more about cyclical securities. The same would be true for Asia, Japan and Emerging Markets.

Thomas Shrager: Just look at the enormous stimulus that is being created in the U.S. by federal spending,



«Intel can grow and compound over time»: Jay Hill.

and the continued purchase by the Fed of Treasuries and mortgage-backed securities. These are some of the elements that have led to higher inflation expectations and to higher expectations of economic growth. The million dollar question of course is what will happen in the second half of 2022 and beyond: Will we then revert to lower growth, because stimulus wears off and taxes rise? This is the longer term question. But for the time being, we can say value is back.

Jay Hill: Investors are starting to realize again that there is a distinction between a great business and a great investment. The difference between them is valuation. One more thing I would add is if you listen to corporate conference calls of multinationals, it's clear that input costs across the board are rising. There is inflation in just about everything, whether it's lumber, copper, wheat, shipping costs, logistics. I even hear companies say they see wage inflation and they have a hard time finding people with the right skill sets.

Do you see a repeat of the pattern of 2000 to 2002, where technology crashed, while value stocks rose up?

Roger de Bree: I personally think that Apple, Microsoft or Amazon will continue to grow, they're great companies, but they are currently out of reach for us valuation wise. But maybe they will come back into reach again. The pattern after the crash of 2000 went as follows: The good companies, those with a strong business model, suffered a huge contraction in valuation, but their underlying business continued to grow. They remained great companies, they just got a lot cheaper and offered great opportunities for value investors. Cisco and Microsoft are examples. But, as in every bubble, there are many companies that are just hot air, that don't have real business models and don't have a moat. So I think what will happen in tech is that the strong ones may suffer a valuation contraction, while the weak ones will disappear.

Such as?

De Bree: There are many. But just as an example: I don't believe that Tesla has a long-term moat. And it has a crazy valuation today.

You do own some tech companies, however: Alphabet, Baidu, Alibaba and Intel. What's the value case there?

Andrew Ewert: Let's start with Alphabet, the parent of Google. If you exclude their losses from their cloud business and their moon shots, some of which ideally have value, Alphabet trades at about 17x forward Ebit. It has grown its intrinsic value by 15 to 20% per year, while producing a lot of free cash flow to invest in new businesses or acquisitions. Good examples are the acquisitions of DoubleClick and YouTube, or their investment in autonomous driving with Waymo: They all created a lot of additional value. So you have a fairly valued company that can grow its intrinsic value at a high rate, plus it has the optionality of creating valuable enterprises with its investments.

Are you not worried about regulatory issues?

Ewert: We are not naive about them, and certainly their core business is maturing. But at 17x forward Ebit, with solid intrinsic value growth, that's reasonable. The management team of Google has done a really good job of looking around the corner, seeing what changes happen in their markets, positioning the company in the right place and reinforcing their moat when this happens. Google is not Netflix. It is a very profitable company, with a statistical valuation that is not obscene.

And its Chinese counterpart, Baidu?

Ewert: Baidu has been statistically cheap. While its share price has appreciated quite a bit lately, at points in time it was valued at less than 5x the Ebit of its core search business. It's not as valuable as Google or Alibaba, but it's still a very high return, monopolistic search business in a very large market with good growth. If we do a sum of the parts analysis of Baidu, where we give modest values to the moonshots and their equity stakes, their core search business is valued at still less than 10x Ebit. Ideally, this will grow at a mid to high single digit rate and produce a lot of excess free cash flow.

What do you like about Alibaba?

Ewert: We were able to buy it in late 2020 at about 12x Ebit for their core e-commerce business, where it still trades today. They have a myriad of businesses, but only the e-commerce business makes money. This is very high margin, with infinite returns on invested capital, it has a 60% market share in e-commerce

in China, growing at 20% per year over time. That is really attractive. Apart from e-commerce, their cloud business is starting to break even, they have a holding in Ant Financial and a bunch of equity stakes, as well as a startup venture for e-commerce businesses in Southeast Asia.

But there is a huge regulatory cloud hanging over them, as the move by the central government to stop the IPO of Ant has shown.

Ewert: Obviously there is a big regulatory overhang, and some uncertainty we can't assess. From what we have learned about Ant, we see it as deserving of the government's regulatory response. It was a case of regulations not having kept up with the business model of Ant. We don't think the regulator in China is out to crush the e-commerce business or the tech sector in general. We could be wrong, but Alibaba is an engine of innovation for China, and it would not seem rational for the Party to upset that. It also is an engine for small businesses and entrepreneurship. Unlike Amazon, most things sold on Alibaba are sold by small merchants. Alibaba has lifted countless merchants out into mainstream storefronts. Anything can happen, the regulatory situation is opaque to say the least, but our assessment shows a pretty attractive risk/reward for Alibaba.

Shrager: Whenever we buy a stock, there is a level of uncertainty that is higher than average. Otherwise, we as value investors would not be given the opportunity to buy. It is our job to analyze and try to see whether the uncertainty surrounding that business is temporary or permanent. In the case of Alibaba, we have reached the conclusion that the wind is at their back. Will the government tell them they have to sell parts of their business? Probably. But we don't think the government will want to destroy their business model.

What's the fair value of Alibaba?

Hill: We've come up with a fair value slightly over \$300 per share. The bulk of that value comes from its e-commerce business in China. But the next largest piece of the valuation is their cloud business. It's very similar to the cloud business of Amazon, AWS, which is currently one of the most valuable businesses in the world. Alibaba is the market leader in the cloud in China, at an early point in its life cycle and revenues are growing fast. The cloud business should be profitable by the end of this year. This business requires high upfront investment, but it offers very high margins over time.

You bought Intel in 2020. What's your case?

Hill: Intel is a leading semiconductor designer and manufacturer, with a dominant market share com-



«Our assessment shows a pretty attractive risk/reward for Alibaba»: Andrew Ewert.

pared to their main competitor, AMD. We all know Intel's long history of innovation, and they have a great long term financial record. We bought the stock at around \$50 per share, which was about 8x Ebita or a P/E of 9. That is screaming cheap for the quality of the business. Intel has a conservative balance sheet, they are a consistent generator of free cash flow, which they allocate to M&A, share repurchases and dividends in a thoughtful way. Just a great company, we bought it comfortably below intrinsic value. Intel also has a couple of hidden assets: Investments in companies that don't make any money today, but have the potential to be very valuable in the future. One example is Mobileye, which makes all types of products for autonomous vehicles.

Intel had a deep fall from grace last year, when it became apparent that they have fallen behind TSMC in high-end manufacturing.

Hill: That's why we got the opportunity to buy at a cheap price. Poor leadership and poor execution had slowed Intel's improvement in manufacturing. Intel has fallen behind TSMC and Samsung in semiconductor manufacturing, at the 7 nanometer node, the highest end chips. AMD, Intel's chief competitor, made the decision a long time ago to only design semiconductors, and outsource manufacturing to TSMC, hence they benefit from the latest technology. But our research revealed that Intel will close this gap again. After we purchased the stock, they got rid of their old CEO and hired a new CEO, Pat Gelsinger, who is a former Intel engineer. Gelsinger is very highly regarded, and he has made the decision that it makes most sense to stay in designing and manufacturing their own chips. To sum it up: A cheap stock, great balance sheet, great long term record. We believe the problems they are facing are temporary, not permanent.



«Valuations for pharma stocks are unreasonably cheap»:
Thomas Shrager.

Intel now trades at \$65. Is it still undervalued?

Hill: It's getting closer to fair value. But we think it's a business that can grow and compound over time. Plus, the market is not rewarding their other businesses, like Mobileye, yet.

Wyckoff: You have to be careful when you invest in a mature tech company, because you have to always worry that its technology may have become obsolete. Then you're stuck in a value trap. But, we feel that's not the case with Intel. Just to give you another example: More than ten years ago, we bought Cisco. At the time we bought it, it was a single digit P/E, had a huge amount of cash on the balance sheet, an incredibly strong company, but it had lots of competition. The future was highly uncertain for Cisco, but we were confident that they have a path forward. We bought between 15 and 20 \$ per share. Today, the stock trades at 50. Every now and then you can buy tech companies when they become too cheap. Intel is such a case.

Not only tech has had a hard time in the past few months, but also the healthcare and consumer staples sectors. This is a field where you traditionally have large holdings, like Roche, Glaxo, or Nestlé. What do you do with them?

Shrager: As far as the pharma stocks are concerned, their valuations are unreasonably cheap. We look at a period of time where the reputation of the pharma industry has improved remarkably, because some of them have solved this pandemic in a record time. Second, there seems to be less concern about what will happen to pricing in the U.S. The Biden Administration may put some pressure on pricing, but they are also talking about increasing the subsidies in the Obamacare exchanges, which means more people will be able to afford drugs. Roche trades at 10x Ebitda, Novartis at 11x, Glaxo as well. Glaxo will have a major event next year, when they split the pharma-

ceutical business from the OTC business. These valuations are ridiculous.

Why is the market treating pharma stocks so harshly?

Shrager: I think the market has been driven, over the last ten years, increasingly by themes. It's all thematic, people jumping from one theme to the next, with a short attention span. This is the mentality of the market, the Robinhood phenomenon, the SPAC phenomenon, which by the way makes zero sense if you are not one of the sponsors of the SPAC. This mentality does not fit healthcare stocks, where it takes years to develop a drug.

So you just keep your pharma stocks and wait?

Shrager: Yes, and they pay you a decent dividend while you wait. They are very cheap, and at some point the market will realize that. A few years ago, many people saw the patent cliff of Roche and thought this would be a disaster. But in the last three years, Roche came up with a fantastic pipeline that will more than compensate for the drugs that lose their patent. In the case of Glaxo, people underappreciate the split that will happen in 2022. Our sum of the parts valuation suggests a 18 to 20 £ range, yet the stock trades below 13. That's unbelievably cheap.

With Novartis, there is always the question about their structure with the Sandoz generics business and the pharmaceutical business under one roof. Would you like to see a more focused structure?

Shrager: They have started slowly on that part with the spin-off of Alcon, which created a lot of shareholder value. They are reasonable people. If Sandoz lives up to its promise, I would personally like to see them taking the opportunity to distribute it to shareholders.

How about Nestlé, one of the largest holdings in your funds? Walk us through your case.

De Bree: Nestlé is not cheap anymore, not even if you back out the stake in L'Oréal. But within the consumer goods business, we like the companies that build value for the long term. You see, there are what we call the 3G companies, the ones that are driven by the investor group 3G, such as AB InBev and Kraft. We steer clear of them, because all they do is cut costs and manage their profits for the short term. The kind of companies we own, such as Nestlé, Diageo and Heineken, don't do that. These companies manage to grow their earnings per share by 5 to 9% per year, with steadily growing dividends, so we look at them like growth bonds. If the positions become very big and the valuations too high, and if we are presented with lucrative new opportunities, then we let some

go. We have owned Nestlé since the 1990s, it has been a good investment for us.

CEO Mark Schneider has been trimming the portfolio and selling low-performing businesses. Is Nestlé on the right track?

De Bree: Mark Schneider has taken all the right initiatives on the cost and the portfolio restructuring side. There are probably some more businesses they could let go, but all in all, we like the path they're on. I love the way they approach coffee, innovate constantly, stay close to the customer, invest in the product, intelligent distribution. They still have a lot of geographical room to grow. Nespresso is a great business model. The same is true for the pet food or the specialty food business. These are good choices, to move away from things like candy. It takes conviction and courage. They want to be number one in very good businesses, and they want to be able to grow them.

But Nestlé is not undervalued anymore?

Shrager: If you look at the sum of the parts, and if you consider the multiples at what some similar businesses have sold for in the market, Nestlé is probably still somewhat undervalued. But again, we see Nestlé as a growth bond. They grow their top line at 3 to 4% per year, they have shown the ability to increase margins, and they have been using some of the excess cash to buy back shares. So we see EPS growth in the 5 to 7% range, plus a dividend of 2.7%. This gets us into the 8 to 9% compounding range, year after year, in Swiss Francs.

The sector that has been doing very well in this environment of steepening yield curves is financials. You own stocks like Bank of America and U.S. Bancorp, as well as banks in Asia such as DBS. But none in Europe. Why?

Shrager: Let's say you own a business and you want to sell it. Which bank would you choose to sell the business? Would it be Goldman Sachs, JPMorgan, Morgan Stanley, or Deutsche Bank? I bet your answer would be one of the American banks. Furthermore, the money management business, with the exception of the Swiss, and a few exceptions in Italy and Spain, is dominated by big American institutions. And lastly, the lending business: Net interest margins in Europe have been on a downward trend for a long time, because of the ECB policies. So European banks have a problematic lending business, and they are disadvantaged in investment banking and in money management. We don't like that combination.

Hill: With Bank of America, we like the fact that they have very high returns on tangible equity at 14%, with a credible plan to increase it to 15-17% over the next couple of years. This is a business that already



«I don't believe that Tesla has a long-term moat»: Roger de Bree.

has 50% of its revenue from fee income, rather than just interest income from spread lending. BofA is very well capitalized, with a 11.4% CET1 ratio, their deposits are very low cost, their loan to deposit ratio is only at 58%. Valuation is reasonable, they pay good dividends and buy back shares. That's just more attractive than European banks.

Shrager: Mind you, we are not averse to European financials, just EU banks. We own insurance companies, like Zurich, Scor, CNP, or Munich Re. As interest rates have declined, the insurance companies were forced to increase their premiums, which is a healthy development. Insurance companies in Europe offer good value, the banks don't.

What else have you bought lately? Do you still find value in these markets?

Shrager: Yes, among others we lately bought Conzetta, a small Swiss industrial conglomerate; Fresenius, a German healthcare company; Rubis, a French gas distribution company; Fukuda Denshi, a Japanese medical products company; or Kamigumi, a Japanese port operator.

Which are the most exciting value cases?

De Bree: We like them all, but let me walk you through our case with Rubis. It's listed in Paris, but it's really an emerging markets business, because it is a distributor of petroleum products in the Caribbean and in East Africa: Markets where you have young populations, an enormous amount of people entering the motoring age, plus economic growth. Rubis forms monopolies that are based on logistics, they own the value chain from refinery to shipment to various islands in the Caribbean all the way to their own gas stations. They own more than 1000 gas stations. Their business model offers a very high return on capital, we calculate a 25 to 30% pre-tax return on assets. Rubis has a clean balance sheet, we bought it at a 5% dividend yield, at 12x net earnings. They buy

back shares, but interestingly, they have put a ceiling to that buyback: They won't pay more than 55 € per share. I like it when a company has the same price-sensitive approach to buybacks that we as value investors have.

What's your case for Fresenius?

Ewert: It's a German healthcare conglomerate, they run dialysis centers, hospitals in Spain and Germany, as well as generic injectables under the Kabi brand. The stock trades at 10x Ebit on a sum of the parts basis, at 70% of its intrinsic value. They benefit from growing healthcare outlays and aging demographics, so you can expect a mid single digit organic topline growth and high single digit net income growth, plus they pay a slightly higher than 2% dividend yield.

Fresenius used to be a stock market darling, but they've lost their shine. What happened?

Ewert: The company had hit a few speed bumps prior to Covid, and then Covid caused a share price capitulation. The pandemic has hit their dialysis business hard, because many patients with kidney problems died, which caused their patient population to shrink. So what once was a growth stock that sold for a high multiple is now a value stock.

And you think these setbacks are just temporary?

Ewert: Yes. We don't think the structural demand outlook for any of their businesses has changed. It will take time, but the generic injectables and the dialysis businesses are very well positioned. The dialy-

sis business is a duopoly in the U.S., it benefits from economies of scale. Worldwide, the number of people with kidney problems is increasing over time. The generic injectables business benefits from high barriers to entry.

Shrager: The bulk of the business of Fresenius will return to growth, and you get it today at 10x Ebit. Additionally, there has been significant insider buying both at the level of Fresenius and the level of Fresenius Medical Care. The managers have even expressed the willingness to explore breaking up the conglomerate structure if that's necessary to unlock value.

Why have you bought Conzzeta?

Shrager: The history of Conzzeta was a conglomerate where they didn't care about the shareholder at all. But over the last couple of years we have seen significant changes. They are selling the outdoor garment brand Mammut and the Foam Partner chemicals business. They have decided to become a machinery company, focusing on the Bystronic laser-cutting business. A transformational story, done by a good board and management team. The CEO and CFO who underwent this change even made themselves redundant and fired themselves. That's very rare, managers willing to create value even if it means terminating their own employment. Bystronic is an interesting niche business, offering good growth opportunities, especially in Asia. They have a German and a Japanese competitor, but in our assessment, Bystronic is moving faster. You could buy the stock for 10x its normalized Ebit after deducting values for the non-core businesses. That's good value.

The Largest Holdings in the Funds of Tweedy, Browne

Top 20 Holdings, per March 31, 2021

International Value Fund (CHF)	International Value Fund (EUR)	Global High Dividend Value Fund (EUR)
Nestlé	Berkshire Hathaway	Diageo
Berkshire Hathaway	Alphabet	Nestlé
Alphabet	Safran	DBS Group
Diageo	United Overseas Bank	Total
Zurich Insurance	DBS Group	Unilever
DBS Group	Heineken	United Overseas Bank
Roche	Zurich Insurance	Roche
GlaxoSmithKline	Roche	Trelleborg
Alphabet	SCOR	Siemens
Safran	Trelleborg	Safran
Heineken	Total	Zurich Insurance
CNH Industrial	Novartis	Munich Re
Novartis	CNH Industrial	3M
United Overseas Bank	Johnson & Johnson	SCOR
SCOR	Nestlé	Johnson & Johnson
Alibaba ADR	AutoZone	Cisco Systems
BAE Systems	SOL SpA	BASF
Rubis	Fresenius	BAE Systems
Fresenius	Alibaba ADR	GlaxoSmithKline
Total	BAE Systems	Novartis

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