the market
NZZ

INTERVIEW

«This is an Exciting Time for Value Investors»

Thomas Shrager, Managing Director of investment boutique Tweedy, Browne, talks about the market environment, the appeal of the «Magnificent Seven» and reveals where he currently sees the best buying opportunities.

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Deutsche Version

«Value investors have nothing against buying growth stocks. But they have to be at attractive valuations», says Thomas Shrager. The value veteran has been in the business for more than 35 years, and his firm, the New York value boutique Tweedy, Browne, has been in the business of identifying undervalued stocks for a good hundred years. The firm has worked with and for value legends such as Benjamin Graham, Walter Schloss and Warren Buffett.

After many years of drought, when the most absurd business models were rewarded with stratospheric valuations under the impression of zero and negative interest rates, Shrager and his team are currently finding attractive buying opportunities – especially outside the US and in the small and medium-sized company sector.

In an in-depth interview with The Market NZZ, which has been lightly edited for length and clarity, Shrager shares his latest investment ideas as well as the value case for companies like Vertex, Novartis and Fresenius.

«Valuation Does not Matter Until it Does Matter»: Thomas Shrager.

We've had a big rise in interest rates, with ten year Treasury yields touching 5%. And yet, for most of the year, big US technology stocks have vastly outperformed. What do you read into this?

> When people have done well in certain stocks for a long time, they have a tendency to continue to invest into these stocks. Past is seen as a prologue to the future. Some of the companies that have become known as the Magnificent Seven are in a very good financial condition. They are perceived as a safe haven. So investors say this is a good place to be when bad times are coming. By doing that, they care less about valuation, they care about safety in uncertain times.

Are they right in their thinking?

> I'm wary, because we've been at this game before. As you remember, the company with the largest market cap in the US just before the crash in 2000 was Cisco Systems. It was a good company, high quality. It was growing, and it continued to grow throughout the years. Yet its stock price went from 75 to 10, all the while when earnings per share went from 25 Cents to 1.35 $ between

2002 and 2008. Its valuation crashed from 150 times earnings to something like 10 times. So, Cisco suffered a huge, multi-year valuation compression, even though the quality of the company remained high. Valuation does not matter until it does matter. To us, safety comes not only from a good financial condition – that is important – but also from a discount to intrinsic value.

Among the Magnificent Seven, the only one you own in your funds is Alphabet. Why?

It's the cheapest one among them. We've owned Alphabet for many years. Mr Market gave us an opportunity around 2011, when the stock fell out of bed, because people thought they had missed the train in mobile advertising. We were able to buy it at 11 times operating income, while the company was compounding at 20% per year. Value investors have nothing against buying growth stocks. But they have to be at attractive valuations.

Why hold it now?

Alphabet continues to grow in the double digits, and it continues compounding. Its valuation is about fair, it's not overvalued like Nvidia is, for example. There is a fear that they are outcompeted in search because Bing is now using artificial intelligence. But I think that fear is overblown. After all, Google was using AI for years, it's not as if this is something that has suddenly appeared out of nowhere. Search is important for Alphabet, of course. But in addition to that, their cloud business has recently become profitable. This business is now essentially owned by three players: Amazon, Microsoft and Alphabet. Also, YouTube seems to be turning around. That's a very valuable business. That's our logic for investing in Alphabet.

We know you are bottom-up investors. But let's talk macro for a minute. What is your view on the current market environment?

The main risk we see is not just the new level of interest rates, but the rapidity of the increase in interest rates that we have seen. Usually, this kind of move causes stress. This time, the stress will not be so much in the US housing market, because many people have refinanced their 30 year mortgages at 3%.

The stress comes from corporate debt maturity distribution. Corporates generally don't borrow for 30 years. They go between one and five years. So when they have to refinance, they have to refinance at significant premiums. Another topic that we see is the huge, increasingly irresponsible budget deficit in the US. This year, interest payments reached one trillion $, which is more than the defense budget. All in all, we have interest rates going up, and there will be a recession at some point. The main reason for the strong consumer spending in the past couple of years was the significant increase in transfer payments households received from the government. This is over.

One reason for the rise in interest rates was inflation, which had reached the highest levels in 40 years. What's your outlook there?

It's fiendishly difficult to forecast inflation, hence I won't do it. Suffice to say that I don't see interest rates going back down to zero or negative levels. The Fed is committed to bringing inflation down, and it's not going to be easy to bring it down quickly. Look at the wage settlements in the automotive sector, for example. These numbers can to a certain degree filter down to suppliers or other industries. The counter force, which makes it difficult, is that we have a slowdown in the economy. We will have to see how these forces balance out. But the probability is that it will take time for the Fed to get back to their 2% target rate. On top of that, the US is no longer the marginal producer of oil that can affect the oil price. We see strikes all over Latin America against the expansion of copper mines. Countries like Indonesia are taking back control of nickel production and refining. This creates supply issues. It's not clear to me that raw material prices will help reduce inflation. If anything, they will be higher.

The market seems to adjust itself to interest rates that will be higher for longer. That should bode well for value investors.

Absolutely. In a low and even negative interest rate environment, the present value of future earnings was infinite. This allowed many companies that were complete airballs to be valued at crazy levels. But we are now seeing a return of value. Overall, value has been outperforming since late 2020. We just had a hiatus during the first half of this year, when stocks that were perceived to be winners from the AI hype were bid up.

This environment should offer you buying opportunities. Do you find any?

Yes, we find many great opportunities, it's a very exciting time. The valuation discount of stocks outside the US versus the S&P 500 has never been higher. Also, look at the Russell 2000 small cap index versus the Russell Top 50 large cap: The latter is up 140% since January 2020, while the Russell 2000 has fallen way behind. So there are opportunities among small caps, where many high quality companies have been hammered. So, in general, we find more value opportunities outside the US, and we buy more small and medium caps versus large caps. In terms of sectors, we find particularly attractive opportunities among industrial stocks. That's where the valuation discrepancies are.

What did you buy lately?

One stock we bought is Brenntag in Germany. It's the largest chemical distributor in the world, with a market cap of about $10bn. Brenntag operates in two segments, bulk and specialty chemicals. The stock is valued at 9x EV/Ebit, P/E is 13, the dividend yield is 3%.

Walk us through your case, please.

The company has 180'000 customers, it's a highly fragmented market. Brenntag only owns 5% of the market, which means they can continue to grow through small acquisitions. Bulk chemicals are sold in tons. Scale is very important, network density, global reach, and safety standards. It's not easy to enter this market. The other part is specialty chemicals, which amounts to 40% of Ebitda. Specialty chemicals are sold in kilograms, not in tons. Margins and returns on capital are higher in this segment. They are generally selling to industries that are growing faster than average, such as fragrance and flavoring, cosmetics, and so on. There's an added twist to this case: An activist group has tried to break up the company into its two businesses. The proposal has failed in the annual general meeting, but after this, Klaus-Michael Kühne, a highly respected entrepreneur, has increased his stake in Brenntag to 10%. He certainly wants to increase the value of his investment.

Would it make sense to separate the two businesses?

There are some synergies between the bulk and the specialty chemicals business. But the valuation of the two parts is significantly higher than the present price. Some of their competitors in specialty chemicals, such as IMCD and Azelis, trade at much higher multiples. The management has not excluded a separation. They are looking at it. We don't push them, but we'll see what they want to do. There will be a capital markets day on December 5.

Does it make sense to invest in such a cyclical business when we might be looking at a recession?

Yes. While during a recession operating income will go down, cash flow will actually increase, because of a decline in working capital. This in effect provides a financial hedge to an operating headwind.

What else did you buy recently?

Another stock is Teleperformance, a French company specializing in the call center and outsourcing business with a market cap of about $6bn. The market got spooked after a slowdown in like-for-like sales growth this year. People were assigning this to the idea that AI will soon replace call center workers in the Philippines or in India. In addition to that, there was an issue in Colombia, where Teleperformance does content moderation work for companies like Google. There were allegations that their working conditions were bad. An investigation by the Colombian government reached the conclusion that this was not the case, but ESG-minded investors sold off the stock.

You think the stock was wrongly punished?

Yes. AI has always been used to a certain level in this industry, it's not a new trend. What made sense to automate has been automated. Part of the business will always need a human being at the other end of the line, because usually, somebody calls a company when there is a moment of friction, when something is not working for the client. At that point, it's not just the information that matters, but the emotions that will decide whether they

remain a client or not. Automation will continue to increase in areas which make sense, but companies will also continue to outsource. This business of Teleperformance is growing at 7% per year.

What's the valuation?

Mr Market has given us an opportunity to buy at eight times earnings for a company that even this year continues to grow revenues by 6%. Earnings per share are going from 15 to 17 € this year. The dividend yield is 3.5%.

One more recent buy?

Winpak, a company based in Canada, but the majority of shares are held by a Finnish family. The market cap is $1.8bn, they have about $400mn net cash on their balance sheet. Winpak does plastic packaging for perishable food products. Their twelve year average organic revenue growth is 6% p.a., of which 4% is volume and 2% is price. This is excellent for this kind of business. Their twelve year average Ebitda margin is 21%, return on invested capital is 19%. These numbers are among the highest of any packaging companies. Their accounting is conservative, they don't do one time charges and other shenanigans. If we apply a fair value of 9 times Ebitda, their stock should trade in the low 50s. We were able to buy them in the low 30s.

What could they do to boost their share price?

They should buy back shares because they have excess cash. We rarely advise companies to take on debt to buy back shares, but Winpak has too much cash on their balance sheet, which is inefficient.

Did you find anything in Switzerland lately?

Some smaller and medium sized companies have fallen out of bed, and they are getting attractive again. The opportunities are coming back, but I can't tell you any names yet.

Nestlé is one of the biggest holdings in your funds. The stock has corrected by 20% lately. Why?

I would call it the Ozempic effect. Many stocks in the food sector have been affected by the rise of weight loss drugs, be it Ozempic by Novo Nordisk or Mounjaro by Eli Lilly. The way these drugs work is that they essentially tell the brain earlier that you should stop eating, because you're full. Stocks in the food sector have sold off because people think their sales will fall. But I think this fear is overblown. For one, they will find ways to sell smaller portions at the same price, thereby increasing margins. And concerning Nestlé, the area that may be affected is frozen food. Their main business lines are not affected: Coffee, pet food or infant nutrition will have zero Ozempic effect.

So is the stock a buy at less than 100 Swiss francs?

Yes. It's not super cheap, but decently valued for a company that can still compound in the 7-8% range. Decent dividend, they bought back shares in the past. Very entrepreneurial for a company their size. Nestlé has strong brands, it's a great company. The CEO, Mark Schneider, has positioned the company to be in growth areas. Pet food is a growth area and will continue to be. Coffee is a fantastic business with great margins. He's done some good sales, getting out of a number of lines of business and focussing on areas of growth. We're generally happy with how Schneider has done.

Among the healthcare stocks you own are Novartis and Roche. What do you like about them?

Yes, we own Novartis and Roche, among others. In the US, we also own Vertex and Ionis, for example. But let's start with Novartis. This is the company we like most among the majors. Their main sales drivers are Kisqali in breast cancer, Cosentyx in psoriasis, Entresto in heart failure, Zolgensma in spinal muscular atrophy, and Kesimpta in multiple sclerosis. This is a great line-up. Plus, they have a good pipeline, among them a leukemia drug, a prostate cancer drug, while Kisqali is being tested in new cancer applications. If some of these drugs come to market, Novartis will do very well.

Through the spin-off in October, you received shares of Sandoz, the generics business of Novartis.

We are no longer shareholders of Sandoz. Perhaps the management will succeed in changing the perception, but we believe that Sandoz missed a great opportunity to be stronger in biosimilars four or five years ago, when many biotech drugs lost their patents. We are happy that Novartis has spun out this business. This was a shareholder friendly move.

How about Roche? Their share price has gone nowhere over the past ten years.

Roche is going through a difficult transition. A few years ago, a number of big and successful drugs like Avastin and Rituxan, among others, went off patent. They amounted to about $20bn in sales. Roche managed to replace those sales with new drugs like Ocrevus in MS, Hemlibra in hemophilia A, or Vabysmo in age-related macular degeneration. This was a big achievement. Lately, though, they had a number of disappointments. They had an Alzheimer failure, and another failure with a cancer drug that was supposed to work together with Tecentriq. Roche is going through a period of transformation.

Why the disappointments?

My speculation is that they either pushed drugs too quickly through the development process, or they had poor trial design in a number of cases. Take the recent news with a drug they developed with Sarepta against muscular dystrophy. The main result was negative, but all the secondary factors were positive. This indicates poor trial design. But again, this is speculation on my part. Another example: Tecentriq is, in my view, entirely comparable to Keytruda by Merck, which is now an $18bn drug. Roche had the time advantage, but I think they rushed through the trials, and Keytruda's numbers were initially much better. Roche could have been much better with Tecentriq, they could have made it into a $10bn plus drug instead of a $5bn drug, if the trial design had been better. We hope that the new CEO, Thomas Schinecker, who is more of a scientist than a finance man, will think more seriously about trial design and how quickly drugs are pushed through testing.

So this was a management issue?

Yes. Hopefully it will be corrected. Roche has become a show-me stock in a sense. The valuation of its shares is ridiculously low. That's why we are not selling now.

What do you make of the valuation of Novo Nordisk and Eli Lilly?

The fundamentals of the companies are very good, but of course the valuations are very high. Their weight-loss drugs have an immediate and visible effect. Sometimes there are these drugs that are life-changing for a pharma company. We looked at Eli Lilly a few years ago, but it never got to an area where it was cheap enough. In markets like these, you see huge amounts of money moving to something that has momentum. Novo and Lilly do have good fundamentals. We just can't buy them because their valuation is too high.

What's your case with Vertex?

That's an extraordinary company. Their basic business is in cystic fibrosis, where they have a multibillion dollar drug. But now they are in phase III development of a non-opioid acute pain medication, which is an area of huge unmet need. This drug by Vertex seems to be as effective in acute pain, without the addiction risks of opioids.

Another company you own and that you made the value case a couple of years ago is Fresenius. It has disappointed again and again.

The main reason for the disappointment is Fresenius Medical Care, in which Fresenius owns a minority stake. Fresenius itself, especially the hospital supply business under the Fresenius Kabi brand, is doing very well. The Helios hospital business has been improving as well. The main problem has been the dialysis business in FMC. During Covid, a lot of patients with kidney disease, who would have become patients for dialysis, have unfortunately died. This meant fewer patients for FMC, while they still had high fixed costs for their dialysis centres. By now, the dialysis patient population should have normalized, but it hasn't. My suspicion is that Ozempic is also having an effect

here. These drugs reduce obesity, which means less people with kidney problems. That may be a bigger problem for FMC in the longer term.

Do you still own the stock?

We have sold our position in FMC but still own Fresenius. They should separate this business and get rid of the millstone that is FMC. The reason they have not done it has caused many investors to sell Fresenius too. They should address this. A separation would be of tremendous value, because it would bring forth the value in Fresenius itself. The value case for Fresenius is very strong.

Largest Holdings in the Funds of Tweedy, Browne (SICAV)

Top 20 Holdings, per October 31, 2023

International Value Fund (CHF)	International Value Fund (EUR)	Global High Dividend Value Fund (EUR)
Berkshire Hathaway	Berkshire Hathaway	TotalEnergies
Alphabet	BAE Systems	Progressive Corp
Safran	Safran	Johnson & Johnson
TotalEnergies	Alphabet	Kemira
BAE Systems	Heineken	BAE Systems
Diageo	SOL SpA	Nestlé
Nestlé	United Overseas Bank	SCOR
SOL SpA	TotalEnergies	Diageo
United Overseas Bank	Vertex Pharmaceuticals	Novartis
Heineken	AutoZone	DHL
DBS Group	Trelleborg	Teleperformance
Ionis Pharmaceuticals	Ionis Pharmaceuticals	Fresenius SE
SCOR	Fresenius SE	Rubis
Novartis	DBS Group	GSK
CNH International	Diageo	Safran
Rheinmetall	DHL	DBS Group
Trelleborg	Rheinmetall	Howden Joinery
GSK	Zurich Insurance	United Overseas Bank
DHL	Nestlé	Megacable Holdings
Fresenius SE	Nestlé ADR	Roche

Tabelle: themarket.ch, MD • Quelle: Tweedy, Browne

Thomas Shrager

Thomas H. Shrager, Managing Director, has worked for Tweedy, Browne since 1989. He is a member of the firm's Investment Committee and Management Committees. Previously he had worked in mergers and acquisitions at Bear Stearns, and as a consultant for Arthur D. Little.

ENGLISH

«People Are Still Trying to Deal with the Shock of Much Higher Rates for a Long Time»

The world is experiencing a historic surge in interest rates. Jim Grant, editor of «Grant's Interest Rate Observer», believes the turmoil could be the beginning of a multi-decade bear market in bonds. In this in-depth interview, he explains what the risks are – and where opportunities arise.

Christoph Gisiger 27.10.2023

ENGLISH

«We've Hit an Interest Rate Level That Is Very Attractive for Bond Investors»

Mike Gitlin, incoming president and CEO of Capital Group, shares his views about the current economic environment, monetary policy, rising interest rates and how investors should deal with them.

Mark Dittli 29.09.2023

INTERVIEW

«Price Matters Again»

Thomas Shrager and Robert Wyckoff, Managing Directors of New York-based value boutique Tweedy, Browne, are finding new opportunities in the current market turmoil. They share what they have bought and why they are holding on to Novartis and Roche.

Gregor Mast 28.06.2022