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

Harry Hartford
Causeway Capital Management

Flight Plan

With a keen eye on valuation, Causeway Capital over time has proven quite skilled at investing in cyclical companies whose volatility may scare other investors away. In a market where cycles and volatility have gone a bit haywire, Causeway President Harry Hartford and Portfolio Manager Jonathan Eng describe where they see opportunity in returning to some previous winners.

Causeway came out with a paper early in the recent market crisis describing opportunity you were finding in more-cyclical companies. Describe your thinking there and how you acted on that.

Harry Hartford: As the economic cycle was truncated quite dramatically, almost any company deemed even nominally cyclical went on sale at clearance prices, which meant we could be very selective in focusing on best-in-class operators in areas like transportation, tourism/hospitality, industrials and materials. By selective, that meant companies that we believe have excellent management teams, defensible franchises and the resources to weather the current environment. Also, as always, it was critical to assess if there were any structural issues – especially in light of the current crisis – that might derail the reversion to the mean we were counting on. In many cases we were buying companies we'd owned before, had sold due to valuation, and they were now again attractive.

Jonathan Eng: To give a couple examples, we reestablished a position in Compass Group [London: CPG], which is a global food-services business serving the educational, healthcare, corporate and sports/entertainment markets. Its business has been directly hit by the economic fallout from the coronavirus, but has over the long term been a quite stable compounder of value. We also bought back into Vinci [Paris:DG], which is a French company that owns and manages tollroads and related concessions, airports and related concessions, and also has a big infrastructure construction business. A number of its businesses have also been directly impacted in the current environment, but we believe the issues are not permanent, the company is well-managed and financially sound, and that it will come through all this as strong on the other side. That longer-term view we didn't think was reflected in the share price, which was cut in half from mid-February to mid-March.

You've also highlighted finding opportunity in aviation and aerospace, another industry in distress. To flesh out an example, describe the upside you see today in Rolls-Royce [London: RR].

JE: Rolls-Royce manufactures airplane engines for wide-body aircraft such as the Airbus A330, the Airbus A350 and the Boeing 787. This market is essentially a duopoly with General Electric, and sports an attractive business model. Engines are typically sold at a loss, but then generate a cash-flow stream over some 25 years based – in Rolls-Royce's case – on the number of hours planes with its engines are in the air. It is responsible for major servicing of the engines every five to seven years, but the aftermarket annuity stream is usually 4-5x the original purchase price paid.

Even before the pandemic problem, the company was struggling with issues around its Trent 1000 engine, which is used on the 787. The blades haven't lasted nearly as long as expected, so there's been incremental maintenance required that the company hadn't accounted for. The fixes have also taken time, so it's had to lease replacement planes for Boeing to compensate. On top of all that, when the planes can't fly they're not earning Rolls any ongoing revenue. It all snowballs in a negative way and the company has taken a hit on the Trent 1000 of some £2.4 billion in cash flow over the past three years.

HH: Our sense that the company was getting on top of this problem is what brought us back to the stock in January and February. If we were right, we thought its monopoly position in the A330 and A350 programs were poised to generate a tremendous amount of cash that would be far more visible as the extraordinary Trent 1000 costs fell away. Then COVID-19 hit.

How are you processing the financial impact of that?

JE: We estimate Rolls could lose something on the order of £1.5 billion in revenue this year due to the crisis. Offsetting that, however, management is confident that they can cut operating and capital expenses by approximately £1 billion to help offset that. That means free cash flow overall could come in at up to negative £500 million this year. That's obviously not good, but against roughly £7 billion in liquidity the company has from net cash on hand and from drawing down revolving credit lines, it wouldn't be a catastrophe.

While the growth trajectory has been stretched out, we ultimately believe the medical breakthroughs needed for society to jettison "social distancing" are within a two-year investment horizon, and that secular air passenger demand will rise again. Air-travel penetration in emerging economies with rising incomes have plenty of room to grow, which should translate into good growth in global aircraft orders. You can see that in the order-backlog numbers, which are coming down but still indicate strong forward demand. Given the strength of its market position and the attractiveness of its business model, Rolls should be very well positioned to reap the benefits of that long-term demand.

With a longer-term outlook, how cheap do you consider the stock at today's £3.60 price, down 60% from a year ago?

JE: Within the next two years, with £500 million in free cash flow from the company's defense and power-systems divisions, and with revenue flying hours in the engine business back to where they were prior to the Trent 1000 issues and the pandemic, we believe the company can generate £1.5 billion in free cash flow. The market cap today is £6.2 billion. Free-cash-flow yields in the sector used to be more in the 5% range, but even at 10% the market value on our estimate of normalized free cash would be nearly 2.5x today's level.

There are two very big issues here that you have to believe are temporary in nature. It would be pretty easy to look at this and say it's just too hard. We don't think that's the right conclusion.

Has anything surprised you about the market's behavior over the past two months?

HH: One of the great things about equity markets is that they clear every single day. What's made the recent situation more challenging for any investor whose process is primarily focused on valuation, however, is that while, yes, we've had market clearing, price discovery has often been all over the place.

I'd illustrate that with an example, also in the aerospace industry. Boeing [BA] obviously has issues, of its own making and associated now with the coronavirus. But you could have bought Boeing shares at $95 on March 20 and sold them at $180 on March 26. And there was a weekend in between. The notion that the single-largest U.S. export company could have

INVESTMENT SNAPSHOT

Rolls-Royce
(London: RR)

Business: Designs, develops, manufactures and services wide-body commercial aircraft engines, systems for civil power generation and defense-related systems and equipment.

Share Information
(@4/29/20, Exchange Rate: $1 = £0.80):

Price	**£3.58**
52-Week Range	£2.49 – £9.40
Dividend Yield	0.0%
Market Cap	£6.17 billion

Financials (TTM):

Revenue	£16.59 billion
Operating Profit Margin	(-4.8%)
Net Profit Margin	(-7.9%)

Valuation Metrics
(@4/29/20):

	RR	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	41.1	21.0

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

Company	% Owned
Capital Research & Mgmt	5.3%
Harris Associates	5.0%
Baillie Gifford	4.8%
Causeway Capital	4.8%
ValueAct Capital	4.5%

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

Shares Short/Float	n/a

RR PRICE HISTORY

THE BOTTOM LINE
The positives of the company's business model, its market position, and the long-term secular growth in its industry are being obscured by a difficult product issue and now the pandemic-induced economic crisis, says Jonathan Eng. Assuming a 10% free-cash-flow yield on his normalized estimates, the stock would trade at nearly 2.5x its current level.

Sources: Company reports, other publicly available information its underlying equity value move 100% in four working days, that says to me that investors in many cases don't really have a clue. We've had stocks move 40% intraday. [*Note*: Boeing shares closed recently at just under $139.]

There are many stocks we've been buying or have bought, but we haven't been able to buy enough of them because the share prices have been gyrating all over the place. But that's why you have a discipline. If stocks clear at a price where you're comfortable buying, you should be buying. If they don't, be patient. VII

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