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Companies in Transition: Price vs. Fundamentals

Opportunities to purchase undervalued investments often occur when businesses embark on meaningful and lengthy transitions. Unlike most investors, we have never shied away from situations which require us to roll up our sleeves and engage in a little extra work. Frequently, these are companies forced into evolving because the marketplace around them changes and their choice is to either adapt or fail. During this period of evolution, which invariably involves many ups and downs, a company's stock price is likely to experience extreme volatility – creating the potential for price and value to diverge widely.

Occasionally, a dominant shareholder recognizes this mispricing and initiates an effort to take the company private. We have experienced this first hand with our ownership of both Dell and Best Buy. The founders, frustrated with the market's emphasis on short-term results, recently took matters into their own hands and offered to buy their company back – almost entirely driven by the large difference between the current stock price and fundamentals.

Both of these companies are currently in transition and both have experienced volatile stock prices; and, in our opinion, there continues to be a persistent gap between price and underlying fundamentals.

Best Buy

Throughout the past 11 years we have repeatedly focused on several important investment principles in these Quarterly Letters. These are simple, yet profound, ideas which play an enormous role in determining long-term investment success. Recently, our position in Best Buy (BBY) provided another opportunity to witness one of these principles in action: that the volatility of stock prices often times does not reflect the volatility of the underlying business.

In 2012 BBY was the second worst performing position in the portfolio, starting the year at $23.37 and ending at $11.85 (a 49% decline). Today, just over three months later, the stock is again trading at $23.38 (as of April 17th) and was the second best performing stock in the S&P 500 during the first quarter. A better way to appreciate this volatility is to analyze it in the context of market capitalization – in a little over 15 months the total value of Best Buy fluctuated from a starting point of $8.9 billion, to a low of $4.0 billion, and then back to $8.1 billion.

Judging simply by the gyrations in the stock price you would conclude that the company's prospects deteriorated considerably during 2012 and, then, remarkably brightened at the start of this year. In reality, however, businesses simply don't change dramatically in such a short time frame. And, in the case of Best Buy, this is supported by both numbers and logic.

While the competitive threats facing the company are real, most of them existed well before 2012, namely: the impact on pricing from online competitors like Amazon, the lack of major product innovation in consumer electronics since 2010, and the increasing mix shift to electronic goods by mass merchant retailers like Wal-Mart, Costco, and Target. We factored these concerns into our analysis early on and believed the company could overcome them by differentiating through enhanced service, the eventual implementation of online sales tax, and purchasing scale. The newer threat of mobile transparency and “showrooming” was not anticipated but, in our opinion, never represented the “kill shot” imagined by Wall Street or the media.

Speaking of Wall Street and the media - both of these parties contribute in their own way towards short-term thinking and stock market volatility. The media tends to sensationalize current successes and failures in order to sell newspapers and advertising. Equally culpable are the short-term focused sell side analysts that never produce a model with earnings estimates beyond 24 months.

The chart below shows various headlines relating to BBY throughout 2012. You quickly get a feel for the difficult news climate the company faced as 2012 progressed. During the middle of the year, when the gap between price and value simply became too wide, BBY’s founder stepped in and explored an offer to take the company private.

BEST BUY (BBY)

1) “Retailers Try to Thwart Price Apps” (WSJ) = 12/23/11	**2)** “Why Best Buy Is Going Out of Business” (Forbes) = 01/06/12

3) "Showdown over Showrooming" (WSJ) = 01/23/12	**4)** "Electronics Retailers Scramble to Adapt to Changing Market" (NY Times) = 06/19/12
5) "Best Buy Founder's Offer Meets Uncertainty" (WSJ) = 08/06/12	**6)** "Best Buy Buyout Looking Harder Analyst Say" (WSJ) = 11/21/12
7) "Big Box Retailers Wrestle E-Commerce Gorilla" (WSJ) = 11/25/12	**8)** "No Best Option for Best Buy Shareholders" (WSJ)=12/14/12

In contrast, a look at Best Buy's U.S. comparable store sales over the past six quarters reflects the relative stability of the overall business (especially in relation to the stock price): -4.1%, 0.1%, -3.7%, -1.6%, -4.0%, and 0.9%. Even the company's gross margins have remained relatively stable over the past 12 months at 23.9% compared to 24.4% for the prior 12 months. While these types of results certainly don't warrant a celebration, they nonetheless provide a stark difference to the volatility of the stock price.

Most business owners will tell you that the intrinsic value of their company does not fluctuate to any significant degree from month-to-month, quarter-to-quarter, or even year-to-year. Yet, many investors frequently draw a parallel between the short-term movements of a stock price and the fundamentals of the underlying business. A situation like Best Buy serves as a good example of the folly in this thinking; and, reminds us that intelligent investors are better off focusing on long-term fundamentals then the daily vacillation of the stock market.

DELL

Dell is another core position in the portfolio that recently experienced headline news after the announcement of a management led buyout. We discussed the transaction briefly in the fourth quarter Quarterly Letter but would like to share our thoughts with you in more detail now that the offer was officially announced on February 5th.

We are extremely disappointed with the proposed offer made by Michael Dell and Silver Lake to purchase the company for $13.65 per share in cash. In many ways we feel like a bride being left at the altar. After six years of ownership resulting in a breakeven investment, this transaction, if consummated, would force us to sell out in the midst of a transformation where the future looks better than the past.

Over the past five years the company invested more than $13 billion in acquisitions and R&D to transition itself from a pure play PC and hardware company into a fully integrated enterprise solutions and services business (ES&S). This transition is not yet complete but the numbers speak for themselves: today, 36% of revenue and more than 50% of gross profit is derived from the higher margin, faster growing ES&S segment (compared to just 23% of revenue and 31% of gross profit in 2008). In the years ahead, as the migration to solutions and services continues, the company's revenue growth rate will accelerate and margins will expand, ultimately laying the groundwork for significant increases in cash flow.

We do not believe that the upside potential should accrue solely to Michael Dell and private equity investors rather than public shareholders. The justification put forth – that a company undergoing a long-term transition needs to be taken private in order to avoid short-term focused shareholders – does not hold any weight. There are numerous publicly listed companies, many of which we invested in over the years, that successfully executed difficult transitions and reorganizations. Furthermore, the ability of management to foster a long-term focused culture among employees and shareholders has little bearing on whether its shares are publicly traded (Berkshire Hathaway and Leucadia come to mind).

Even in a difficult current environment for global IT spending and a revolutionary change in mobile computing eating away at its legacy hardware business, Dell still generated $1.60 per share in cash flow during the preceding twelve months. Given the company's long-term growth prospects in the ES&S segment, and assuming that the decline in the legacy consumer hardware business begins to subside, we conservatively predict annual cash flow will approach the low-to-mid $2/share range in the next three to four years; implying a fair value in the high $20's.

Juxtaposed next to the management led buyout offer of $13.65 it's hard to make a compelling case that existing shareholders are receiving full value in this deal. After stripping out $3 per share in after-tax cash on the balance sheet, the buyout values Dell at just 6.6x trailing free cash flow. And the fact that Michael Dell is willing to role his entire stake in the company into the deal, valued at $3.4 billion, plus an additional $700 million in cash, represents one more reason to believe the buyout price is woefully inadequate.

However, with all that being said Michael Dell is no fool. He perceives a stock price trading at a large discount compared to its long-term value. From his perspective the thinking is simple: "…*if the market is not willing to value this company correctly then I will take this opportunity to capitalize on the short-term thinking".* We do not begrudge him this point of view; we're simply stating that all shareholders should be given the option to participate.

Fortunately, other large shareholders recognize the same value as we do. Subsequent offers at higher prices from Blackstone and Carl Icahn indicate the inherent value in Dell's future. In our opinion, these offers have the added benefit of providing existing shareholders the opportunity to participate in Dell's upside: each of them propose the option of an "equity stub" in lieu of cash. We view this type of structure favorably and would most likely participate in the stub if either one of these transactions wins shareholder approval (although it appears in recent days that Blackstone will not pursue its offer). Otherwise, we will vote "No" on the management led buyout offer.

New Investment: Quest Diagnostics (DGX)

During the first quarter we purchased a new position in Quest Diagnostics (DGX). Quest is the largest laboratory testing company in the country utilizing a nationwide network of laboratories and service centers. Our involvement in the diagnostic testing industry is not a new one: we have maintained a core position in the second largest testing company, Lab Corp. (LH), dating back to 2003. Our deep understanding of the industry and experience with Lab Corp helped us develop a familiarity with Quest over the years.

Our reasons for purchasing the company now are simple. Like Lab Corp., Quest will benefit from accelerating volume in the coming years due to the following factors: the continued aging of the U.S. population, the stress on smaller independent labs and hospitals from continued reimbursement pressure, and the increase in 30 million new insured lives as a result of Obamacare. Our belief is that the number of lab tests (or accessions) will accelerate and disproportionately benefit Quest and Lab Corp. because of their scale and nationwide footprint (which combined account for 43% of the independent lab market).

Moreover, under a new management team, the company is embarking on a cost reduction plan to eliminate $600 million of costs by 2015, and potentially another $400 million longer-term. One of our hesitations in owning Quest in the past was its bloated infrastructure and sporadic execution – resulting in sustainably lower operating margins than Lab Corp. We are impressed with the company's newly appointed management team – the CEO was recently the CEO of Phillips Healthcare and other senior executives were formerly with G.E. Healthcare and Pfizer. The team is focused on streamlining the company's cost structure and reigniting growth. These efforts should provide a significant tailwind to cash flow in the next few years.

At an initial purchase price of $56 per share we were able to invest in the company at just 10x 2013 earnings per share and 7x EBITDA. The relatively meager multiple reflects a concern by some investors that the changing healthcare environment and continuing pressure on reimbursement levels will prove too difficult to overcome. Our research and analysis suggests otherwise: that although industry pricing will be challenged, the two large independent testing companies will win market share from smaller independents and hospitals due to their size, efficiency, and scale. Under this scenario we expect Quest to grow earnings in excess of $8 per share in 2017, which yields a fair value of around $100 per share.

Miscellaneous

As an SEC registered investment advisor we are required to provide you with an annual Privacy Notice and an updated Part 2B Brochure. This Brochure is filed with the SEC on an annual basis and contains information on our firm and investment strategy. You will find both of these documents enclosed with this letter.

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