"When there's nothing particularly clever to do, the potential pitfall lies in insisting on being clever"

Howard Marks

Statement from the Chair

Chairman of the Investment Committee: Rishi Krishnan

Our opening quote of this letter underscores the most important characteristic that successful investors require: patience. Almost a decade into an economic expansion, with valuations at levels unseen since the dot-com boom, it's no secret that it can be a challenging task to find compelling opportunities without overpaying. The pressure to chase short-term returns during good times has left a trail of burned investor capital and closed-down funds in its wake. As stewards of capital for future generations of University of Chicago students, we should feel no pressure to lower our standards even when our opportunity set becomes more limited.

That being said, as an organization of a college students with only a few years of investing experience under our belts, we are often ill-equipped to take directional or contrarian views on macro trends. That doesn't mean we need to avoid investments sensitive to these factors – it just means that when we do invest, it's important to acknowledge what we don't know and demand an appropriate margin of safety for it.

Our additions to the portfolio this quarter reflect this principle. The club's purchase of Warrior Met Coal (NYSE: HCC) might initially appear like a strange choice. Warrior is a recent visitor to Chapter 11 in an industry commonly perceived to be both commoditized and on the decline. However, Warrior's competitive advantages, which include a consistent pricing premium stemming from unique high-quality assets and a highly variablized cost structure created from the bankruptcy enable the company to generate an attractive FCF yield and remain profitable at a wide range of coal prices. Our other two investments have a surprising amount in common. PRA Group (NASDAQ: PRAA), a consumer debt collection agency, and Trinity Industries (NYSE: TRN), a railcar manufacturer and lessor, are both leaders in high barrier-to-entry industries that are currently at their cyclical trough. For both businesses, we view the current moment as an ideal time to buy in – we are comfortable with their trough valuations and can realize attractive option value on top of them when each industry recovers. As long-term investors, we don't need to rely on timing. We can be patient.

Each year the Investment Committee has the opportunity to build on this club's educational program and invest in our most important resource – the members of this club. This quarter has seen the addition and institution of two noteworthy initiatives: analyst portfolio reviews and individual stock pitches. Investing is hardly just about buying stocks. Monitoring and deciding when to sell a holding are equally important aspects and are areas our club has historically fallen short in educating our members about. Previously the Investment Committee was exclusively responsible for portfolio management, but from now on members of each sector will review existing investments and present recommendations on them to the club. Additionally, in an effort to provide a more comprehensive educational experience, all new analysts now create a brief pitch on an investment idea that they source themselves and eventually meet with a member of the Investment Committee for one-on-one feedback. With this initiative we hope to strengthen our members' education with individualized programming. As the year goes on we will continue to revise these initiatives and experiment with more.

This letter contains each sector's pitch and respective Investment Committee decision as well as updates on the portfolio. Feel free to send me an email at rishikrishnan@uchicago.edu if you have any questions on anything in it. Thanks to everyone for a fantastic quarter – your dedication to this club is what makes this community an incredibly rewarding one to be a part of.

Enjoy your summer and please don't hesitate to reach out. See you in the fall!

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Spring Pitches

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Hawkins, Inc. (NASDAQ: HWKN)

Natural Resources Sector Leader: Kevin Ren

Company Overview

Hawkins, Inc. (HWKN) is a diversified specialty chemicals producer that distributes, blends, and manufactures chemicals and specialty ingredients. Its Industrial segment, located in the upper Midwest, serves the agriculture, food, and metals industries. Its Water Treatment segment utilizes a salesperson approach to provide chemicals for treating wastewater. Its Health and Nutrition segment provides customized formulation solutions for nutraceutical and dietary supplement manufacturers.

Investment Thesis

The Natural Resources Sector recommends a BUY in HWKN for the following reasons:

1. Recession-resilient products mitigate downside risk: HWKN is able to maintain stable revenues across the cycle and in a variety of broader economic conditions due to superior inventory management and multi-year contracted water treatment with municipalities. In particular, chemicals represent a small portion of end users' costs while serving as a mission-critical input, providing resiliency in financial performance. The acquisition of Stauber further contributes to steady growth, as the vitamins industry grew at a 9% CAGR during the last recession. HWKN's exposure to stable demand makes it a low-risk investment with predictable cash flows.

2. Value-added products differentiate Hawkins from competitors: Hawkins is the only customized chemicals manufacturer with 2 domestic SQF & ISO certified production facilities, making it the chemicals producer of choice for health and nutrition companies. Custom formulation for specialty chemicals solutions command higher premiums than commoditized chemicals and allow Hawkins to position itself as the 'sole supplier' for its end users. Its tailored chemicals, designed specifically to meet the needs of the customer, provide sticky revenues and higher bargaining power, giving Hawkins the pricing power to mitigate price fluctuations by passing on costs.

3. Reorientation towards higher-growth and higher-margin products: Greater investment and capital expenditures directed towards the construction, electronic, nutrition, and supplementation industries, which are projected to grow at high-single digit CAGRs over the next five years, will continue to generate top-line growth for HWKN. Geographical expansion of the Water Treatment segment, which opened 7 new branches last year, has expanded the addressable market of municipalities. Rebounding oilfield chemicals demand, fueled by domestic shale gas production, will also significantly contribute to the company's revenues. HWKN will continue to realize higher margins in these industries relative to its ongoing services, yielding continued margin expansion moving forward.

Key Risks and Considerations

1. Addressing debt: HWKN has a $165M Credit Facility maturing in December 2020, without sufficient cash on hand to address the debt paydown. It could choose to address this debt either through refinancing, halting the dividend, or issuing equity; we believe the first is the most likely.

2. Competitive industry dynamics: Commoditized chemicals in the industrials space is a low-margin, competitive business. Active rebalancing towards the Water and Health and Nutrition segments provides higher margins and stickier clients.

3. Recent changes in ownership: Sales of shares from insiders and institutions may serve as a warning sign to deteriorating fundamentals. However, each of the insiders still maintains a significant stake in HWKN, and compensation is structured to align interests with shareholders.

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Decision: NO PURCHASE

Natural Resources Investment Committee Representative: Bruce Li

The Natural Resources Sector pitched HWKN on Wednesday, April 25, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided to not purchase HWKN. Our reasons are as follows:

FIRST: We are concerned with the company's lack of clear competitive advantages and primary product offerings being largely commoditized chemicals. Although we are encouraged by the strategic shift to the higher-margin water treatment segment, we still believe that the segment's growth is insufficient to warrant a purchase. The company has not been able to pass higher input prices onto its customers due to competitive pressure, which is another sign that HWKN's products are largely undifferentiated. We are also concerned with consistent decreases in the industrial segment's gross profit in the current fiscal year, which have not been offset by the water treatment or health and nutrition segments. Furthermore, we observe that water treatment growth is mostly acquisitions-driven, which we view as relatively unattractive and reliant on additional capital. Although the custom formulation in the health and nutrition segment leads to a stickier customer base, recent sales declines from reduced manufacturing demand raise concerns as to whether this is sustainable. Even in light of margin improvements, we are worried about the decline in ROIC from the mid-teens in 2011 (16%) to the high-single-digits (7%) today, especially given that we estimate WACC to be 7-10%.

SECOND: We do believe that HWKN's business segments provide the company with a degree of recession resiliency, but we do not totally attribute HWKN's superior performance in the 2008-2009 recession to core business strength. We acknowledge that the contract-style model, set of long term customer relationships, and inelasticity of water service demand position HWKN to weather economic downturns better than most companies, but we conclude that the surprisingly strong performance in the crisis is in large part due to inventory management. Specifically, we note that management reported significantly higher gross profits from historical levels for fiscal year 2009 due to the sale of lower-cost inventory on hand in that period of increased prices and constrained supply. This in mind, we believe that the positive stock performance in that time period is primarily attributable to a fortunate inventory mix. We are uncertain of HWKN's ability to repeat its performance in a future downturn.

THIRD: We do not believe that HWKN is undervalued. HWKN trades at a similar multiple (7.5x EV/EBITDA, low-teens P/E) to competitors, many of which are significantly larger, have better margins, and benefit from a stronger distribution network. Given this, we do not find the current price an attractive entry point.

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CorePoint Lodging, Inc. (NYSE: CPLG)

Special Situations Sector Leader: Lance Hao

Company Overview

CorePoint Lodging (CPLG) is an owner of midscale to upper-midscale hotels formed through a spinoff of La Quinta's portfolio of real estate assets. The company, which plans to reorganize as a REIT, is a manager of mostly suburban and airport area properties as well as a select service hotelier and owns 317 hotels and approximately 41,000 rooms spread across 41 states. La Quinta is also selling off its operating company to Wyndham's future management company, and as a result is distributing $8.40 per share to shareholders along with the 1 share of CPLG.

Investment Thesis

The Special Situations Sector recommends a BUY in CPLG, post spinoff, for the following reasons:

1. Taxable spinoff creates incentive to understate performance: Typically, the vast majority of spinoffs are tax-free to shareholders. In this case, due to the acquisition of La Quinta's management company, the spinoff of CPLG has become taxable. Wyndham has drafted a unique tax agreement that sets aside $240M for the spinoff taxes – if the actual tax payments are lower than this expected amount, CPLG is legally allowed to keep the balance. This creates unique incentives for both management and shareholders. Management is incentivized to depress share prices temporarily in order to maximize the tax gain from Wyndham and number of shares they are compensated with, since their equity package is based on a fixed dollar amount of shares. Shareholders are also incentivized to minimize share price on the first trading day, in order to lower capital gains taxes as much as possible.
2. Potential for institutional sell-off: We believe that significant institutional selling will unfairly depress CPLG's share price and thus create a more attractive entry price. First, REIT spinoffs have traditionally been more unattractive than their management counterparts. Their low growth prospects, high capital requirements, and illiquid assets, combined with investor restrictions and the prospect of income investing, lead many institutional and retail investors to sell off. Additionally, the explosion of interest in timeshares draws available funds away from the relatively unattractive CPLG to higher growth opportunities, like Wyndham's spinoffs. Lastly, if CPLG is unable to attain REIT status, it will be further limited in investor interest and will likely be temporarily punished until it manages to acquire the status.
3. Artificially depressed EBITDA: We believe CPLG's latest EBITDA numbers understate its potential for cash flow generation. The impact of the 2017 hurricanes affected CPLG's largest portfolios in Texas and Florida, with an estimated 8% of total rooms out of service due to the disasters. La Quinta also began a massive capex program in 2016, repositioning more than 50 total hotels and more than doubling cash used in investing activities. We believe that the benefits from the improvements have not yet been reflected in revenue. Finally, we believe that the Wyndham acquisition, which opens CPLG up to 6x their previous rewards program, will lead to further revenue increases and opportunities to rebrand.
4. Insider action: We believe that insider action points to the strength of the investment. The current CEO of La Quinta, Keith Cline, has chosen to move to the real estate portion of the business. In addition, Blackstone has a 30% stake in La Quinta and has supported past expansion, the IPO, and in 2017, the sale of its real estate assets.

Key Risks and Considerations

1. Macroeconomic risk: As interest yields increase, REITs, which have bond-like return characteristics, may become more unattractive. In addition, recessionary pressures heavily impact the leisure industry.
2. Business fundamentals: With lower FFO conversion and operating margins, CPLG seems more unattractive than other public lodging REITs operating in the upper scale space. If CPLG has inherently worse business fundamentals, it will not deserve to trade at the median industry multiples.
3. Catalysts: With recent high profile acquisitions in the space (FelCor bidding war, PK, and Blackstone's LaSalle acquisitions), the depressed share price, as well as taxable nature of the spinoff, we believe that there is a significant probability of a near term acquisition. However, if this does not happen, there may not be reliable catalysts for CPLG to realize its intrinsic value.

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Decision: NO PURCHASE

Special Situations Investment Committee Representative: Anlei Tang

The Special Situations Sector pitched CPLG on Wednesday, May 2, 2018 in General Meeting as a BUY. The Investment Committee (ICOMM) decided to not purchase CPLG but will monitor it until after the spinoff. Our reasons are as follows:

FIRST: We do not find the midscale lodging segment particularly attractive. Currently, CorePoint operates at an EBITDA margin of 24.5% and a RevPAR (revenue per available room) of $60 vs upper-end to select service competitors who operate at EBITDA margins of 30% and RevPAR in excess of $100. This is significant when considering the sensitivity of the valuation: a 4% decrease in AFFO margins erases the upside on the valuation. Additionally, we do not agree with the sector's opinion that the business is recession resistant. We concede there will be some luxury and high-end lodging customers who switch to midscale, but we do not believe this is significant enough to offset overall industry declines. This is particularly important when considering CorePoint's high operating leverage which would lead a top-line slump to heavily impact overall earnings.

SECOND: We believe that CorePoint is currently fairly priced. The company trades at an EV/EBITDA multiple of 9.2x and a P/FFO multiple of 6.5x. The sector argued that when compared to comparable medians of 13.2x and 11.5x respectively, CorePoint is trading at a discount. However, due to the industry's heavy maintenance capex requirements, we believe that AFFO is the most appropriate metric from which to evaluate the company. CorePoint trades at a 10.4x P/AFFO multiple versus a comparable median of 12.1x, which is a much smaller discount and explained by the company's significantly higher maintenance capex requirements (9% of revenue vs. 3-5% for comparables) and poorer business fundamentals. We also do not see an obvious catalyst for this investment. The sector stated that a potential acquisition is likely. However, the current appetite for REIT M&A is focused on the luxury and upscale lodging segment, such as LaSalle Properties or FelCor.

THIRD: However, we do agree with the sector that there are attractive characteristics around this spinoff including its taxable nature and the old management moving to the new company. CorePoint is set to spinoff from La Quinta on 5/31 and we will continue to monitor its post-spinoff movement to see if an opportunity for a more attractive entry-price presents itself.

UPDATE (6/11): Post-spinoff, we see no meaningful decline in CPLG's market valuation. Given this, the ICOMM has decided to not purchase CPLG.

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Booking Holdings, Inc. (NASDAQ: BKNG)

Consumer Sector Leader: Melaina Rapisarda

Company Overview

BKNG is the world's largest global online travel company, operating under the brands Booking.com, Priceline, KAYAK, agoda.com, and OpenTable. The company has three primary revenue streams: agency profit (74%), merchant profit (19%), and advertising profit (7%). The company derives revenue from Europe (59%), Asia (21%), North America (10%), LATAM (4%), Africa (3%), and Australia (2%).

Investment Thesis

Our BUY recommendation can be broken down into three key value drivers:

1. Sustainable competitive advantages yield superior financial performance: BKNG outperforms its key competitors in nearly all relevant financial performance metrics by harnessing three key competitive advantages: a superior cost structure, economies of scale, and disciplined management. First, nearly all of BKNG's revenue is driven from the agency model, as opposed to the merchant model that most of its competitors use to drive revenue. In the agency model, hotels decide prices and conditions on the platform, and OTAs make commissions on every sale at customer check-in. This is advantageous since there is no cost of inventory on sales and BKNG does not have the risk of unsold inventory. Additionally, this model is preferred by hotels and customers and is more flexible when scaling up the business. Second, given BKNG's high operating leverage, the company is poised to benefit from rapid global expansion and the network effect, especially with a business model demanding virtually no COGS. Finally, we believe that management's consistent earnings beats (100% in past year) as well as effective management of capital (significant cash balance) differentiate BKNG from its competitors. Despite these competitive advantages, BKNG trades at a discount to its peers on a forward P/E and EV/EBITDA basis.

2. Unique brand strategy positioned to capture global market share in Europe and China: BKNG's unique strategy of investing in China allows the company to capture favorable Chinese market growth. BKNG has continued to invest in CTRIP, China's leading OTA, allowing it to cross-promote accommodation inventories. BKNG holds about $1.5B in CTRIP convertible notes, as well as $655M ADSs, which imply a holding of approximately 15% of CTRIP's outstanding equity. In Europe where BKNG is the dominant player, the company is poised to benefit from the "winner-takes-all" market. Since the European market primarily consists of small boutique hotels with limited marketing budgets, hotels are reliant on OTAs like BKNG to attract customers. This means the top OTA in the market attracts more hoteliers, creates better selection, and reinforces the platform as the top destination for travelers. Given BKNG's unique positioning, we expect the company to continue to capture greater market share.

3. Underappreciated alternative inventory system: BKNG currently has ~5M listings in its alternative accommodation segment (greater than Airbnb's ~4.85M). Unlike other competitors that made large investments in the space, BKNG integrated its listings with its existing website at little additional cost. Given that online penetration for alternative accommodations is estimated at 10%, we expect this to be a major area of growth for BKNG moving forward.

Key Risks and Considerations:

1. Google's advertising threat: Google's meta-search allows larger hotel chains and some independents to directly market to consumers, which could lead to greater price competition and necessitate higher advertising spend. Google might also enter the OTA market itself, but we don't believe this is likely since the OTA industry is its largest source of advertising revenue.

2. Business cyclicality: If another recession occurred, the OTA market might be hit by a decrease in consumer spending. However, in 2008, BKNG saw an increase in revenue, operating margin, and FCF growth due to the increased ad spending of hoteliers to help fill their empty rooms at a discount.

3. Increased competition in China: If the market becomes more competitive, CTRIP could lose market share and make BKNG's exposure to China soley dependent on its Agoda platform.

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Decision: NO PURCHASE

Consumer Investment Committee Representative: Katherine Gerdes

The Consumer Sector pitched Booking Holdings, Inc. (BKNG) on Wednesday, May 9, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase BKNG. Our reasons are as follows:

FIRST: Although BKNG has been able to grow rapidly over the past five years (revenue CAGR of 15.8% while maintaining a steady, above industry average operating margin of 34%), we are concerned about the sustainability of this growth into the future. We are concerned that the OTA market is becoming saturated in the United States and Europe, the geographies in which BKNG conducts most of its business. Therefore, future growth for BKNG is highly reliant on the performance of Asia (which we estimate accounts for 21% of revenue) and South America, Africa, and Australia (which we estimate collectively comprise 9% of revenue). We are unconvinced that these geographies can achieve enough growth to offset possible stagnation in the United States and Europe. Furthermore, given the relatively small size of BKNG's stake in CTRIP relative to BKNG's overall enterprise value, we don't believe that even spectacular performance of CTRIP in Asia would materially affect BKNG's value and therefore don't see the CTRIP stake as a meaningful way for the company to capture growth in the Asian market.

SECOND: Another concern we have is that BKNG's margins may deteriorate if the company's advertising spend becomes less efficient and customer acquisition costs rise. This is likely to happen as the United States and Europe reach saturation and competition for market share intensifies. Therefore, while BKNG's margins have been substantially superior to those of competitors such as Expedia and TripAdvisor in the past, we are unsure if BKNG's superior profitability can continue into the future. If margins compress due to an intensification in competition, we expect a contraction in BKNG's multiple.

THIRD: We believe BKNG's valuation is not currently attractive enough for us to buy. In order for us to earn an annualized return of 13%, BKNG would need to grow revenue at a CAGR of 11.4% over the next five years. It is clear that the market is already pricing in substantial growth, and we cannot adequately justify assumptions of higher growth.
Since we never want to invest at a price that requires a company to perform perfectly for us to achieve an attractive return, we do not believe that BKNG presents a sufficient margin of safety to invest.

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Laboratory Corporation of America Holdings (NYSE: LH)

Healthcare Sector Leader: Matene Alikhani

Company Overview

Laboratory Corporation of America (LabCorp or LH) is a medical diagnostics and contract research company. The company is divided into LabCorp Diagnostics (LCD), its core diagnostics business, and Covance Drug Development (CDD), its contract research organization (CRO) that was acquired in 2015 for $5.7bn. LH receives 70% of revenue from LCD, which competes in a mature oligopoly, and 30% from CDD, which operates in a growing and fragmented industry.

Investment Thesis

The Healthcare Sector recommends a BUY in LH for the following reasons:

1. Core diagnostic strength: Laboratory diagnostics are a low-margin, high volume industry that necessitate significant economies of scale. LabCorp and Quest Diagnostics are the largest players in the industry and grow through the acquisition of smaller, primarily hospital-based laboratories. The recent PAMA cuts, which decrease Medicare reimbursement rates for diagnostic testing, dramatically lowered industry revenue. Most affected are hospital-based laboratories, which receive a significant portion of revenue from Medicare covered patients. The financial distress of these laboratories has actually increased the potential for LabCorp and Quest to make attractive acquisitions. In the scenario that the cuts are repealed, the two stand to grow revenue alongside growth already received from acquisitions.
2. Business synergies: With 30 years of diagnostic results, LabCorp possesses over 30 billion test results that can be utilized by CDD to run more efficient and cost-effective patient tests. For a global CRO, running efficient trials worldwide is a key appeal to pharmaceutical and biotechnology companies. In addition, LabCorp's central laboratory capabilities are a key competitive advantage. LabCorp owns 18 ISO-15189 standard laboratories in total, five of which are utilized by CDD and make it the only CRO to use the standard. The ability to use internal laboratory capabilities is important for CDD since it is both cost-effective and helps LabCorp build a more comprehensive database for clients.
3. Patent cliff: Between 2017 and 2022, $194bn in drug sales are expected to expire. The impending patent cliff and potential cut in R&D expenditures is a significant risk for drug development companies. However, we believe that the looming patent cliff will drive pharmaceutical and biotechnology companies towards CROs like CDD. Even if total R&D expenditure remains static or decreases slightly, the percent of R&D expenditures allocated to CROs is expected to increase.
4. CRO diversification: The diagnostic industry is a saturated market, with organic growth in the low single digits. As a result, diagnostic companies seek artificial growth through acquisition of small laboratories. CROs, in contrast, operate in a high growth industry. With this growth comes increased risk, especially as CROs are often reliant on a few major accounts. We believe that LabCorp's diverse business lines provide future growth while mitigating risk.

Key Risks and Considerations

1. Volume testing dangers: In order to improve data aggregation and create synergies with CDD, LabCorp has focused on increasing the volume of tests. This creates the opportunity for specialized diagnostics companies to step in and provide more niche testing as larger players focus on volume in core testing areas.
2. Patent cliff: While we expect CRO revenues to increase as a result of the patent cliff, there is a marked risk that pharmaceutical companies are significantly impacted by expiring drugs and, as a result, decrease CRO expenditures. This is especially a risk for companies like Eli Lilly, which will experience $2bn in expirations within this patent cliff
3. CMS/PAMA reimbursement rates: Reduction in reimbursement payments for diagnostic testing will cause a significant revenue loss. While we believe that revenue loss will be made up for by growth prospects, this revenue loss does represent a risk to the value of LabCorp's diagnostic business, and will need to be made up for by short-term CDD growth.

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Decision: NO PURCHASE

Healthcare Investment Committee Representative: Sam Zager

The Healthcare Sector pitched Laboratory Corporation of America Holdings (LH) on Wednesday, May 16th, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase LH. Our reasons are as follows:

FIRST: We are concerned about LH's prospects in the face of intense regulatory headwinds in its LCD segment, which accounts for 70% of total revenue. While the PAMA reimbursement schedule cuts may create attractive acquisition targets for LH by rendering small laboratories unable to compete, the cuts obviously adversely impact LCD revenue as well. The sector argued that Medicare reimbursements account for only a small portion of LCD revenue, but we believe that the PAMA cuts will indirectly affect a much larger portion of LCD revenue due to the role that the Medicare reimbursement schedule plays in pricing diagnostic tests across the industry. Many private contracts are indexed to Medicare reimbursement rates, including UnitedHealthcare's sizable contract with LCD that expires later this year. As that contract and others come up for potential renewal, we see a significant risk of large pricing cuts (potentially as large as the cumulative ~30% cuts to the PAMA schedule) which would lead to a massive decline in total revenue.

SECOND: While the sector's argument that the industry-wide distress created by the PAMA cuts creates attractive acquisition opportunities for LH is certainly plausible, we can find little information on the company's acquisitions. Given that artificial growth is often unattractive with respect to its returns on capital, we would need to understand the kinds of multiples that the company is paying for its acquisitions and the types of costs that can be cut when LH does acquire a smaller laboratory. Since none of this information is public, we cannot verify that LH is making prudent acquisitions and as a result cannot be sure that its growth, which is entirely artificial at this point, won't destroy more stakeholder value than it creates.

THIRD: Since 2013, LH's ROIC has declined from approximately 12-14% to 7% in the most recent fiscal year, with margins contracting in the same timeframe. Given the sector's calculated WACC of 7%, we find this decrease concerning. With continuing declines in ROIC, margins, and revenue a very possible scenario and significant regulatory uncertainty, we don't believe that LH's current valuation of 15x forward earnings is an attractive entry price to currently invest.

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Momo, Inc. (NASDAQ: MOMO)

Tech, Media, and Telecom Sector Leader: Henry Gao

Company Overview

Momo is a social platform business that aims to connect strangers through interactive offerings, such as location-based services, live video streaming, dating, group games and others. The company went public in 2005 and operates the largest platform of its kind, primarily in China, with about 100 million monthly active users (MAU) growing at 22% annually. Momo monetizes its platform through basic and premium memberships, virtual gifts, in-game purchases and advertisement. The company is already cash flow positive and is still rapidly growing with LTM revenue of $1.3 billion at a 138% CAGR.

Investment Thesis

The Tech, Media & Telecom sector recommends a BUY in MOMO for the following reasons:

1. Attractive network business model: Momo's business model has a strong multi-way network effect among its users. Within the Live Video Streaming (LVS) segment, viewers and broadcasters generate a powerful network effect where more broadcasters attracts more viewers and spending, and vice versa. The value of this virtuous cycle is captured by Virtual Gifts, which viewers use to gift to their favorite broadcasters or compete against other viewers. Although LVS currently accounts for 80% of total revenue, Momo's other offerings complement LVS and enhance the network effect.
2. Dominant position with minimal direct competition: The LVS industry primarily competes on differentiated content offerings. Momo differentiates itself by emphasizing casual lifestyle streaming. Most of its competitors, such as YY.com and Douyu, focus almost exclusively on structured programming focused on video games, singing competitions, and sports. Momo also has the largest user base of 99M MAU, 30% more than its biggest competitor YY.com. It is better positioned for monetization since most competitors rely on "Talent Guilds" which recruit broadcasters and erode platforms' bargaining power. Not only are the number of paying users increasing across the industry, Momo's ARPU has also consistently increased while competitors' ARPU has declined. Lastly, while most competitors are pure live streaming and entertainment businesses, Momo uses live streaming as a monetization strategy to augment its core social platform.
3. Multi-directional growth potential: Momo can grow its business in multiple directions effectively by expanding into new business segments, improving user engagement, and augmenting its user base. The unique socioeconomic environment in China, including the former One Child Policy, waves of migrant workers, asymmetric population density, and systemic gender imbalance, allow Momo to strengthen its existing core segments while aggressively expanding into the dating industry. Momo has its legacy dating service named Diandian, but recently made a $735M bargain acquisition of Tantan which cemented Momo's monopoly position in the Chinese mobile dating market. Momo can simultaneously expect organic expansion in its user base from a continued increase in internet and mobile penetration in China.
4. Unique position in the long-term competitive landscape: Momo would inevitably face the threat of established Chinese internet giants in the long run, but it is perfectly positioned to thrive and co-exist with other existing social platforms, such as WeChat and Weibo. Momo's platform materializes a network for "Stranger Relationships" which have a natural degree of separation from the other networks. While Alibaba and Tencent arguably dominate the business and personal networks, we believe that Momo operates in a distinct market and will continue to thrive as the dominant player.

Key Risks and Considerations

1. Government crackdown: In 2017, a large-scale government crackdown occurred against the live streaming industry in which hundreds of mobile applications and thousands of related entertainment studios were punished (although Momo was not one of them). Momo has historically been the target of regulatory scrutiny and if it cannot effectively monitor its content it may face the risk of heavy-handed government intervention.
2. Reliance on live streaming revenue: Momo has been increasingly reliant on live streaming revenue, with the live streaming segment comprising 85% of total revenue in the most recent year. If live video streaming and virtual gifts are merely a fad and Momo is unable to find other ways to monetize effectively, it will likely see a precipitous drop in revenue. Additionally, Momo has advertisement monetization that is below industry standards and has not yet monetized its dating segment.

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Decision: NO PURCHASE

Tech, Media, and Telecom Investment Committee Representative: Nick Nigro

The Tech, Media and Telecom sector pitched Momo, Inc. (MOMO) on Wednesday, May 16, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided not to purchase MOMO. Our reasons are as follows:

FIRST: We agree with the sector that Momo operates a network with attractive competitive dynamics in an industry which is likely to continue growing rapidly. We believe that there is a meaningful niche to be filled in operating a network which connects strangers to each other—as opposed to one which connects a user to his or her friends or to businesses—and we believe that Momo's position in this niche will help protect it from future competition from companies like Tencent or Alibaba. Moreover, we believe that Momo's presence in this niche helps differentiate its streaming service from those of competitors. Finally, we agree with the sector that demographic trends will lead to continued growth in the number of users using services such as Momo's.

SECOND: Although we believe that Momo operates an attractive network from a competitive standpoint, this network is only valuable to us as investors if Momo is able to effectively monetize it. Currently, ~84% of Momo's revenues are derived from its "Live Video Services" segment, which represents revenue Momo earns when users purchase virtual gifts to send to broadcasters. Momo keeps a percentage of the revenue from each purchased gift (generally around 50%), while the remainder is passed on to the broadcaster to whom the gift was given. Momo has had a strong user base since at least 2013 (when the company first reached 50 million MAUs), yet had for years struggled to effectively monetize this user base. However, since launching Live Video Services in 2015, the company has grown revenue from $134 million (FY 2015) to $1,318 million (FY 2017), with almost all of this growth coming from Live Video Services. We are concerned about the fact that Momo's dominant revenue stream—and the only revenue stream it has demonstrated an ability to grow meaningfully—essentially comes from commissions on donations made through Momo's service. Although monetizing through the sale of virtual items is certainly a better-established business model in China than in the U.S. (see Tencent), it is unclear to us whether Momo's specific implementation of this—taking an approximately 50% commission on donations to random broadcasters—is a sustainable business model or simply a fad.

THIRD: We are concerned about Momo's ability to monetize in ways other than Live Video Services. At the moment, Momo's also derives revenue from premium subscriptions to its livestreaming service (~8%), advertising (~6%), and mobile gaming (~3%). Mobile gaming hasn't grown in the past two years, and although we expect premium subscription revenue and advertising revenue to continue to grow steadily as a result of Momo's growing user base and increasing user engagement, we don't expect this growth to compensate for any meaningful decline in Live Video Services revenue. Athough Momo may be able to invent new ways to monetize its network, we are not currently aware of any particularly attractive opportunities. We are bullish on the company's dating properties—Diandian and Tantan—which together constitute a near-monopoly of the Chinese online dating market. However, as neither has yet been monetized, we don't yet have any information on what the economics of these businesses will look like in the long-term.

On the whole, we believe that Momo is an attractive business with substantial upside, but which faces significant idiosyncratic risks in the form of 1) regulation by the Chinese government, and 2) the possibility that its only established means of meaningfully monetizing its network (Live Video Services) may be a fad. As a result, we would only be willing to purchase a position in Momo if we thought the valuation worked even after assuming a significant probability that the company's livestreaming business is worth close to nothing.

At the time of the pitch, Momo was trading at approximately 20x TTM earnings after adjusting for cash and the approximate value of Momo's dating services (which currently contribute nothing to earnings, but which we estimated to be worth at least $735 million, the cost of the Tantan acquisition). Given that Momo had more than doubled revenue in the previous year and operates a business with a meaningful network effect and minimal capital requirements, this valuation suggested that investors were pricing in a significant chance of the company's Live Video Services business being worth close to nothing.

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However, we were uncomfortable purchasing Momo at the time, due to our inability to quantify both the magnitude of the risks facing the company and the potential for upside in the event that things went well.

In the weeks after the pitch, the sector did additional work on the valuation in an attempt to more precisely estimate what was priced in with the regard to the chance that Live Video Services would fail. However, over that same period, the stock appreciated significantly in response to first quarter earnings which showed strong growth in both users and Live Video Services revenues. The stock now trades at approximately 25x TTM earnings (after adjusting for cash and Momo's dating properties in the same manner as above). We believe that this multiple expansion is primarily due to investors discounting a significantly lower chance of the Live Video Services segment failing. As a result of this multiple expansion, we don't believe that the present implied chance of the company's streaming business being worth close to nothing (around 15-30%, depending on how much upside you assume there is) is meaningfully lower than what seems intuitively plausible to us. Consequently, we don't believe that the current price is attractive enough to justify a purchase.

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PRA Group, Inc. (NASDAQ: PRAA)

Financials Sector Leader: David Ozen

Company Overview

PRA Group is a consumer debt collection agency that operates mainly in credit card debt. The company purchases non-performing loans from financial institutions at a steep discount to face value and attempts to collect upon the debt. PRA operates in North America and Europe, with revenue almost exclusively coming from collection on debt portfolios acquired.

Investment Thesis

The Financials Sector recommends a buy of PRAA for the following reasons:

1. Duopoly industry structure: The consumer debt collection industry is controlled almost exclusively by PRA and their chief competitor, Encore. These two players have become entrenched and possess a moat that makes the industry almost impenetrable. Small players are unable to enter into the industry due to the capital constraints required to be a player. The debt portfolios that PRA and Encore acquire have purchase prices ranging from $500K to $200M with an average purchase price in the tens of millions. Even large players with the capital to buy these portfolios usually cannot due to the buying process. To join a debt auction, an investor must pass a stringent bank auditing process that heavily favors established players due to regulation instated in 2014. Finally, even if a new entrant hurtles these two barriers, they must create the infrastructure to collect on the debt. It takes significant logistical expertise to extract returns from these debt portfolios since returns must be generated on the individual level. Historical cases of hedge funds and private equity firms leaving the consumer debt industry due to the difficulty of generating returns outside of their core competency corroborate this claim.
2. Superior performance to only competitor: Between the two industry leaders, PRA has historically outperformed Encore. PRA has two main operational differences that causes outperformance: exclusively in-house collections and a more diverse portfolio. PRA has been able to leverage data from years of collections to better inform their debt portfolio purchases. Additionally, PRA has a significantly more diverse portfolio than Encore which helps PRA outperform throughout various market conditions. PRA acquires insolvency debt which has a more consistent and safe payment schedule whereas Encore does not. The differences in strategies have had a clear end result: PRA has consistently outperformed Encore with respect to their ROICs and cash margins.
3. Cyclical trough: Continued softness in the debt collection industry is reflective of the industry's natural trough. The industry follows a counter-cyclical trend with a delay: debt collection agencies perform best the two to four years following a recession. During a recession, more debt defaults or becomes non-performing. This increased supply drives down prices and allows debt collection agencies to purchase a significant amount of debt at fire sale prices. The collection agencies then collect upon this debt when the economy improves and collection rates increase. Since it has been nine years since the last recession, purchasing opportunities have stagnated, evidenced by extremely low net charge offs and delinquency rates. However, given that outstanding consumer credit card debt now surpasses 2008 levels, the next recession will prove very fruitful for PRA. With PRA trading at an unprecedentedly low multiple on its book value, we believe that now is the best time to invest.

Key Risks and Considerations

1. Unpredictable regulation and changes in the European market: The terrible reputation of the industry makes it a frequent target for regulation. Significant banking regulation in 2014 on selling debt and the creation of the Consumer Financial Protection Bureau reshaped the industry. Europe is also a very young market with many competitors, including "mom and pop" shops that can enter and compete in debt buying panels alongside massive players like PRA. It is unknown how the regulatory environment will change and how the European market will mature.
2. PRA is especially dependent on the greater economy: PRA depends on defaulted debt and as a result thrives in a recessionary and immediately post-recession environment. Consequently, PRA's profitability could decrease as the economy maintains its strength. However, we believe this is mitigated by the results of our zero-growth model, which projects a 19% downside if PRA was to exclusively collect on their current debt portfolio.

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Decision: BUY

Financials Investment Committee Representative: Abhimanyu Sharma

The Financials Sector pitched The PRA Group (NASDAQ: PRAA) on May 23, 2018 in General Meeting as a Buy. The Investment Committee (ICOMM) decided to follow the recommendation and purchase PRA at a 5% position. We believe PRA is attractive for the following reasons:

1. Oligopolistic industry with high margins and barriers to entry**:** We agree with the sector that PRAA competes in an oligopoly with significant barriers to entry, which makes it fundamentally profitable in nature. While we are less sure about the strength of capital requirements as a barrier to entry, the sharp drop in the average number of debt panel participants from around 40-50 prior to the Great Recession to around 4 currently is confirmation that the market has grown markedly less competitive. New regulations favor already established players, allowing PRAA to garner higher market and negotiating power. These fundamental dynamics are reflected in its favorable ratio of total collections over purchase price, which reached a high of 368% for debt purchased in 2008-09 and has ranged from approximately 200% to 350% over the past decade. PRAA's high cash margins and ability to reinvest substantially all earnings, especially during a recession, make it attractive in all business environments.
2. Consistently attractive returns on capital, even at cyclical trough: PRAA's superior financial results, especially relative to Encore, reinforce our view of its fundamentally strong positioning. Historically, PRA has managed to deliver ROICs of 11+% (vs. Encore's ~8%) and cash margins of 60% (vs. Encore's ~45%). We agree with the sector that these superior results are a function of PRAA's operational structure and negotiating power. For instance, PRAA utilizes in-house collection methods through owned call centers (as opposed to third-party collectors) which allow it to use the data collected to optimize collection practices since the company can predict which accounts are worth expending time on and how to collect cost-effectively and strategically. This data provide a competitive advantage that would take both significant capital investment and a long period of time to replicate.
3. Highly conservative valuation: We find the sector's zero-growth model compelling. PRAA has historically been very accurate, if even a little conservative, in estimating its total collections. Using the sector's model of $5.8B in estimated remaining collections (disclosed by the company) on the existing portfolio apportioned over the next 8 years using PRAA's typical collection schedule and adjusted by a 60% cash margin plus interest expense, we reach an equity value just 19% less than the company's current market capitalization. Given that PRAA has historically reinvested all its earnings into its business, we find this valuation extremely conservative and are comfortable investing in the current moment. If the economy turns for the worse (a growing possibility given increasing net charge offs of consumer credit), we expect the company and our investment to perform very well.

Key Risks and Considerations:

1. Transfers from core to insolvency portfolio: PRAA's insolvency portfolios, which include consumer debt in or post-bankruptcy process, generate an approximately 50% lower ROI than its core portfolios in both the Americas and Europe. While debt in the insolvency portfolios have some advantages such as a fixed payment schedule if a bankruptcy process is concluded, we consider them much less attractive and are encouraged that they currently comprise less than 20% of PRAA's overall receivables. However, if a material amount of core debt is converted to insolvency debt in an economic downturn because of increased bankruptcies, it may weigh down the company's collection returns.
2. Uncertainty surrounding Europe and the threat of changing regulations in the U.S.: While PRA is well-diversified, regulations in Europe are conducive to more players, making the market increasingly more competitive. This was less of a concern previously when the company almost exclusively operated in the US, but in the past decade PRAA's exposure to Europe has grown to 40% of the company's balance sheet. With little insight into the agendas of dozens of national legislative bodies, we are unsure how attractive this market will be moving forward. In the US, PRAA's more profitable market, regulation that increased potential liability for sellers of consumer debt decimated competition in debt auctions. If these restrictions are repealed, the landscape may grow significantly more competitive and reduce returns on debt purchased.

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Trinity Industries, Inc. (NYSE: TRN)

Industrials Sector Leader: Richard Archer

Company Overview

Trinity Industries is a diversified industrials company that operates in five key segments: railcar manufacturing, railcar leasing, energy equipment manufacturing, construction products manufacturing, and barge manufacturing. Approximately 65% of revenue comes from railcar related groups, with another 21% from the energy group and 11% from construction products.

Investment Thesis

The Industrials Sector recommends a BUY of TRN for the following reasons:

1. Spinoff focuses management and creates opportunity to invest in attractive segments: Trinity intends to spin off its energy group, barge group, and approximately half of its construction products group, forming a new entity called Arcosa. Trinity's leasing group has demonstrated EBITDA margins of above 40% and 50% in recent years, whereas the barge and energy group show lower and declining margins. Furthermore, Trinity's competitive advantages exist only within its railcar business, as discussed below. We believe that this spinoff represents an opportunity to invest in the rail groups without the drain that the other groups previously represented. We recommend immediately purchasing Trinity and selling the Arcosa shares we will receive as a result of the spin-off.
2. Only leader in both railcar manufacturing and leasing: Railcar manufacturing and railcar leasing are distinct but highly complementary businesses, and Trinity is the only player with meaningful and dominant shares in both areas. We believe that this provides Trinity with a superior position to adapt to shifts in market demand. Trinity can avoid unpredictable secondary markets by immediately manufacturing the railcars necessary for its leasing business.
3. Valuation at cyclical low is attractive: Railcars have useful lives of between forty and fifty years, so historical oversaturation continues to suppress the industry. We anticipate growth in the industry for two key reasons: rebounding oil prices, which stimulates demand for tank cars, and the increase in average fleet age, which indicates that a wave of cars will be retired over the next three to seven years. Using Trinity's average EBITDA over the last five years ($1.21bn) and a multiple of 7.5x, we arrive at an implied price of $38.41; given that this implies that the next cycle will peak only as high as the last, we find this relatively conservative. Given these factors, we believe that this industry's cyclicality has provided an attractive entry point.

Key Risks and Considerations

1. Timing of railcar recovery: As it is necessary for the economy to replace retired railcars, it is very likely that demand for railcar manufacturing and leasing will fully recover on a ten-year time horizon, especially for those designed to transport consumer staples and agricultural products. However, we anticipate the recovery happening sooner, and any delay would hurt our returns.
2. Oil prices: Part of the last upswing in Trinity's revenues was driven by booming oil prices; as pipeline capacity expands, oil becomes less of a significant revenue driver for Trinity. However, because Trinity is the only player with significant positions in both manufacturing and leasing, we believe it is the railcar business best positioned to deal with this change.
3. Price competition: Although Trinity's margins in leasing are well above 40% and it is better able to maneuver due to synergies between its businesses, the railcar industry remains price competitive, and it is possible that cost efficiencies may not remain as robust as they have been historically.

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Decision: BUY

Industrials Investment Committee Representative: Liam Zhao

The Industrials Sector pitched Trinity Industries (NYSE: TRN) on May 23, 2018 in General Meeting as a Buy with a 4% position. The Investment Committee (ICOMM) decided to follow the recommendation but instead purchase TRN with a 6.5% position to target holding a 5% position in its railcar segments after its Q4 spinoff. After further discussion and analysis, we agree with the sector's thesis that Trinity is an industry leader well positioned to capture the industry growth in the next few years, with its current share price suppressed by poor performing non-core segments and the industry cyclical trough. We believe TRN is an attractive investment for our portfolio for the following reasons:

1. Spinoff of non-core segments unlocks shareholder value: Trinity is scheduled to spin-off its non-core segments of Construction, Barge, Energy and Others, which constitute 37% of its revenue as of fiscal year 2017. These businesses are rather commoditized, with much lower margins relatively to its core railcar segments, and Trinity has no competitive advantage in these markets. Spinning off these segments in Q4 2018 will allow Trinity to further focus on its core segments of railcar manufacturing and leasing, and catalyze a revaluation of Trinity's stock. Although there are no specific projections, management has already disclosed their plans to improve margins and further capture railcar market share post spin-off. There have also been significant insider buy-ins since the announcement of this spin-off, in addition to both the CEO and CFO staying with the company, which gives us more confidence in the spin-off situation.
2. Demand rebound generates cyclical growth: The railcar industry is highly cyclical and is currently at its trough, and will most likely experience strong upswing growth in the next three years or so. The railcar industry cycle typically lasts between 5-7 years and the last peak was during Q4 of 2014. Increasing backlogs in the past two quarters also indicate that demand is starting to rebound. Moreover, this cyclical peak has the potential to be higher than the previous one due to oil-driven end demand and retirement of outdated fleet. Specific railcars such as tank cars are mainly used to transport oil, and therefore their demand is highly correlated with the production and transportation of oil. With Permian production expansions reducing pipeline capacity to 160k barrels a day by end of 2017, rail transportation, as a cheaper option than pipeline, has seen strong utilization growth. We expect the trend to continue as production further exceeds pipeline capacity. Furthermore, North America average fleet age is approaching an all-time high of 20 years, which entails growing demand for railcar manufacturing and leasing. Finally, a new safety regulation enacted in 2017 requires upgrades for existing warehouse tank cars, which means that most crude oil and ethanol transportation tank cars will need to be phased out within the next five years. As a result, we expect to see more production and leasing demand for these regulated tank cars.
3. Best positioned player trading at reasonable valuation: Trinity's unique integrated structure of both manufacturing and leasing railcars enables it to best capture growth and navigate changing trends within the industry. The market has experienced an increasing switch from owning railcars to leasing them due to the lower costs and increased flexibility associated with leasing. As the only major player in both railcar manufacturing and leasing sectors, Trinity is best positioned to match the changing market demand. Importantly, the company is also cheap on a cyclically-adjusted basis, trading at a discount to a mid-cycle multiple of 7.5x on average mid-cycle earnings of $1.21 billion. This valuation outcome accounts for no additional earnings growth over last cycle. Thus, we believe there is potential for upside in our valuation due to improvement in margins and increases in market share made possible by the spin-off. Furthermore, additional end-market demand driven by more oil transportation and retirement of aging existing railcars (along with the new regulation of rail tank cars), will also generate a higher upside.

Key Risks and Considerations

1. Uncertainty of timing of demand rebound: A key part of our thesis relies on the fact that the rail car industry is at a cyclical trough and will experience favorable growth in the next few years. The strength of the thesis depends on how quickly demand will rebound. The sector argued that demand should grow again by 2019, but if industry growth rebounds slower or worse, if the next cyclical peak is much lower than the prior one (although unlikely), then the intrinsic value of the company might be much lower than we expect.

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2. Pricing pressure could negatively impact profits: As evident from the past, margins tend to fluctuate through cycles, and pricing pressures during the industry upswing could be tough on the bottom-line. Moreover, we do not have detailed information or projections of pricing going forward, and none of the major players (including Trinity) have strong pricing powers over customers. However, compared to its competitors, Trinity is more vertically integrated and has better control over its manufacturing costs, which mitigates the impact of pricing on profits to some extent.
3. Performance of non-rail segments prior to spinoff: Since we are buying TRN before its scheduled Q4 spin-off rather than after, we bear the risk of a potential poor performance from the non-rail segments of Trinity (Inland Barge Group, Energy Equipment Group and Construction Products Group). Unimpressive bottom-line results from these segments might cause the market to undervalue Trinity and lead to a drop in stock price. Nevertheless, given the limited holding period before spin-off and the fact that these commoditized industries are already likely being priced in at low multiples, we do not see this as a significant concern.

Taking into consideration of all the points above, we will continue to monitor the industry growth closely, focusing on the top-line and pricing trends before and after the spin-off. In addition, we will pay particular attention to the performance of the rail groups shortly after the spinoff. Since the spinoff is scheduled for Q4 2018 and much of the cyclical growth is expected to begin in 2019, we will soon know if our thesis is correct and how quickly our investment will be realized.

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Other Investments

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Warrior Met Coal (NYSE: HCC)

Natural Resources Investment Committee Representative: Bruce Li

The Natural Resources Sector pitched Warrior Met Coal (HCC) on March 7, 2018 in General Meeting as a Buy. Upon review, the Investment Committee (ICOMM) decided to follow the sector's recommendation and purchase the stock for a 3% position in the portfolio. We concur with the analysis and discussion completed in the Winter 2018 Investor Letter, which we summarize and expand upon below.

FIRST: We agree with the sector's assessment of HCC as a best-in-class met coal producer, which positions it to succeed within the long-term met coal price forecasts of $130/mt. HCC produces a unique low volatility formulation of hard coking coal, which is best suited for steel production and commands a consistent price premium. HCC was also successfully in using its bankruptcy to renegotiate and variabilize much of its costs, including its transportation and labor agreements. These two points enable strong FCF generation at a low cash tax rate due to the company's NOLs, leading to compelling shareholder returns.

SECOND: We find HCC's current valuation to be attractive due to a 25% FCF yield and the undervaluation of Walter Energy's (the predecessor company) mines in the Section 363 auction that formed the company since the restructuring occurred in a met coal price trough. Additionally, the $2B of NOLs lock in ex-creditors, now shareholders, since major share sales would invalidate the NOLs.

THIRD: Our favorable view of the company was previously tempered by continued uncertainty surrounding competing blast oxygen furnace (BOF) and electric arc furnace (EAF) steel production methods and their effect on met coal demand. Post review, we conclude that BOFs, which use met coal, will continue to play a key role in global steelmaking within our investment horizon. We acknowledge increased investment in EAFs globally but believe that those furnaces will not impact met coal demand long enough to jeopardize our investment thesis. In addition, we are encouraged by Asian steel producers seeking to diversify their coal reliance away from Australian production, which pairs with HCC's push to increase its own Asian exposure through its Xcoal partnership. Finally, we observe increasing industry production costs from reduced capex, which better positions HCC as a lower-cost producer amongst its competitors.

FOURTH: Recent coal asset sales, including the Hail Creek, Valeria and Kestrel mine sales, have implied optimism in future coal prices. Rio Tinto divested several mines to concentrate on other commodities, with the sales generating significant bidder interest and attractive sale prices. While there is risk that these buyers overpaid, we view the ultimate buyers (Glencore, EMR Capital, and Adaro Energy) as generally savvy capital allocators. We also note that an attempted sale by Anglo American for its Moranbah and Grosvenor coking coal mines in Australia led to an initial bid of $1.5B, which was soon increased to $2B, before being rejected by the board. Based on our analysis, these transaction prices imply a long-term met coal price of $130-$170/mt, substantially above HCC's cost of production, which we calculate to be around $100/mt.

FIFTH: We have a favorable outlook on the company's management and shareholder-friendly policies. HCC's CEO, Walter Scheller, was instrumental in leading the company through bankruptcy. From sampling large met coal producers' public statements, we believe that the industry favors returning cash to shareholders over increasing capex. Based off of the HCC's statements and dividend history, we predict that HCC will continue to follow this trend.

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Exited Positions

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Sold American Express (NYSE: AXP) for $101.97

Bought at $77.25 (32% total gain; 8.7% CAGR)

We purchased AXP in early 2015 under the belief that the company would expand growth through small-business initiatives and international partnerships. In the intervening time period, our thesis has largely been broken. The company's most attractive customer base, high-spend consumers, are already saturated by American Express cards and have contributed little to revenue growth. We are also skeptical of AXP's initiatives to reach lower-spend consumers, given that the company's business model has historically focused on generating a large amount of revenue from a small card base. Visa and MasterCard, which have several times as many cards in service and benefit from their scale, have business models that are much more complementary for this market, and we do not expect AXP to be successful in gaining market share. Finally, AXP has been essentially unsuccessful in penetrating international markets. The original thesis highlighted a partnership with UnionPay in China as a potential avenue for growth, but the venture has been one-sided, allowing UnionPay to take most of the profit and creating limited exposure for AXP in the market. Overall, we see few avenues for growth moving forward, and based on a P/E of 30x trailing earnings and our own valuation, believe that the market is pricing in future growth that we cannot justify.

Sold Barnes and Noble Education (NYSE: BNED) for $6.60

Bought at $10.09 (35% total loss; -27% CAGR)

Our initial thesis assessed the spinoff of Barnes and Noble's education segment as an opportunity to invest into a highly attractive business that benefitted from local monopolies on college campuses and sold compellingly differentiated products. We believed that the combination of these two unique factors would allow BNED to avoid the pressure facing the rest of brick and mortar retail. Since our investment, however, same store sales have substantially declined, decreasing 3% in FY17 and 4.7% through Q318. The company's ROIC has dropped to a dismal 4.9%. We are also concerned about BNED's new focus on online textbooks, where it would need to outcompete established names like Amazon to succeed. With a broken thesis and no end in sight to the deterioration of company fundamentals, we believe it's high time to exit the investment.

Sold Praxair (NYSE: PX) for $162.00

Bought at $12.51 (26% total gain, 5.6% CAGR)

We bought PX in 2013 emphasizing the company's competitive advantages in scale and distribution as well as an extensive growth runway. Five years later, we still believe that the business is very attractive but cannot justify the 35x earnings multiple the stock now trades at in anticipation of the company's planned merger with Linde AG. While the two companies will end up controlling half of industrial gas production in an industry that rewards scale, they face many regulatory hurdles and the challenge of integrating two massive companies. Given that the market clearly prices in significant synergies that we are less sure about, we believe that our investment thesis has essentially played out and now is an appropriate time to sell.

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Portfolio Weightings

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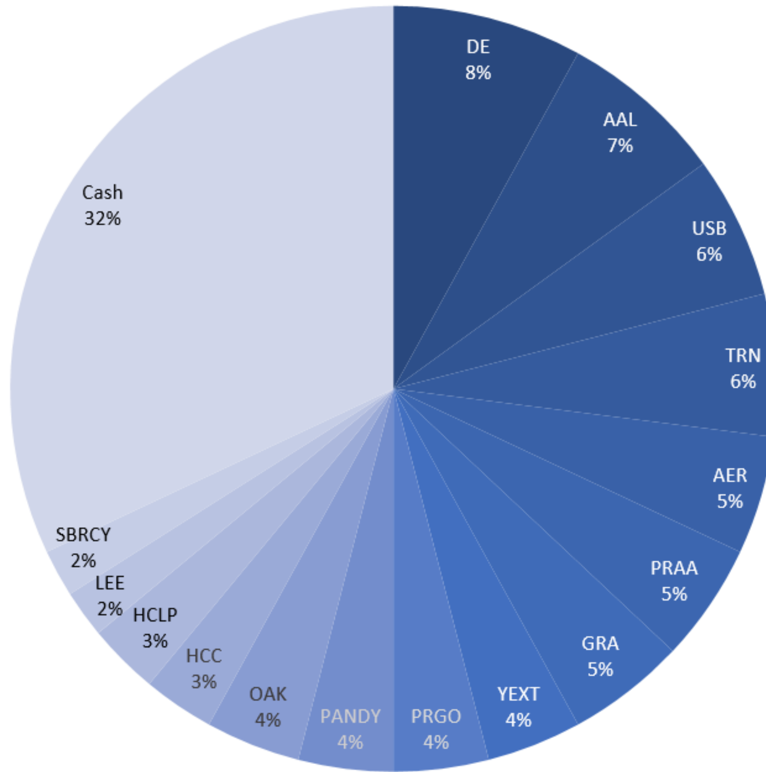

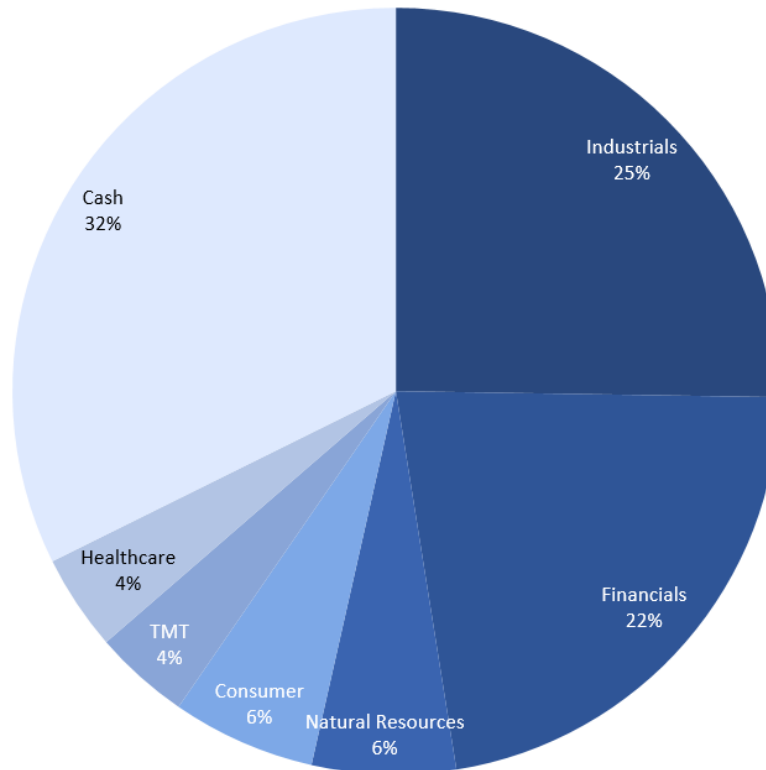

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