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ValueInvestor INSIGHT

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Enduring Strength

It's often how they interpret information that sets investors apart. On that score, Chris Mittleman's interpretation skills have so far proven world-class.

INVESTOR INSIGHT

Chris Mittleman
Mittleman Investment Management

Investment Focus: Seeks companies with enduring franchises when the market's overreaction to macro or company-specific adversity creates a "valuation aberration."

Don't expect Chris Mittleman to beat his chest over his enviable investment record. "You really have to ban emotion from your process," he says. "It's not a game where you win and you cheer and you lose and you sulk. Either of those can lead you to do things you otherwise wouldn't."

Keeping an even keel has certainly worked out well for him so far: Mittleman Investment Management has earned a net annualized 23.0% return since the beginning of 2003 through August 31st of this year, vs. 11.5% for the Russell 2000 index.

Recently finding a number of ideas in which to put cash to work, Mittleman sees opportunity in such areas as lotteries, Asian holding companies, Russian energy and mass-market cosmetics. See page 10

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INVESTMENT HIGHLIGHTS

Investor Insight: Chris Mittleman

Chris Mittleman of Mittleman Investment Management explains how he assesses business durability, the off-the-beaten-path places he's putting his dwindling cash balance to work, why a common value-investor misstep doesn't bother him much any more, and why he sees mispriced value in GTECH, Jardine Strategic, First Pacific, Gazprom and Revlon.

You speak often of companies needing to meet your criteria for investment. Describe those criteria.

Chris Mittleman: We're looking for businesses where, based on an extended history of economic performance, we can make reasonably comfortable bets on what the next five or ten years will look like. That means they have defensible business models that generate free cash flow and are usually run by highly capable managers with great track records. Most important, however, every single investment we've made has been one based on a valuation aberration. We expect our businesses to grow over time and that we'll benefit from that, but that's not the driving force. It's all about trying to find something at an extreme undervaluation.

Breaking those criteria down a bit, how do you judge business durability?

CM: Much of it has to do with how the business has performed in the past, so we're focusing on companies that have endured harsh environments. Our performance was terrible in 2008, but what wasn't affected were the cash flows of most of the businesses we owned. For two-thirds of them, cash flows were steady or actually grew through the Great Recession. Carmike Cinemas' [CKEC] stock, which we still own, went from $10 to $1, but its movie-theater business barely flinched. Virgin Media, a U.K. cable-TV operator [since acquired by Liberty Global], saw EBITDA and free cash flow grow during that period. We think our portfolio rebounded so quickly after 2008 in large part due to the resilience of the companies we owned.

There are some types of businesses we avoid. Those that compete based on fast-shifting technology, which can turn a winning company into a troubled one relatively quickly, keep us away. We avoid companies with consistently heavy capital spending demands that limit free cash flow availability. We shy away from most fashion-sensitive businesses, including retail. Finally, we avoid severely cyclical businesses that burn cash during bad times. I recognize you can make a lot of money in industries like airlines or auto manufacturers if you time the cycle right, but I'd rather not bet on our ability to do that. We find plenty of great values in businesses that don't go into cash-burn mode every time there's a recession.

ON CYCLES:

You can make money in certain industries if you time the cycle right, but I'd rather not bet on our ability to do that.

How do you handicap management?

CM: People ask why we don't fly around the world to meet with managements and the reason is that I think you can glean all you need to know from what they say and do publicly. How do they describe the dynamics of their industry and where they're focused in it? How do they answer questions on conference calls? Do they over time articulate what they're going to do and why, and then do it?

A lot of it, of course, is how they've performed. One of our most recent purchases is holding company Jardine Strategic [JS:SP], the assets of which have been controlled and run by the Keswick family out of Hong Kong for decades. Over the past 15 years it has produced a compound annual total return of 23%. We're not counting on them doing the same over the next 15 years, but that record gives some confidence that NAV can continue to grow at a respectable rate.

Another of our recent buys is Pacific Rubiales [PRE:CN], the largest independent oil and gas company in Colombia. Energy is a cyclical business that can burn cash in bad times, but we're willing to buy when there's a reserve base behind the current income of a company that you're getting cheaply enough to provide a backstop against permanent capital loss. On top of that with Pacific Rubiales is that you have management with an astonishing record since it took over in 2008, taking the company's EBITDA from $38 million in 2007 to an estimated $3.1 billion in 2014. The stock is under pressure due to fears that the company might lose its right to drill at its largest oil field in Colombia in mid-2016, but even if that happens management says it can offset that lost production out of existing and acquired reserves. When the stock in January got down to around 3x EV/EBITDA, we were willing to give them the benefit of the doubt.

What qualifies as a valuation aberration?

CM: We try to appraise every company in a way that reflects its private market value in a sale today. That involves applying target multiples of total enterprise value to current EBITDA and market value to current free cash flow. The multiples are based on where the company has traded, where comps trade, and where comparable private-market transactions have occurred. That gives you a range of fair values and we usually pick a point near the middle of that range. Appraising fair value is the most important thing we do and it's been something we've gotten right much more often than not.

The differential between price and fair value that we'll accept will vary, based on the volatility and quality of the business.

But it would be hard to imagine our investing in anything where we didn't see at least a 25% upside to fair value. That's a minimum – the potential upside of most of what we invest in is significantly higher.

Talk about some of the reasons these differentials to fair value occur.

CM: It sometimes involves scandals, like buying into Tyco in the summer of 2002 after its CEO was arrested, or into Health Management Associates, a large hospital company, in January 2012 after a couple of its hospitals were implicated in an overbilling scam. With HMA, we assessed the damage if it was guilty and fully penalized and concluded that was manageable and being overstated by the market. That turned out to be the case and the shares responded accordingly.

In many cases there's a fundamental problem with the company's business and you have to figure out whether that's as big an issue as the market seems to believe. In the case of TV Azteca [AZTECACP:MM], the second-largest producer of Spanish-language television content in the world, the shares have been weak because the market is concerned about the opening of the commercial-TV market in Mexico to new competition. We agree that will pressure them, but we wouldn't underestimate the company's competitive resourcefulness honed over the past 20 years competing with dominant Mexican broadcaster Televisa, and we also believe the advertising market in Mexico will expand more quickly as other industries are opened up to competition as well. We think the stock is worth at least 10x EV/EBITDA, but it trades at only 6.5x today.

Another example we own is Bouygues [EN:FP], pronounced "Bweeg," a French conglomerate that owns the world's 8th-largest construction business, one of France's largest cellular service providers, a big real estate company, and substantial stakes in French television broadcaster TFI and industrial-equipment manufacturer Alstom. The market appears overly fixated on problems in the cellphone business, where new competition has significantly cut into margins. We don't know if that business ever recovers, but we think there's a good chance it doesn't get worse from here, which allows us to value it along with all of the other parts of the business. When we do that, our sum-of-the-parts share value is well above the current stock price of €25.25. In the meantime, we're earning a dividend yield at our initial entry price of about 7%.

ON NON-U.S. INVESTING:

Given how relentlessly up the U.S. market has been, it's not a surprise our international positions have increased.

The last general reason I'd cite for why things get cheap would be some sort of negative macro issue. A perfect example of that is all the negativity around Russia, which while no doubt largely warranted, we believe has created opportunity in both energy company Gazprom [OGZD:LI] and in Russia's largest bank holding company, Sberbank [SBER:LI].

We recognize that Russia is one of the most corrupt places on the planet and that Mr. Putin's geopolitical forays and the kleptomania of his inner circle are damaging the country's economy. But Gazprom and Sberbank are both dominant franchises of immense importance to Russia and their shares are widely held by its financial institutions. It's hard to imagine the Kremlin taking any action to deliberately harm either company, especially since the Russian state already owns just over 50% of both companies. Could they in some way threaten minority shareholder value? That's not impossible to imagine, but our reading of the current situation leads us to believe that we're not at high risk of having our shares stolen in either company. With Sberbank trading at a 5x P/E ratio and 85% of book value, and with Gazprom trading at 2.4x EV/EBITDA with a dividend yield over 5% and at a price per barrel equivalent of reserves that is 10-20% of peer levels, we think the risk/reward ratios are well in our favor.

Are turnarounds in your playbook?

CM: Almost never. We see a lot of ideas where the thesis is the company can make a lot more money if it changes things up by cutting costs, divesting businesses or otherwise restructuring. We can see the logic in those types of ideas, but we really don't like to make investments based on the possibility those things might happen. While we obviously aren't attracted to businesses run by morons, we believe that even with incompetent management we can make money if the valuation is cheap enough.

Are you increasingly active outside the United States?

CM: We normally have 30-40% of the portfolio in foreign companies, but the number today, 55%, is the highest we've ever had. Given how relentlessly up the U.S. market has been and how cheap various markets in Asia, Latin America, Russia and elsewhere are relative to the U.S., it's not a surprise our international positions have increased.

Even with all the technology and information available today, we still find it more likely to find companies outside the U.S. markets that operate relatively under the radar. We like that in general – our median market cap as of June 30 was less than $3 billion – but today especially we find even much bigger players overseas that aren't well analyzed. Jardine Strategic has a $20-billion-plus market cap, but it's not widely followed and we think is misunderstood. Bouygues earns more than two-thirds of its EBITDA outside of its cellular business, but it's mostly followed in Europe by telecom analysts who focus mostly on its weak telecom business. Such things can create opportunity.

What's your typical time horizon?

CM: We go in expecting our investments to work out over three to five years, but we've ended up holding for an average of about 2½ years. Some ideas have taken much longer than that, and we try to be patient and not let the market push us out just because a certain amount of time has elapsed. Some investors give up if the market doesn't seem to get it quickly enough, but we've almost always been rewarded when we have the fundamentals right and we wait for the market to figure that out.

Is that what's going on for you today in educational-toy company LeapFrog [LF]?

CM: LeapFrog has yet to work out for us and whether it will or not remains to be seen. The primary reason is that we've gotten their earnings wrong in a big way thus far. Industry-wide toy sales haven't been great and we overestimated the company's ability to withstand a number of new market entrants that offer similar products at lower prices.

The good news is that the brand remains well regarded, the toys rank high in popularity and the company is releasing for the holiday season a number of new products, including a new iteration of its LeapPad tablet. We also knew going in that the company had a balance sheet that would provide a cushion if things went wrong. Net cash is about $200 million, on a stock with a $420 million market cap. The shares now trade at an enterprise value of only 5.8x our $40 million EBITDA expectation for next year. If we're right on that, this type of business would typically trade at a 9x multiple. That makes it worth our while to be patient.

You've actually been lowering your cash balance. Where is it now?

CM: We've had a very productive last few months in finding ideas, so our cash balance is now down to about 8%. But we've had high cash balances in the past – last year the portfolio was up over 49% even with a 16% average cash balance for the year. We only own 20 or so companies at a time, so with every investment we make we want to feel absolutely compelled to act. If we don't feel that, better to hold on to the dry powder until we do.

Turning to where you've been deploying cash, describe the investment thesis for Italy's GTECH [GTK:IM].

CM: GTECH is the leading lottery management company in the world, generating predictable recurring revenues by running the Powerball, Mega Millions and Lotto lotteries in many big U.S. states, as well as national lotteries like the one in their home country of Italy. This has been a recession-resistant business, with high barriers to entry and with concessions mostly under long-term contracts. The company has averaged 35% EBITDA margins over the past ten years and generates consistent and plentiful free cash flow.

Lotteries aren't a high-growth market, but through organic growth and acquisitions, GTECH has increased revenues at a 10% annual rate since the beginning of 2008. The company believes it has some tailwinds behind it, including growth in developing markets, where per capita spending on lotteries is typically very low, and a continued trend toward privatization, with governments increasingly recognizing that it's to their benefit to enlist a professional expert to do this for them.

We first bought the stock earlier this year when it was under pressure due to fears the company would buy International Game Technology, the gaming-equipment company it actually did agree to buy

INVESTMENT SNAPSHOT

GTECH
(Milan: GTK:IM)

Business: Leading global supplier of lottery-game systems and, after the close of its pending acquisition of International Game Technology, casino gaming equipment.

Share Information
(@9/29/14, Exchange Rate: $1 = €0.794):

Price	**€18.79**
52-Week Range	€15.24 – €24.13
Dividend Yield	4.0%
Market Cap	€3.29 billion

Financials (2013):

Revenue	€3.06 billion
EBITDA Margin	33.9%
Net Profit Margin	5.7%

Valuation Metrics
(Current Price vs. TTM):

	GTK:IM
P/E	19.6

THE BOTTOM LINE
Chris Mittleman believes the company, following a pending acquisition, will become the premier player from a profitability and management perspective in the lottery- and gaming-equipment business. But in applying even a middle-of-the-road EV/EBITDA multiple to pro-forma 2015 estimates, he arrives at a fair value 60% above the current share price.

Sources: Company reports, other publicly available information

in July. The uncertainty around that seems to have put a ceiling on the stock in the interim.

What's your take on the IGT deal?

CM: It is a huge undertaking and increases leverage on the balance sheet, but overall it makes a lot of sense. Revenues of the new entity will be roughly 50% gaming equipment and 35% lotteries, and both businesses benefit from scale in attracting new customers and in investing in R&D. Gaming equipment is a more cyclical business, but the slot-machine industry is long overdue for a replacement cycle, as casinos have under-invested in slot replacements versus historical norms since 2006. We're not saying an up cycle will make this a genius deal, but over three to five years it could certainly help.

GTECH has a strong record of integrating acquisitions and realizing projected synergies, and here they've laid out $280 million in cost synergies they expect to realize over the next three years. If they hit that, assuming no growth, they will have paid only 6.3x EV/EBITDA for IGT, well below where most comparable deals have been done.

Does the increased leverage concern you?

CM: Net debt to EBITDA will go from 2.6x to around 4.5x after the acquisition, so this will be a highly leveraged entity. But given the historic resilience of these businesses and their excellent free-cash-flow production, we think the balance sheet can comfortably tolerate that level of leverage.

An Italian private equity firm, De Agostini S.p.A., owns nearly 60% of GTECH's shares outstanding. Pro or con?

CM: De Agostini's chairman since 1997 is Marco Drago, who has generated a Buffett-esque track record from buying stakes in the types of free-cash-flowing, durable businesses that attract us. We're more than comfortable investing alongside him with GTECH.

How are you valuing GTECH stock, recently trading at €18.75?

CM: For fair value we focus on both where comps trade and where transactions have happened in the past. Gaming-equipment companies tend to be bought out at 8.5x to 10x EV/EBITDA, which is the same range at which public competitors in the lottery business trade. We believe GTECH will be the premier player from a profitability and management perspective, but even if we assume a multiple at the low end of that range – 8.8x expected pro-forma EBITDA of more than €1.6 billion in 2015 – we arrive at a fair value of €30 per share.

That's assuming little top-line growth, which could be conservative. We also think that the increased visibility from the stock trading on the NYSE after the merger closes in the first half of next year could provide a boost to the valuation.

What makes you think Jardine Strategic is misunderstood?

CM: Most of the holding company's assets are publicly traded, so step one in judging whether it's misunderstood is to ask whether the stock is undervalued based on a sum of the parts at current market prices. That's a clear yes.

To give some history, Jardine Strategic is 82.5% owned by Jardine Matheson [JM:SP], which was founded in 1832 and has been led by Sir Henry Keswick as Chairman since 1967. Jardine Strategic

INVESTMENT SNAPSHOT

Jardine Strategic
(Singapore: JS:SP)

Business: Hong Kong-based holding company with key assets in supermarkets, vehicle manufacturing, real estate, automobile retailing and insurance brokerage.

Share Information (@9/29/14):

Price	**34.85**
52-Week Range	30.06 – 38.10
Dividend Yield	0.7%
Market Cap	$39.09 billion

Financials (2013):

Revenue	$32.7 billion
Operating Margin	10.5%
Net Profit Margin	4.9%

Valuation Metrics (Current Price vs. TTM):

	JS:SP
P/E	12.3

THE BOTTOM LINE
Given the company's exemplary track record and its holdings' bright prospects for growth and future cash-flow generation, Chris Mittleman doesn't believe its shares should trade at a high discount to net asset value. Using just publicly traded values for its component parts – with one downward adjustment – he arrives at a fair value of $53 per share.

Sources: Company reports, other publicly available information

holds stakes in several blue-chip Asian companies addressing markets with intrinsically high growth rates. In a rather bizarre twist – which may account for some confusion about Jardine Strategic's value – while Jardine Matheson owns the majority of Jardine Strategic, Jardine Strategic at the same time owns 56% of Jardine Matheson.

You have to correct for that last twist, but our valuation of Jardine Strategic is pretty straightforward. Its key publicly traded holdings are in Dairy Farm International [DFI:SP], which operates supermarkets and convenience stores throughout southeast Asia, in Jardine Cycle & Carriage [JCNC:SP], which owns 50% of a large industrial conglomerate in Indonesia, in Hongkong Land Holdings [HKL:SP], a commercial and residential real estate company with properties in China and elsewhere in Southeast Asia, in Mandarin Oriental International [MAND:SP], the luxury hotel chain, in Zhongsheng Group [881:HK], a big Chinese car retailer, and finally in Jardine Matheson, which has direct interests in a number of diversified businesses in Asia.

If you add up the current values of the publicly traded stakes and some other small investments and residual cash on the balance sheet – correcting to not double-count because of the cross holding – the net asset value today is just over $58. We make one further adjustment to that in arriving at fair value, which is to mark down the valuation of Dairy Farm, which is a great business but one we consider too richly valued by the market. When we mark that stake down to 11x EV/EBITDA and 17x free cash flow, that brings the overall NAV down to around $53.

That's clearly attractive relative to today's share price of below $35, but what gives you confidence the discount will close?

CM: One catalyst, which we expect eventually to happen, would be if the confusing ownership structure were resolved, most likely by Jardine Strategic being rolled into Jardine Matheson.

Many Asian holding companies trade at big discounts to NAV, but that usually is tied to significant Chinese real estate holdings whose net asset values may be suspect. While Jardine Strategic has important exposure to real estate through Hongkong Land, the bulk of the holdings are in nicely growing businesses that are generating and sharing free cash flow, allowing the holding company to reinvest in smart new ideas. That's the dynamic we look for in all our holding-company plays. If you can buy into such situations at big discounts to net asset value, you usually make money over time because you're not just relying on the discount narrowing. If and when the discount narrows, all the better.

Is the story similar for fellow Asian holding company First Pacific [142:HK]?

CM: The growth profile and cash-flow characteristics are similar, but First Pacific is smaller, its holdings are in completely different businesses, and the vast majority of the underlying assets are in the Philippines and Indonesia.

The key components of the NAV here are a 25.6% stake in the top cellular, fixed-line, and broadband services provider in the Philippines, Philippine Long Distance Telephone [TEL:PM], a 50.1% stake in Indofood [INDF:IJ], one of the largest instant-noodle makers in the world, and a 55.8% stake in Metro Pacific Investments [MPI:PM], which has major interests in

INVESTMENT SNAPSHOT

First Pacific
(Hong Kong: 142:HK)

Business: Hong Kong-based holding company with key assets in packaged foods, telecommunications, infrastructure construction and natural resources.

Share Information
(@9/29/14, Exchange Rate: $1 = HK$7.768):

Price	**HK$8.09**
52-Week Range	HK$7.35 – HK$9.48
Dividend Yield	2.6%
Market Cap	HK$34.80 billion

Financials (2013):

Revenue	$6.21 billion
Gross Profit Margin	29.5%
Net Profit Margin	3.8%

Valuation Metrics
(Current Price vs. TTM):

	142:HK
P/E	16.4

142:HK PRICE HISTORY

THE BOTTOM LINE

Chris Mittleman expects the company's net asset value to grow nicely over time as its key holdings in Indonesia and the Philippines benefit from continued, if fitful, economic modernization. He says that growth will allow him more leeway for patience in waiting for the current market value discount to NAV – now a surprising 45% – to eventually narrow.

Sources: Company reports, other publicly available information

things like water utilities, toll roads and power generation in southeast Asia.

These are all good businesses that generate free cash flow and have entrenched and defensible franchises. Philippine Long Distance has dominant market share in both mobile phone (59%) and broadband services (64%), in a country trying to follow the Chinese path to industrialization through heavy infrastructure spending. Indofood is a significant business, with important brands throughout the region, and should benefit if the new president in its home country of Indonesia can enact the reforms promised to modernize the economy. Metro Pacific is similarly well positioned to benefit from the big infrastructure-spending programs of countries throughout the region, many of which are underway.

How does your sum-of-the-parts value compare to the current share price of HK$8.50?

CM: Making no adjustment to current market values of the publicly held assets because we view them as reasonably priced on average, adding in estimates for smaller holdings, and accounting for balance sheet cash and debt, we put current net asset value at HK$14.50.

Again, we don't know when the discount might narrow, but good things tend to happen when you can invest at such a high apparent discount to an NAV that you expect to continue to grow at a satisfying rate over time.

Walk through in more detail your thesis for Gazprom.

CM: I mentioned earlier our interest in energy companies when they're cheap relative both to their resource base and to free cash flow. The reserves provide a backstop of value that is added protection if near-term commodity prices go against you.

Here the valuations are beyond low. Gazprom stock trades in U.S. dollars, both in London and on the U.S. OTC market, at a recent price of just over $7. That's one-third of the $22 book value, which is also the value at which DeGolyer & MacNaughton, a highly regarded energy consultancy, appraises the NPV of the company's reserves after net debt. The market is pricing Gazprom at around $1.50 per barrel equivalent of reserves, vs. more than $8 for BP and over $20 for Chevron.

This for a company that generates substantial EBITDA and free cash flow. Consensus EBITDA estimates for the next couple of years, which I won't pretend to outguess, are around $50 billion, down 20-25% from 2013 in large part due to impacts of the recent events in Ukraine. Annual free cash flow in recent years has averaged $10 billion, which is not out of line with what they should be able to do going forward. So at today's market price, the shares go for 2.4x EV/EBITDA ($120 billion in total enterprise value divided by $50 billion), and around 8.3x free cash flow ($83 billion in market cap divided by $10 billion).

Compare those multiples to other national energy companies in countries nearly as corrupt as Russia. Argentina's YPF [YPF], which "renationalized" a stake in it held by Spain's Repsol in 2012, trades at an EV/EBITDA multiple of 5x. PetroChina [857:HK] trades at 5x EBITDA. Brazil's Petrobras [PBR] trades at 6x EBITDA, and while it has a high level of reserves, it's burning through cash at an extremely high rate to develop them.

How do you arrive at an estimate of fair value for Gazprom?

INVESTMENT SNAPSHOT

Gazprom
(London: OGZD:LI)

Business: Exploration, production, transportation and storage primarily of Russian-sourced natural gas used by domestic and Eastern and Western European customers.

Share Information
(@9/29/14):

Price	**7.03**
52-Week Range	6.25 – 9.87
Dividend Yield	5.7%
Market Cap	$82.69 billion

Financials (2013, $1 = RUB 39.533):

Net Assets	RUB 9.63 trillion
Net Sales	RUB 5.25 trillion
Net Profit Margin	21.7%

Valuation Metrics
(Current Price vs. TTM):

	OGZD:LI
P/E	n/a

OGZD:LI PRICE HISTORY

THE BOTTOM LINE

While negativity around Russia today is no doubt warranted, Chris Mittleman argues that it's gone too far in this case, sending the company's shares to much lower EBITDA and free cash flow multiples than even national energy companies in "nearly as corrupt" countries. At 3.7x EV/EBITDA and 15x free cash flow, he estimates fair share value at $12.75.

Sources: Company reports, other publicly available information

CM: This is obviously a subjective endeavor. What might appear to be a rational fair value would be far higher than the number I'm using. That's a recognition of the fact that this is Russia and it may be a long time before people are prepared to pay a real fair value for its leading energy company.

We're targeting $12.75 per share, 80% above today's share price. That's 15x free cash flow and about 3.7x EV/EBITDA. Given its position as Russia's leading gas supplier, its extensive and profitable pipeline infrastructure, and the long-term potential to supply giant markets like China and India, we don't consider those multiples at all unreasonable.

I'd add that Gazprom also pays a nice dividend, on a current yield basis around 5.5%. That's not insignificant while you're waiting for this to work out over the next three to five years.

Sticking closer to home, explain your continued interest in Revlon.

CM: We started buying Revlon at the end of 2010 for just under $10 per share, when we thought it was worth around $20. The business has done well, with EBITDA and free cash flow growing every year, and our estimate of fair value has gone up to the extent that we still consider the shares undervalued.

The mass market in cosmetics, where Revlon competes, has been weak for the past 18 months. Their typical end customer is not doing as well as the higher-end buyer. But unlike competitors like Elizabeth Arden and Coty, Revlon has actually held up quite well through that. That doesn't mean they always outperform, but it is somewhat of a reflection of the stability of the brand franchise.

The biggest news for the company was the purchase last year for $665 million of Colomer Group, which Revlon had sold in 2000 for $315 million when it needed to deleverage its balance sheet. At that time, Colomer was basically Revlon's professional-products business, but it has since added to that with a line of men's hair-care products and a very successful CND Shellac nail-polish business. If Revlon extracts the synergies it expects by 2015, it will end up having paid roughly $705 million for a business doing a pro-forma $97 million in EBITDA. That's a 7.3x multiple, which is quite low for a set of such high-quality brands in this industry.

Following the deal, Lorenzo Delpani, who ran Colomer, was named CEO of Revlon. That's important because he comes from the industry and has a strong record of product innovation, which has been somewhat lacking at Revlon as it has been run mostly by a succession of finance people or those from outside the cosmetics industry. The benefits of his taking over are hard to quantify less than a year into his tenure, but we consider it a real positive given his track record.

Is mass-market cosmetics at all a growth business?

CM: There aren't any secular industry trends that would lead us to expect anything above GDP growth in developed markets going forward. The opportunity is better in developing markets, where Revlon is meaningfully exposed. We assume modest annual top-line growth

INVESTMENT SNAPSHOT

Revlon
(NYSE: REV)

Business: Manufactures, markets and sells branded beauty and personal-care products, primarily through mass-market retailers but also to professional outlets worldwide.

Share Information
(@9/29/14):

Price	**31.95**
52-Week Range	22.12 – 35.14
Dividend Yield	0.0%
Market Cap	$1.67 billion

Financials (TTM):

Revenue	$1.79 billion
Operating Profit Margin	13.1%
Net Profit Margin	n/a

Valuation Metrics
(@9/29/14):

	REV	Russell 2000
P/E (TTM)	n/a	71.2
Forward P/E (Est.)	14.2	18.4
EV/EBITDA (TTM)	11.8	

Largest Institutional Owners
(@6/30/14):

Company	% Owned
Fidelity Mgmt & Research	3.7%
Mittleman Inv Mgmt	3.5%
Dimensional Fund Adv	2.0%
Vanguard Group	1.4%
BlackRock	1.2%

Short Interest (as of 9/15/14):

Shares Short/Float	3.3%

REV PRICE HISTORY

THE BOTTOM LINE

The company's modest valuation significantly undervalues the durability of its brand franchise and that franchise's value to a potential acquirer, says Chris Mittleman. He considers his $50 per share estimate of private market value to be conservative, reflecting multiples of EBITDA and free cash flow that are below historical and current comps.

Sources: Company reports, other publicly available information

overall, which is all it takes when a company trades at such a modest valuation.

Describe the modesty of the valuation at today's $32 share price.

CM: In a controlled company like this – Ron Perelman owns more than 75% of the shares – what matters most to us is the value of the business to a buyer. Public markets can push the valuation around, reacting to short-term news, and the illiquidity of the stock can suppress valuation. But there is a long history of M&A in companies like Revlon, which is now the sole independent, publicly traded mass-market consumer cosmetics brand of scale in the U.S.

Based on that history, it's hard for me to imagine Revlon selling itself for less than $50 per share. That's 12x EV/EBITDA – $4.5 billion in enterprise value divided by the $375 million in EBITDA I estimate the company can earn in 2015. The market cap at a share price of $50 is 15x the free cash flow I expect in 2015. For comparison purposes, 12x EBITDA is at the very low end of where deals have been done in the past, and it's exceedingly rare for businesses in this field to go for less than 20x free cash flow.

The valuation at $50 also compares favorably with where other iconic branded cosmetics companies trade right now. Estee Lauder and L'Oreal are considered more attractive because they've shown better growth than Revlon and address higher-end consumers, but the EBITDA margins each earns is very close to Revlon's 19%. Estee Lauder currently trades at just over 13x EV/EBITDA on 2015 numbers, while L'Oreal is at 13.5x.

Do you think Perelman is a seller?

CM: He's in his early 70s and has controlled or owned Revlon outright since 1985, so who knows? My reading is that he is sensitive to cycles and if he sees progressively higher multiples being paid for comparable consumer-products franchises, he wouldn't hesitate to put out the for-sale sign.

In the meantime, is the leveraged balance sheet a concern?

CM: Net debt to EBITDA is close to 5x, versus 4x prior to the Colomer deal. For a business that grew EBITDA and free cash flow straight through the Great Recession, we think that relatively high leverage ratio is manageable.

ON HUMILITY:

If you allow yourself to start thinking you've got it all figured out, that's probably the beginning of the end.

You recommended the shares of rental-car company Avis Budget at just under $15 last time we spoke [*VII*, July 31, 2012]. The stock is now close to $60. How much of that increase have you captured?

CM: We sold our last shares in May 2013 at just above $30. That was around our estimate of fair value, which reflected a concern that used-car prices – which had been strong for an unnaturally long period of time, benefitting Avis as it sold off inventory – were likely to go down. That's what typically happens when new-car sales pick up, as they were. But even though new-car sales have been strong, used-car prices have held up well. So the urgency I felt in getting out of Avis, in hindsight, proved to be wrong.

Selling too early is a common value-investor misstep. Does it bug you?

CM: After plenty of experience with it, it doesn't really eat at me that much any more. The best I can do is try to learn from the mistakes. Was it something I could have reasonably avoided? In the case of Avis, based on my understanding of the cycles affecting used-car prices, I think I made a rational and responsible decision. We'd made an excellent return and I felt like we had better things to do with the money. I can't remember exactly what we did with our Avis sales proceeds, but hopefully it was something reasonably smart.

Your asset size has grown considerably as your record gets better known. Do you worry about growing too fast?

CM: A given level of assets may be too much in one environment and not enough in another. The opportunity set is always changing and we have no constraints due to geography or market cap.

If we find ourselves with an untenable amount of cash, where I don't see how to put it productively to work, we'll stop taking in money until we work through that. If we still have too much cash, we'll give some back.

There are plenty of examples of investment managers with good track records who rake in a ton of money and then see their returns revert to the mean. The track record is too important to me to risk debasing it to pump up short-term fee revenue, and we're not willing to bend our investment discipline to accommodate ever-increasing assets under management. I think we have done a good job to partner only with like-minded, long-term clients. The temperament and quality of our client base really is as important to us as the quality of our portfolio.

In a similar vein, how do you guard against success going to your head?

CM: Success in investing comes down to how much discipline you can muster in changing circumstances, including when times are good. You make a certain amount of money and you start believing that money is somehow a validation of your intelligence. That can lead you to act on instinct and cut corners, contrary to the way you generated success in the first place.

The market serves up more than enough adversity to keep us humble. If you allow yourself to start thinking you've got it all figured out, that's probably the beginning of the end. VII

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