AAII December 2015 meeting

December 12, 2015

DISCLAIMER

Before making an investment decision, investors are advised to read carefully the Offering Memorandum, including the description of the risks, fees, expenses, liquidity restrictions and other terms of investing in the funds. Performance data has not been prepared to meet any specific requirements applicable to the presentation thereof and should in no event be viewed as predictions or representations as to actual future performance. Investment may involve a high degree of risk and should be considered only by investors who do not require access to their capital and can withstand the loss of all or part of their investment. Return targets in this document are subjective determinations and do not reflect either actual past performance or a guarantee of future performance. Referenced benchmarks may fail to provide a meaningful comparison. Forward looking statements are based upon assumptions which may differ materially from actual events. This information should not be relied upon in making an investment decision.

Key Objectives Today

- Learn how to properly analyze a company in the following industries:
  - Differentiated Manufacturing
  - Property & Casualty Insurance
- Learn how to minimize your downside risk in those industries

Agenda

- Differentiated Manufacturing
  - Summary of key qualitative and quantitative points
  - Valuation guidelines
  - Protecting your downside
  - Case Studies
- Property & Casualty Insurance
  - Summary of key qualitative and quantitative points
  - Valuation guidelines
  - Protecting your downside
  - Case Studies

Differentiated Manufacturing

Differentiated Manufacturing Explained

- Non-commodity, branded consumer products
- Examples:
  - Cars
  - Paint
  - Smart Phones
  - Furniture
  - Carpet
  - Fashion Accessories
- Anything you buy at any store or online
- Excludes B2B input goods

Summary of What We Look For

Qualitative	Quantitative
• Strong Distribution • Bargaining Power with customers and suppliers • Successful R&D • Good allocators of capital • Solid Brand	• Operating Margin >10% • ROIC > 10% • FCF/Revenue > 5% • TATO > 1.0 • Industry low cash conversion cycle

Looking for Durable Competitive Advantage

- Qualitative and Quantitative focus points all geared toward determining whether or not the company has a durable competitive advantage ("DCA")
- Existence of a DCA helps company sustain and grow revenue profitably
- Consumer products company without a DCA can see sales evaporate quickly

Strong Distribution

- Highly underappreciated by most investors
- Includes where product is sold and how it gets there
- Cannot sell what customers cannot easily find
- Best companies tout their distribution network
- Prefer “dedicated retail”
  - Company-owned stores
  - Exclusive dealerships

Bargaining Power with Customers and Suppliers

- Dominant customer or supplier can dictate terms
- Examples:
  - Apple – GT Advanced
  - Wal-Mart – Rubbermaid
- Avoid companies with greater than 20% of sales to one customer
- Cash conversion cycle good indicator of bargaining power

Cash Conversion Cycle ("CCC")

- A cash flow calculation that attempts to measure the time it takes a company to convert its investment in inventory and other resource inputs into cash.
- CCC = Days Inventory Outstanding + Days Sales Outstanding – Days Payables Outstanding
- CCC of zero means you pay your suppliers the exact day you collect on accounts receivables
  - Rare
- Varies by industry but tends to be at least 40
- Negative CCC is indicative of a moat
  - Should result in negative non-cash working capital since turning inventory and collecting on receivables before paying suppliers

Successful R&D

- Required to stay competitive
- Rare for one company to be ahead of peers for long
- Product refresh cycle
  - Prefer longer refresh cycle – lower risk of obsolescence
  - Carpet vs Smart Phones
- Generally R&D/Sales of greater than 5% indicates R&D intensive industry

Good Allocators of Capital

- Management is the steward of shareholder capital
- Capital allocation includes acquisitions, buybacks, dividends, investments in new or existing product lines, expansions into new geographical areas, expansion of distribution network, etc.
- Risk of institutional imperative
- Focus on ROIC over time, especially before and after acquisitions
- Good allocators can create tremendous shareholder value
- Warren Buffett & Charlie Munger

Solid Brand

- Listed last because least important
- Brand Bubble, published in 2008
  - Brand trustworthy ratings dropped almost 50% from 1998-2007
  - Esteem and regard for brands fell by 12% in 12 years, and very few brands were widely regarded across general population
  - Awareness of brands fell by 13% in 13 years
  - Brand quality perceptions fell by 24% 1994-2007
  - Only 7% of prime time commercials were found to have a differentiating message
- Very few brands create a competitive advantage
  - Apple, John Deere, Disney, Coca Cola
- Main focus is a brand that isn’t tarnished

Significance of Key Metrics

- Operating Margin > 10% & FCF/Rev > 5%
  - Above average profit margin indicates above average operations
    - Good distribution, bargaining power, capital allocation, and brand
  - Compare to competitors by line item to understand how efficient the operations are
- ROIC > 10%
  - Excess value created when ROIC>WACC, which is generally under 10%
- Total Asset Turnover Ratio > 1.0
  - Measures ability to utilize assets to generate sales
  - $1 of assets should generate at least $1 of sales

Valuation Guidelines

- ~12.5x sustainable Free Cash Flow ("FCF")
  - Assumes 11% discount rate and 3% perpetual growth
  - FCF normalized
- If ROIC>WACC, value is NBV at a minimum
  - The capital employed is realizing a rate of return greater than the cost of that capital, so the company is worth more than net book value

Protect Your Downside

- Price you pay is key
- Avoid stocks trading for 20x FCF or higher unless you are very confident growth will be 20% annually for at least 5 years
- Avoid companies with ROIC below their WACC unless you expect ROIC to increase substantially in the near future
- Avoid value traps
  - Looks inexpensive but competition driving sales down rapidly
  - Multi-year declining operating margin might indicate DCA erosion
  - FCF elevated due to changes in working capital or lower than required R&D or CAPEX

Case Studies

- Apple (AAPL) - bought
- LeapFrog (LF) – passed
- See additional case studies in Appendix

Apple (AAPL)

- Mac, iPhone, iPad, iTunes, iPod, and Apple TV
- Stock had dropped 30% from recent high by the end of 2012 on fears that Steve Jobs was the sole reason for Apple's success
- Apple has a September year-end, so we had the newly issued 2012 10-K to start with

Apple (AAPL)

- 5 years prior to our investment, through FY 2012: (in billions)

Category	2008	2009	2010	2011	2012
Revenue	$32.5	$42.9	$65.2	$108.2	$156.5
Growth	35%	32%	52%	66%	45%
Op Margin	19.3%	27.4%	28.2%	31.2%	35.3%
FCF/Rev	25.8%	20.9%	25.2%	27.8%	26.5%

  - 5 year revenue CAGR = 45%
  - Smartphones and tablets still in early stages with long growth ahead
  - Exceptional margins clearly indicative of a DCA

Apple (AAPL)

- Exceptional distribution
  - First tech manufacturer to successfully open and operate it's own stores around 2000
  - Over 200 stores accounting for over 10% of revenue by 2012
  - No customer greater than 10% of sales
- Incredible bargaining power with customers and suppliers

Category	2008	2009	2010	2011	2012
CCC	-59.6	-47.6	-49.5	-52.0	-52.0

- Successful R&D

Category	2008	2009	2010	2011	2012
R&D/Rev	3.4%	3.1%	2.8%	2.2%	2.2%

Apple (AAPL)

- Exceptional stewards of capital

Category	2008	2009	2010	2011	2012
ROIC	27.2%	30.2%	34.7%	41.0%	42.0%
TATO	1.00	.99	1.06	1.13	1.07

  - WACC estimated to be 8-9%
- Strong balance sheet with $134B of cash and no debt
- Market cap was $440B gross and $306B ex-cash
- P/FCF, ex-cash, was a mere 7.4
  - Priced for zero growth
- Valued at a minimum of 15x FCF, plus cash, or $730B
  - 66% upside potential with limited downside

Apple (AAPL)

- Protect our downside checklist:
  - Reasonable price paid? Check
  - ROIC above WACC? Check
  - Margins maintaining? Check
  - FCF not artificially elevated? Check

Apple (AAPL)

- Performance over ensuing 3 years:
  - Revenue grew 14% annually
  - Op margin averaged 29.3%
  - FCF/Revenue averaged 28%
  - ROIC averaged 28%
- Most importantly, stock price appreciated 58%, or 16.5% annually plus an annual dividend yield of ~3%
  - Had appreciated 83% at peak earlier in 2015
- Stock still undervalued, trading for under 8x FCF, ex-cash

LeapFrog (LF)

- Leader in educational entertainment for children
- Stock was down 30% from it's recent peak in August 2013 when we analyzed it in June of 2014
- Coming off one of the best years for any toy manufacturer in 2012, when it had 3 of the 10 best selling toys for Christmas

LeapFrog (LF)

- 5 years prior to our analysis, through FY 2013:
  (in millions)

Category	2009	2010	2011	2012	2013
Revenue	$380	$433	$455	$581	$554
Growth	(17%)	14%	5%	28%	(5%)
Op Margin	(2.1%)	1.8%	5.2%	11.0%	6.3%
FCF/Rev	(5.2%)	(10.4%)	11.1%	7.4%	7.9%

  - Revenue actually peaked in 2003
  - Company has rarely been profitable in its history
  - FCF in 2011 and in 2013 elevated by unsustainable draw downs of working capital

LeapFrog (LF)

- Weak distribution
  - Rely heavily on Toys R Us, Wal-Mart, and Target
    - 55% of sales vs under 30% for Mattel and Hasbro
    - Inventory re-stocking issues in 2012
    - LeapPad 2 fiasco in 2013
- Clear lack of bargaining power with customers and suppliers

Category	2009	2010	2011	2012	2013
CCC	90.8	118.6	137.0	110.48	125.36

  - Days payables rapidly declining – suppliers tightening terms
    - Peaked at over 90 days in 2009, down to 29 days by 2013

LeapFrog (LF)

- High R&D without revenue growth long-term

Category	2009	2010	2011	2012	2013
R&D/Rev	8.9%	7.7%	7.4%	6.3%	6.5%

  - Red Queen Effect – mental model

- Checkered history as stewards of capital

Category	2009	2010	2011	2012	2013
ROIC	(2.6%)	3.1%	11.4%	46.6%	35.8%
TATO	1.24	1.44	1.46	1.53	1.18

  - ROIC averaged negative 56.3% 2005-2008
  - WACC estimated to be 13%
  - 2012 and 2013 artificially benefitting from capitalizing content development costs and reversal of valuation allowance on deferred tax assets

LeapFrog (LF)

- Company had no debt and the stock looked inexpensive at under 3x FCF, ex-cash
- Ultimately could not place a value on it because cash flows were too difficult to predict
  - Felt the retailers had too much power and threat of competition rapidly eroding sales too great
- Downside checklist:
  - Reasonable price paid? Possibly
  - ROIC above WACC? No
  - Margins maintaining? 2 good years not enough to go on
  - FCF not artificially elevated? No

LeapFrog (LF)

- Performance over ensuing 1.5 years:
  - Revenue declined ~50%
  - Op margin dropped to (41.3%)
  - Company hemorrhaging cash
  - New products LeapBand and LeapTV deeply underperformed
- Most importantly, stock price declined 90+%
- Still not interested even after the decline

Property & Casualty Insurance

Property & Casualty Insurance

- P&C insurance is very broad and, for the purposes of this presentation, includes auto, home, worker's comp, director's liability, malpractice, loss of business, renter's, etc.
- Excludes health insurance and life insurance

Summary of What We Look For

Qualitative

- Risk-focused mgmt
- Pricing discipline
- Claims mgmt
- Conservative Reserving
- Conservative Portfolio

Quantitative

- Combined ratio < 100%
- ROE > 10%
- Survival ratio > 3.0
- Consistent investment yield

Insurance Primer

- Two ways to make profit
  - Underwriting
  - Investing
- Float
  - Cost of Float
- Reinsurance
- Value Chain:
  - Distribution
  - Underwriting
  - Investing
  - Claims Management

Risk-Focused Management

- Single most important ingredient
  - Surprising how few mgmt. in a risk-management business are risk-focused
- Reflected by:
  - Sticking to areas of expertise
  - Pricing discipline
  - Conservative reserving
- Determined by:
  - Annual report and earnings calls
  - Management's moves
    - Standard carrier extending to excess lines a red flag

Pricing Discipline

- Insurance industry is cyclical, influenced primarily by:
  - Industry capacity
  - Interest rates
- Soft market vs Hard market
- Policy should be priced for profit from day one
  - Yet industry average is a loss on underwriting
    - Most management cannot walk away from business, even if unprofitable – expect to make it up with investing
- Only invest in management with pricing discipline, reflected by combined ratio consistently under 100%

Combined Ratio

- Measures the profitability of an insurer's underwriting
- Sum of the following:
  - Loss Ratio – claims expenses / net premiums earned
  - Expense Ratio – underwriting expenses / net premiums earned
- Premiums written vs premiums earned
- Gross vs net premiums

Claims Management

- How an insurer handles claims as they come in
- Underappreciated area that can create or hurt value
- Difficult to assess as an outsider

Conservative Reserving

- Matching principle
  - Must reserve for expected claims when premiums earned
- Reserve based on actuarial calculations, historical data, and management judgment
- Prior year favorable vs unfavorable reserve development
  - Best insurers consistently over-reserve initially and subsequently have prior year favorable development
- Survival Ratio
  - Best measure of reserve adequacy
  - Current year reserve / average claims paid last 3 years

Conservative Portfolio

- Underwriting and investing are two different skillsets
  - Not many Warren Buffett's running around
- Prefer management focused on underwriting profits and conservative portfolio
  - Mostly fixed income with an appropriate duration
- Consistent investment yield and portfolio make-up

Focus on Balance Sheet and Income Statement

- Insurance companies are financial in nature
  - Assets predominantly financial assets and liabilities are predominantly claims reserves and debt
- We don't even look at the cash flow stmt for an insurer
- Key for balance sheet is adequacy of reserves, debt levels, and investment portfolio
- Key for income statement is combined ratio and investment yield
- ROE ties the income statement and balance sheet
  - Should at least exceed WACC, which is generally around 10-11%
  - ROE of 10% minimum required, 13+% preferred

Valuation Guidelines

- P/B >= 1.5 for quality insurers
  - Adjust for reserve levels
- At least 10x sustainable net income
  - Ties to book value ("BV") via ROE
    - If ROE is 10% and BV is 1.0, then earnings are 0.10
    - 10x P/E means Price should equal 1.0 (0.10 earnings times 10)
    - Price/Book would then be 1.0/1.0 or 1
    - Quality insurers generate higher ROE and demand higher P/E multiple

Protect Your Downside

- Avoid any company without a clear focus on risk management
  - Combined ratio above 100% consistently
  - Loose underwriting policies could be catastrophic
- Avoid companies that under-reserve
  - Will eventually have to increase reserves to appropriate levels and stock will be punished
  - Indicates less than trustworthy management
- Timing matters for cyclical industry
  - Reduce exposure in beginning of a soft market

Case Studies

- W. R. Berkley (WRB) - bought
- Tower Group (TWGP) – passed
- See additional case studies in Appendix

W.R. Berkley (WRB)

- Leading specialty commercial insurer and re-insurer, specializing in niche products
- William “Bill” Berkley founded the company in 1967 and still the chairman and CEO and 19% ownership
- Tangible net book value CAGR over previous 25 years was 21%
- Invested in 2010 when insurance industry was still out-of-favor and WRB was selling for under net book value

W.R. Berkley (WRB)

- Risk-focused management
  - Every communication from the company focuses on managing risk
  - Only underwrites areas in which they possess a strong expertise and only to counterparties looking to truly insure against unexpected loss rather capital arbitrage

W.R. Berkley (WRB)

- Pricing Discipline
  - Preaches pricing discipline constantly
    - "Disciplined underwriting continues to be at the heart of our operating culture"
  - Compensation package incentivizes underwriting profit over premium growth
- Evidenced by exceptional combined ratio history

Category	2005	2006	2007	2008	2009
Premiums Written	$4,605	$4,819	$4,576	$4,033	$3,730
Comb. Rat.	89.3%	88.0%	88.1%	93.1%	94.2%

W.R. Berkley (WRB)

- Conservative Reserving
  - Survival Ratio at 12/31/09 was a healthy 3.66
  - Favorable prior year reserve development every year
- Conservative Portfolio
  - 90+% fixed income with remainder in merger arbitrage
  - Consistent investment yield

Category	2005	2006	2007	2008	2009
Inv. Yield	4.4%	5.3%	5.2%	4.3%	4.4%

W.R. Berkley (WRB)

- History of high ROE well above WACC

Category	2005	2006	2007	2008	2009
ROE	25.8%	27.2%	23.0%	7.8%	10.1%

- Expected double digit ROE to continue, valuing company at approximately 1.5x net book value, conservatively
  - Potential upside of 50+% from price at the time plus dividends

W.R. Berkley (WRB)

- Downside Protection checklist:
  - Risk-focused management? Check
  - Adequate reserves? Check
  - Good timing for the industry? Check - Soft market since 2004 was expected to begin hardening soon.

W.R. Berkley (WRB)

- Performance over ensuing 5+ years:
  - Market hardened as expected
  - Earned premiums CAGR of 8.6%
  - NBV/share CAGR of 9.1%
  - ROE averaged 12%
  - Continued favorable prior year developments every year
- Most importantly, stock price appreciated 211%, or 16% annually plus an annual dividend yield of ~2%
- Stock finally trading for 1.5x net book value
  - Expected to continue compounding shareholder value

Tower Group (TWGP)

- Specialty P&C insurer and reinsurer
- Stock down to 30% of NBV after delaying earnings over 2 months before increasing reserves substantially
- We analyzed the company in October of 2013 the day after they finally reported and increased the reserves

Tower Group (TWGP)

- Risk-focused management – not even remotely
  - The company did not even pay lip service to focusing on risk above growth
  - Company founded in 1990 and grew via aggressive acquisitions at far too high prices for low quality companies
    - "It eliminated our profitable business model…" – directly from 2012 Annual Report regarding 2009 acquisition that tripled the asset base
  - Aggressive use of reinsurance to overload capacity to further grow at any cost, even during a soft market
  - Outsourced 20% of underwriting to third parties – major red flag and usually results in the worst book of policies
  - Chased premiums into specialty areas in which they had no expertise
  - Chronically under-reserved, resulting in artificially low combined ratio of high 90%

Tower Group (TWGP)

- Substantial increase in reserves insufficient
  - Even after increase, survival ratio still only 1.92
    - Grossly inadequate
    - Peers are in the 3.5-5.0 range
- We passed on TWGP
  - No downside protection with such aggressive management not at all focused on risk management
- Subsequent Events:
  - Reserves did prove to be inadequate
  - TWGP had to fire sale itself to a reinsurer for ~60% below the price we passed at

Q&A

Appendix

Additional Case Studies: Differentiated Manufacturing

Sherwin-Williams (SHW)

- Largest paint manufacturer in U.S. and 3rd largest worldwide
- Invested in 2008 when trading for P/FCF of 9 despite:
  - 9% average annual growth over previous 5 years
  - Average ROIC of 19.6% and op margin over 10% previous 5 years
  - Exceptional distribution with company-owned stores
    - Twice as many stores as next 9 competitors combined
    - Even walked away from Wal-Mart deal
  - Expanding internationally and raised prices even through recession
- Stock increased 468% in 7 years, or ~25% annualized return

Spectrum Brands (SPB)

- Diversified manufacturer – batteries, personal care, pet supplies, home & garden, and small appliance markets
- Invested in 2011:
  - Had emerged from bankruptcy the previous year
  - FCF was suppressed due to some expenses that would soon disappear – price to sustainable FCF was under 7
  - Op margin expected to rise to 10% in near term
  - Incredible distribution – doesn't advertise but is top 3 in every major product category and geographic market area
  - New CEO post-bankruptcy with good track record
- Stock increased 370% in 4 years, or ~39% annualized return

Arctic Cat (ACAT)

- Manufacturers snowmobiles, ATV's, and recreational off-highway vehicles
- Passed in mid-2014 when trading for P/FCF of over 20:
  - Could not get comfort over distribution – no dedicated dealerships, sold next to higher quality and bigger branded names
  - Cash flows artificially inflated by trading securities sales, which are not related to the underlying operations but included in the operating segment – true free cash flow was negative
- Stock decreased 50% in 1.5 years as company severely underperformed, still not interested at current prices

Additional Case Studies: Property & Casualty Insurance

Amerisafe (AMSF)

- Invested in mid-2008 after listening to CEO Allen Bradley at Burkenroad Reports Conference
- Hazardous occupations worker's comp insurance headquartered in DeRidder, LA
- Selling for less than net book value despite:
  - Combined ratios consistently below 100%...even below 90%
  - Average ROE of over 20% in the preceding years
  - Favorable prior year reserve developments in recent years
  - Survival ratio of 3.16
  - Best claims management process we have seen
- Timing was early due to soft market, but stock increased 330% in 7 years or a ~19% annualized return

Markel (MKL)

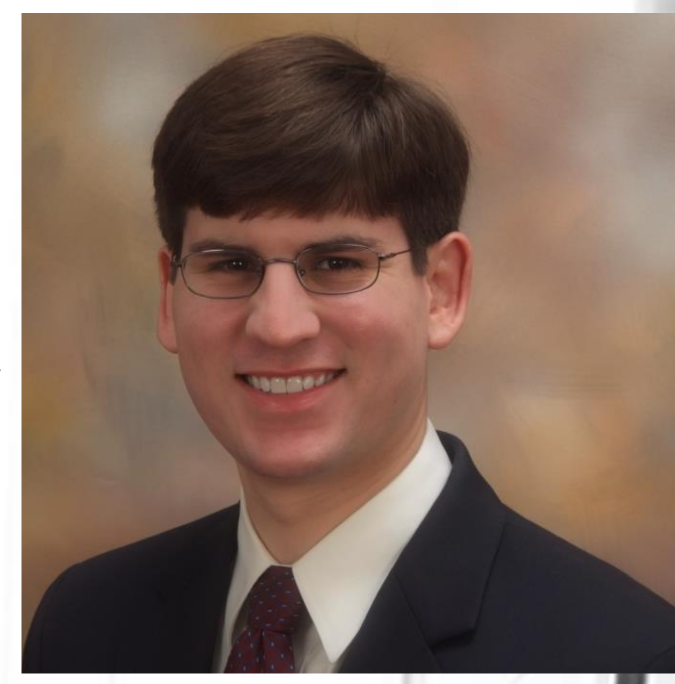
- Leading specialty insurer and re-insurer
- Invested in August 2015 when trading for P/B of 1.4:
  - Combined ratio consistently below 100%
  - Avg growth in NBV/share of 15% for 20+ years
  - Favorable prior year reserve development every year
  - Survival ratio of 4.4
  - Exceptional culture and rare investing acumen
- Stock has increased 15% on average for 20+ years, which should continue
- We waited for a pullback and bought at 1.4x NBV or $775/share and already up 14.5%
  - Overstated reserves mean true P/B was closer to 1.2

Aspen Holdings (AHL)

- Bermuda-based insurer and reinsurer
- Invested in 2012 when trading for P/B of 0.63:
    - Reinsurance industry was out-of-favor at the time
    - Average combined ratio of 93% for prior 9 years
    - Average ROE of 8.8% despite two worst catastrophe years
    - Survival ratio of over 5
    - Conservative investment portfolio with consistent yields
    - Consistent history of good capital allocation
- Stock increased 80% in 3 years, or ~22% annualized return
- Reinsurance market is flooded with new yield-seeking capacity, so we have exited the position

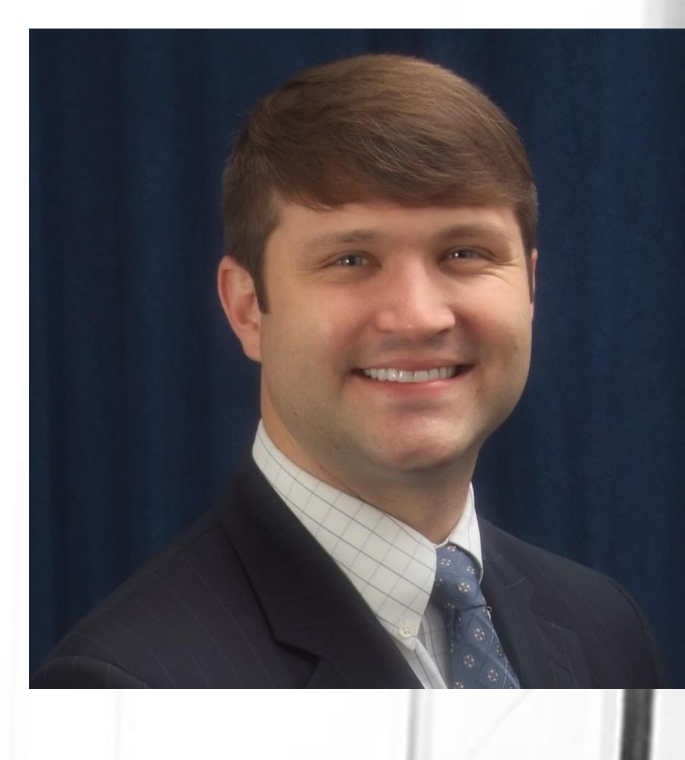
Fund Manager Profiles

About the Managers:
Jonathan Booth, CFA, CPA/ABV



- Passed CPA exam, ABV exam, and all 3 CFA exams on first attempt
- 2006 Elijah Watt Sells Award (top 10 CPA exam score in the world out of 50,000+ test takers)
- 2008 Baton Rouge Business Report "Top 40 Under Forty" Award
- B.S., Accounting and M.S., Accounting from Louisiana State University
- 3+ years of auditing experience with two of the Big 4 accounting firms
  - Exceptional performer every year & early promoted
  - Lead senior of Fortune 500 audit client
- Former Assistant Director of State Economic Competitiveness under Governor Jindal
- Accredited Member magazine and SeekingAlpha.com contributing author

About the Managers: Kevin Laird, CPA



- 7 years of accounting and auditing experience with
  - KPMG – Big 4 accounting firm
  - Postlethwaite & Netterville – largest accounting firm in Louisiana
  - The Edgen Group – Manager of Financial Reporting
  - Edgen-Murray Corporation – Assistant Controller
- B.S., Accounting from Louisiana State University
- M.B.A. from Southeastern Louisiana University
- Louisiana Society of CPA's Business & Industry Committee
- 2012 AICPA Leadership Academy – one of 36 selected from across the nation for prestigious 4 day event

Contact Information

Booth-Laird Investment Partnership
9005 Westlake Avenue
Baton Rouge, LA 70810
(225) 767-1439

Website: www.boothlaird.com
Blog: www.boothlaird.com/boothlairdblog/
Twitter: http://twitter.com/#!/BoothLaird

Jonathan Booth, CFA, CPA/ABV
Chief Executive Officer
Cell: (225) 978-1532
jonathan.booth@boothlaird.com

Kevin Laird, CPA
President & Chief Operating Officer
Cell: (225) 229-6567
kevin.laird@boothlaird.com