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"If you don't know where you are going, you might wind up someplace else." -Yogi Berra

9th of April 2024

Dear Clients and Friends,

The good performance across our portfolio in the first quarter was largely driven by earnings growth and strong fundamentals. The businesses continue to innovate, prudently manage costs, and delight customers. Our holdings are shepherded by talented management, diligently working to deliver growing value to shareholders. We remain bullish on our portfolios' long-term prospects.

Markets rose in Q1 2024, with the S&P 500 and Russell 2000 indices rising 10.6% and 5.2%, respectively. On March 7th, the Federal Reserve indicated that economic conditions may support interest rate cuts in 2024. The expectation of lower rates lifted investors' spirits that borrowing costs will ease in 2024, lowering the cost of capital for businesses and consumers.

The near-term path of interest rates could have a meaningful impact on the market and investor sentiment, but forecasting the direction of interest rates is difficult. We are more confident predicting that customers will continue to value fast delivery from Amazon and affordable homes built by Lennar. Experience has shown that our time is best spent looking for great individual businesses to own because they will adapt to the economic climate. We own a diverse portfolio of such companies and are encouraged by their performance this year.

PORTFOLIO REVIEW

DISNEY (DIS) – $118

The first quarter was a major step forward in Disney's multi-year improvement in profitability. In Q1, Disney grew earnings per share to $1.04 from $.70, and increased its dividend by 50%. For the year, Disney is projecting earnings per share will increase 20% and free cash flow will grow to $8B, the highest level since 2019. With new attractions open at Shanghai Disney (Zootopia) and Hong Kong Disney (Frozen), we believe Disney's Parks business is positioned for a strong 2024, we estimate that Disney could earn $6/share in 2026 and be valued at $150/share.

ALPHABET (GOOGLE) - $159

In addition to its globally dominant and highly profitable core search business, we believe that Alphabet is emerging as a leader in Artificial Intelligence ("AI"). Few companies in the world rival Alphabet's talent, technical capabilities, and financial resources, all key ingredients to success in AI. Across Alphabet's many businesses, including Search, YouTube, Google Cloud, and Waymo, AI can accelerate growth and productivity. Through a combination of 8-10% revenue growth, operating margin expansion and share repurchases, we believe that Google can grow its earnings per share at 12-15% per year through 2026, which approximates our estimated return in the stock.

ALLY FINANCIAL (ALLY) - $39

We believe that Ally's book value and earnings are poised to grow into 2025 as lower rates increase the mark-to-market value of Ally's securities portfolio and the auto lending market remains robust. On March 27th, Ally named Michael Rhodes, the former CEO of Discover Financial Services, as its new CEO. Mr. Rhodes is well-regarded and bring years of financial industry experience. At 10x estimated 2025 earnings of $5.30/share, Ally would be worth $53/share.

META (FACEBOOK) - $514

Meta's resilient business model and multi-year investment into artificial intelligence continues to shine: On February 1st, Meta reported that Q4 revenue increased 25%, operating income grew 156%, and net income per share increased by 203%. After years of investment, Meta is emerging as a winner in AI-based advertising and messaging, allowing it to better monetize its global network of three billion users. Consensus estimates project Meta will earn $26.50/share in 2026; at the same multiple, Meta would be worth ~$660/share.

MANAGEMENT AND CAPITAL ALLOCATION

We seek to invest in companies with a demonstrated ability to allocate capital in ways that deliver returns for shareholders. Public companies have essentially four choices for how they can allocate capital; reinvest into their existing business, pay a dividend, repurchase their own shares, or make acquisitions. When a company executes the right capital allocation strategy, it can create meaningful business value. Below we highlight three of our portfolio companies doing just that:

ALASKA AIRLINES (ALK) - $43

Alaska Airlines ("Alaska") is an exceptionally well-run regional airline. In 2023, Alaska delivered pre-tax profit margins that were among the highest in the industry. On top of great execution, we are optimistic that Alaska's recent decision to acquire Hawaiian Airlines is an excellent use of capital.

On December 3, 2023, Alaska announced that it was acquiring Hawaiian Airlines, the leading regional carrier serving the Hawaiian Islands. Together, Alaska and Hawaii Airlines will form a regional powerhouse, with a fleet of 365 narrow and wide body planes that can reach a combined 138 destinations. The combination allows Alaska to diversify its geographic exposure and improve its competitive position in the Western United States.

Historically, Hawaiian was a highly profitable airline; from 2015-2019, Hawaiian averaged approximately $400m per year in operating profit. Beginning with the massive disruption to the airline industry caused by Covid, together with the tragic wildfires in Hawaii in 2023, Hawaiian faced several years of extreme difficulty, causing the airline to post a cumulative operating loss of $1.6B from 2020-2023.

Alaska's Management believes that the last few years are not reflective of the strength and profitability of Hawaiian's business and agreed to pay $1.9B to acquire the company. If Hawaiian's profitability can revert to pre-Covid levels, Alaska's purchase price could turn out to be a great value. We find Alaska's operational and financial logic for the deal compelling; in success, the acquisition will create a stronger, more profitable company.

POST HOLDINGS (POST) - $102

Post Holdings ("Post") is a shining example of sound capital allocation benefiting long-term shareholders. Post began its corporate life in 2012 as a spin-off of Ralcorp, consisting of just one business: a highly, profitable, but mature breakfast cereal business that included household staples Raisin-Bran, Fruity Pebbles, and Honey Bunches of Oats. At the time, Post's cereal business generated approximately $1B in revenue and $150m in operating profit. Though the cereal business was profitable, it was not growing.

Over the course of the next 10 years, Post shrewdly diversified by making bold, smart acquisitions across the food sector. Funded with low-cost debt and stable cereal cash flows, Post was able to buy market leading food companies. Post's approach was a resounding success; In 2024, Post will generate $8B in revenue and $1B in operating profit.

In a recent investor presentation from March 2024, Post signaled that it may shift its capital allocation focus to reducing debt. This can increase Post's financial flexibility, reduce interest expense, and increase earnings per share. The same investor presentation projected that in five years Post's stock could being worth $191/share compared to $105/share today. If the past is prologue, Post's capital allocation will continue to reward shareholders.

AMAZON (AMZN) –$185

Amazon does so many things well that is easy to overlook that capital allocation is one of its core competencies. Over the last five years, Amazon has invested approximately $230B in capital expenditures, which to our knowledge is more than any other publicly traded company. Over the same time frame, revenue more than doubled from $280B to $574B and net income nearly tripled, increasing from $11.5B to $30B. The scale and time horizon of Amazon's capital investments is difficult for almost any company to match, a competitive advantage that allows Amazon to aggressively pursue growth opportunities that require immense financial resources and patience.

Case in point is Amazon's recent pronouncement that it intends to invest $150B over the next ten years into AWS, its market leading cloud computing business. AWS is a $90B revenue business that generates $24B in operating profit. It is the largest and most profitable cloud computing provider in the world. Amazon aims to further improve AWS ‘s competitive position with more investments into data centers, networking equipment, and specialized hardware purpose built for artificial intelligence-based applications. Amazon's increased investment supports AWS's profitable growth for many years to come, while ensuring that Amazon is on the cutting-edge of AI-based cloud computing services.

Alaska, Post, and Amazon are each employing different capital allocation strategies; Alaska is making a large opportunistic acquisition of a historically profitable and highly strategic business; Post is directing its cash flow to pay down debt; and Amazon is making a substantial long-term capital investment to improve the competitive position of its most profitable business. We like each approach and believe that our portfolios will reap the benefits.

Sincerely,

Ben Weiss, JD
Chief Investment Officer

Tom Eidelman, CFA
President

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