

## Investor Insight: David Samra

*“The uncertainty about whether we’re looking at a disaster or whether everything will be OK is uncomfortable,” says David Samra. Here’s how he’s responding.*

### INVESTOR INSIGHT



**David Samra**  
Artisan Partners

**Investment Focus:** Seeks companies with high returns on capital, strong balance sheets, shareholder-focused management teams – and inexpensive share prices.

He’s been through big market disruptions before, but David Samra speaks for many portfolio managers when he says, “This is a handicapping process that is different and more difficult than when the tech bubble burst or during the financial crisis. The range of outcomes is extremely wide and uncertain. In many ways we’re in uncharted territory.”

Samra is well-equipped for the task. He co-founded the International Value team at Artisan Partners in 2002 and now manages nearly \$20 billion in client assets. The Artisan International Value Fund since inception through February has earned a net annualized 11.2%, vs. 6.9% for the MSCI EAFE Index. In this interview he offers a wide range of insights into how he’s navigating the market’s tumultuous seas.

It seems like a lifetime ago, but for some context, describe generally how you were assessing your investment opportunity set coming into 2020.

**David Samra:** As we were traveling through the end of last year we were seeing little to no earnings growth, yet equity markets were up significantly. We track the aggregate discount to intrinsic value in the portfolio and that had narrowed to the

mid-teens, when 25% or more is when we think things start to look more attractive. We had built cash to our maximum of a 15% position and told clients and shareholders that while we were perfectly comfortable with the businesses we owned, we were concerned about valuations. The expected returns, and therefore the margin of safety, weren’t high enough to make us enthusiastic about the opportunity set.

We look for four key characteristics in

### Benjamin Graham on Fair-Weather Investing

*Editor’s Note: Warning against the risk of lowering one’s investment standards when times are good while also bemoaning the fact that attractive bargains were hard to find, David Samra in his 2019 year-end letter to investors included the quote below from Benjamin Graham’s The Intelligent Investor. We wish we’d shared it then, but the insight is valuable regardless of the market environment:*

[T]he risk of paying too high a price for good-quality stocks – while a real one – is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions. The purchasers view the current good earnings as equivalent to “earnings power” and assume that prosperity is synonymous with safety. It is in those years that bonds and preferred stocks of inferior grade can be sold to the public at a price around par, because they carry a little higher income return or a deceptively attractive conversion privilege. It is then, also, that common stocks of obscure companies can be floated at prices far above the tangible investment, on the strength of two or three years of excellent growth.

These securities do not offer an adequate margin of safety in an admissible sense of the term. Coverage of interest charges and preferred dividends must be tested over a number of years, including preferably a period of subnormal business. The same is ordinarily true of common-stock earnings if they are to qualify as indicators of earning power. Thus it follows that most of the fair-weather investments, acquired at fair-weather prices, are destined to suffer disturbing price declines when the horizon clouds over – and often sooner than that.

the companies in which we invest: a cheap price, a high-return business, a strong balance sheet and a management team with a record of building shareholder value. Though we never purchase shares of a company that doesn't meet our minimum hurdle rates with respect to valuation, the other three criteria exist in shades of gray – some businesses are better than others, some balance sheets are stronger than others and some management teams are more skilled than others. We actually put an excerpt from Benjamin Graham's *The Intelligent Investor* in our Q4 investor letter [see box] talking about how tricky the market was for value investors. To put money to work in cheap stocks, the natural inclination is maybe to compromise on business quality, balance sheet and/or management.

We have always been very aware of that risk, which is why we set up and rigorously follow the four parts of the discipline I mentioned. But as a value investor operating in an extended bull market, it got harder and harder to hang on to the best businesses we owned like Accenture [ACN] or Diageo [DEO] or Medtronic [MDT] as their valuations really started to blow out and the risk embedded in owning them at high prices increased. When you sell them you start looking at more typical value-investor areas that have been depressed – like autos, energy, industrials and materials – where the valuations might be attractive, but they're also more vulnerable in an economic downturn. We bought a few of them that we thought were better positioned in their industries and had balance sheets that could withstand a difficult economy. Given what's happened, we were fortunate to keep as much cash as we did.

**Relative to what you've faced in your investing career, can you put this current market disruption in context?**

**DS:** This is my third big market break. The first was the tech bubble, which was very different because much of the mania – and it was a mania – was embedded in a limited number of sectors. When those sectors blew up, we as value investors benefitted

because we could own a lot of other great businesses that had been undervalued and neglected that came through the bursting of the tech bubble with flying colors.

The second was the financial crisis, where pretty much every sector was impacted as the financial system seized up and there was a severe lack of liquidity. In that case you knew there was going to be a global downturn and as an investor you needed to handicap some level of re-

## ON DEBT LEVERAGE:

**It would seem logical that you'd run your company with excess capital and the market would appreciate that.**

cession and make your security selections based on expected returns as that recession played out and recovered. I don't mean to say that was easy or straightforward, but you could rely somewhat on the process following established cyclical patterns.

This downturn is different in many ways. The speed, breadth and severity of it has so far been far more significant than in the other disruptions I've seen. The economic damage is not focused on tech companies, or banks, but covers a much larger swath of the economy. At the same time we're dealing with an epidemiological issue where issues of public health critically impact both the economic and political outcomes and responses. So much of this is new. I can read expert opinions that say this is nothing but a bad flu and we'll get past it relatively quickly, and those that say if we don't take drastic steps 10-15 million people will die in the U.S. alone. As an investor, that all makes it much more difficult than I've seen before to handicap the end game.

**Describe your research and portfolio-management priorities at such a time.**

**DS:** There are several priorities. I'd say job one is reassessing the financial health of

every company we hold in the portfolio. Watching the balance sheet is always key to what we do, but that's obviously even more important when there's the prospect your business might essentially stop for a couple of quarters. What seemed like a perfectly reasonable leverage and liquidity profile to handle debt maturities, meet debt covenants and pay declared dividends can deteriorate quickly when you need to cover significant operating losses that come out of nowhere. Important here is not only the amount and type of debt you have, but also who owns it. We learned in the financial crisis there can be a lot of forbearance on the part of the banks, but less so from hedge funds or other institutional investors that will take equity if the debt goes bad. That's typically not a great outcome for existing shareholders.

I'd like also to say something about the corrosive nature of very low interest rates. You've seen a tremendous amount of leverage built up in the corporate system – big companies and small companies alike – who have been saying, "Gee, look how cheap debt is. I can make my balance sheet more 'efficient' by taking on additional debt." In my experience that's the wrong way to come at it. In each market meltdown I've seen, the reason overcapitalized companies prosper coming out of it is because they're better able to preserve what they have and take advantage of stress to take market share.

If it's going to happen once a decade, it would seem logical that you'd want to run your company with excess capital and that the market would be smart enough to appreciate that. But too often that doesn't happen. Samsung [Seoul: 005930] was our largest position going into the crisis, when the market only wanted happy stories and didn't want to deal with the fact that there was cyclical demand in semiconductors, despite strong secular demand. Investors also disliked that the company had one-third of its market cap in net cash. I'd argue that companies with that kind of financial strength should trade at a premium, yet in Samsung's case the market wasn't giving it any credit for that at all. By the way, today the market is giving Samsung credit for it.

This gets at something related to portfolio management as well: Investors ask why I carry cash, given the opportunity cost and how little you can earn on it. But that undervalues the potential benefit of having it available to put to work at appropriate times. Companies that haven't leveraged themselves as much as possible benefit from that same kind of optionality.

#### Beyond balance sheets, where are you spending your time?

DS: The next priorities are more offensive and are happening pretty much at the same time. We're fully analyzing every company in the portfolio to assess how significantly they might be disrupted and gauge whether the share-price decline has improved the expected return enough to buy more shares. We clearly know the businesses very well, but there is new information to consider. The same goes for companies we follow closely on our watch list but haven't been able to own recently due to valuation.

It's an evolving process, but our baseline assumption for now is that there will be a couple quarters of declining economics for most every business. That's not wildly dissimilar to the financial crisis, when we generally found our estimates of intrinsic value came down 10% to 15% while stock prices were down far more than that. Whether that's consistent with this time depends on the downturn's duration – if the economics are severely hit for three quarters or more, the impact on intrinsic value is obviously worse.

We're also opportunistically focusing on the industries like travel, leisure and energy where the share-price impacts have been most dramatic. In areas like these the selling can be quite indiscriminate, so we're looking mainly at the market leaders with the best cost structures and best balance sheets. For those we see coming out best on the other side, the share prices relative to our estimates of normalized earnings two to three years from now have in some cases been quite attractive.

#### So you're putting your cash to work?

DS: Yes. We've added to existing holdings, accumulated significant positions in what we consider great businesses off our watch list, and we've also taken meaningful positions in other businesses that have borne the brunt of the damage in this downturn. We're also starting to make additional distinctions within the portfolio to potentially lighten up on positions that have held up relatively well – food companies,

### ON TAKING ACTION:

#### **We've had very benign turnover for the last ten years – our next numbers will be substantially higher.**

consumer-goods companies, healthcare providers, telecom providers – and deploy capital into opportunities we believe now have higher expected returns. We've had very benign portfolio turnover for the last ten years – our next numbers will be substantially higher.

This is an interesting time for value investors. The growth stocks that were leading the market have held up much better than more common value stocks, which may be more cyclical and perceived to be more vulnerable in an economic downturn. That has widened what was already a very wide valuation gap between growth and value stocks. If we get back to normal in a reasonable time frame – and that is a big if – to use some U.S. corollaries it's not Alphabet that is going to outperform, it's going to be something like JPMorgan. The valuation gap is just extremely wide right now.

#### **Describe your general portfolio-management disciplines and how they've served you so far as the market has hit the wall.**

DS: We generally hold around 40 stocks, are pretty agnostic about benchmarks, and don't take position sizes at cost above 5%. I mentioned Samsung was our largest position, which was partly a function of

our risk-weighting expected returns. For a given expected return we could hold more of something like it, in part due to its financial strength. That's been a relatively good thing. We also had some exposure to banks, but in risk-weighting expected returns there we didn't have outsized positions, which has so far been a positive as well. [Note: At year end the Artisan International Value portfolio held stakes in ING in the Netherlands, Bankia in Spain, UBS in Switzerland, and Lloyds and Royal Bank of Scotland in the U.K.]

That's not to say our risk-weighting has worked in every instance. We owned two global catering companies, Compass Group [London: CPG] and Sodexo [Paris: SW], which I viewed among the better and more stable businesses in the world. But if students aren't at school, or workers aren't at work, or fans don't attend sporting events, they don't need the food services. These were outcomes so significantly different from the norm that we didn't, even couldn't, handicap them into our portfolio weightings.

The last thing I'd mention is that position sizing is very dynamic and fluid in this type of environment. Arriving at expected returns is more difficult. Risk-adjusting those returns is more difficult. At the same time, the incredible market volatility can make the right position size one day after a stock is up 15% the wrong position size the next day when it's down 15%. If nothing else, this is also the busiest financial crisis I've had so far.

#### **You mentioned food-service company Compass Group. How are you handicapping its long-term potential from here?**

DS: Compass is the largest institutional catering company in the world, serving a broad range of corporate clients, educational institutions, healthcare facilities and sporting venues. North America is the main engine for the company, accounting for just over 60% of revenues and 70% of operating profits. Overall operating margins in normal times aren't particularly high, 7-8%, but the business isn't very capital intensive so returns on capital em-

ployed tend to be in the low-20% range.

The value proposition comes in the form of cost savings driven by much greater purchasing scale in food and related products as well as more efficient management of labor due to the size of its contract labor force and its experience in managing food-service employees. To institutions whose expertise lies somewhere other than in food service, Compass can offer the same level of service at a much better price than handling it internally, or much better service at a comparable price.

Those economics are driving what we believe is a still-long-to-run trend of secu-

lar growth. Compass is the global market leader in what is a roughly £200 billion annual market, but it still has a less than 10% share. The top four players – also including Sodexo, Aramark and Elior Group – have less than 30% of the market. At the same time, there’s still a lot more outsourcing to be done. In North America, for example, about 70% of the market remains either self-operated or handled by much smaller third-party companies. In Europe, more than 50% of the market is still self-operated.

All that should translate into significant secular growth potential for companies at

scale like Compass. Its North American operation has compounded revenues over the past 16 years at 7.5% per year as the size of the market has grown and the company has taken share of that bigger market. We think there’s still a lot of room for it to grow as those trends continue.

**Does anything other than scale set the company apart competitively?**

DS: One important thing is that the company is organized around end markets, so that each segment is more entrepreneurial-ly run by people who are expert in serving hospitals, or universities, or corporations. They’re still taking advantage of common purchasing, human resources and back-office functions, but the market specialization we think translates into more customized product offerings and has been a key reason Compass is able to consistently take market share.

In terms of areas of improvement, the European business has never been as strong as it is in North America and hasn’t taken as much advantage of scale or vertical specialization. It’s harder in Europe with more diversity in consumer tastes and eating styles, but the company continues to expand there and is starting to organize itself better to capitalize on its scale and vertical expertise.

Outside of Europe and the U.S., the business has also been reset to diversify somewhat away from very significant exposure to oil and gas and mining companies. That has taken a few years, but the rest-of-world business is now in much better shape and growing again.

**Describe the stress-testing you’re doing on the business in light of today’s crisis?**

DS: The company ended 2019 with net debt at just a bit over 1x EBITDA, which appeared perfectly fine for a steady business that held up well even through the financial crisis. Education is generally pretty solid, as is healthcare. Event venues can have some ups and downs depending on how individual teams are doing, but that tends to even out fairly well. The most cy-

INVESTMENT SNAPSHOT

**Compass Group**  
(London: CPG)

**Business:** Provider of outsourced food and related support services to 55,000 corporate, governmental, educational, healthcare and entertainment client locations in 45 countries.

**Share Information**  
(@3/30/20, Exchange Rate: \$1 = £0.81):

**Price** £11.90

52-Week Range £8.66 – £21.50

Dividend Yield 3.4%

Market Cap £19.09 billion

**Financials (TTM):**

Revenue £25.15 billion

Operating Profit Margin 6.4%

Net Profit Margin 4.5%

**Valuation Metrics**  
(@3/30/20):

	CPG	S&P 500
P/E (TTM)	17.2	20.1
Forward P/E (Est.)	n/a	15.8

**Largest Institutional Owners**  
(@12/31/19 or latest filing):

Company	% Owned
BlackRock	8.2%
Massachusetts Fin Services	7.6%
Invesco Adv	4.7%
Vanguard Group	3.0%
Walter Scott & Partners	2.8%

**Short Interest** (as of 3/13/20):

Shares Short/Float n/a

**CPG PRICE HISTORY**

**THE BOTTOM LINE**

When we get back to "a normal human interactive universe," David Samra believes the company can continue to increase its market share in what is a secularly growing market worldwide. At the £1 in normalized earnings per share and 20-22x EPS multiple he could imagine within the next two to three years, the company's stock would reach at least £20.

Sources: Company reports, other publicly available information

cicality is typically in the corporate business, which is impacted up and down by unemployment levels.

That was before now. We're currently assuming revenues fall 25% in each of the next two quarters, which as that flows through would cause net debt to increase by maybe £1.5 billion and for EBITDA to disappear. If that's what happens, the company won't violate debt covenants, which are set at 4x net debt to EBITDA on trailing 12-month numbers. The longer the crisis lasts, the greater the likelihood Compass would need to go out and raise capital. If the stock was trading at 11x normalized earnings, as it is today, we'd be happy to finance a rights offering ourselves at that valuation.

**Looking out to a time when normalcy returns, what potential do you see in the stock from today's price of around £12?**

**DS:** There's no question the company is going to have a really rough couple of quarters and most of the earnings in 2020 will disappear. But in a normal human interactive universe we believe the company, driven by resumed growth, operating leverage and profitability improvements outside North America, can earn around £1 per share by 2022. Also on a normal basis we'd expect the shares of a business of this quality to trade at 20-22x earnings. That would yield a stock price close to double today's.

Note the language I chose. I didn't say we have to return to a "normal economic environment," we just need to get back to people interacting in the same way as before. This is not a demand issue – we're very confident the demand is there.

**Turning to healthcare, describe your thesis for Novartis [Zurich: NOVN].**

**DS:** When we first purchased Novartis more than ten years ago, it was more of a healthcare conglomerate, with operating segments in traditional pharmaceuticals, generics, animal health, vaccines and a specialty ophthalmic business through Alcon. At the time it was overdiversified,

lacked focus and had issues in many of its divisions – all situations we thought were fixable.

The company put in a new CEO, Joe Jimenez, who did a very good job of selling or spinning off a number of assets to focus on the remaining divisions today in core pharmaceuticals and generics. What they call the Innovative Medicines pharma segment is nicely diversified, with more than 30 novel treatments that in most cases have leading share in the therapeutic areas they serve, which include oncology, ophthalmology, neuroscience and immunology. This business in 2020 is expected

to earn close to 35% operating margins on around \$40 billion in sales.

The Sandoz generics business today accounts for another \$10 billion or so in revenues and generates operating margins above 20%. This business has had to be streamlined but is now well positioned and has particular strength in the fast-growing biosimilars area of market.

One key element of our investment case is the current CEO, Vasant Narasimhan, who took over in 2018. Joe Jimenez was the right person at the right time when he was running the company, but we believe Vas is very much the right person to be

**INVESTMENT SNAPSHOT**

**Novartis**  
(Zurich: NOVN)

**Business:** Develops and sells proprietary and generic pharmaceuticals, with key franchises in oncology, ophthalmology, neuroscience, immunology and respiratory treatments.

**Share Information**  
(@3/30/20, Exchange Rate: \$1 = CHF 0.96):

**Price** **CHF 77.80**  
52-Week Range CHF 65.09 – CHF 96.38  
Dividend Yield 3.9%  
Market Cap CHF 189.73 billion

**Financials (TTM):**  
Revenue \$48.62 billion  
Operating Profit Margin 23.3%  
Net Profit Margin 24.1%

**Valuation Metrics**

(@3/30/20):

	<b>NOVN</b>	<b>S&amp;P 500</b>
P/E (TTM)	15.4	20.1
Forward P/E (Est.)	13.5	15.8

**Largest Institutional Owners**

(@12/31/19 or latest filing):

<b>Company</b>	<b>% Owned</b>
Capital Research & Mgmt	3.0%
Vanguard Group	2.6%
Norges Bank Inv Mgmt	2.1%
UBS Asset Mgmt	2.1%
Wellington Mgmt	1.7%

**Short Interest** (as of 3/13/20):

Shares Short/Float n/a

**NOVN PRICE HISTORY**



**THE BOTTOM LINE**

While enthusiastic about the company's long-term business prospects, David Samra says he can make an initial case for its stock today purely on valuation. He argues a well-run business with this growth profile, profitability, R&D prowess and financial strength should trade at a forward earnings multiple of at least 18x, not the current level of 13.5x.

Sources: Company reports, other publicly available information

running it today. All global pharma companies have the potential to benefit from aging populations needing more medical care and from increasing healthcare penetration in developing markets, but more than ever the winners will be those who can best manage the difficult process of translating innovation and R&D into economic opportunity. We believe Novartis is uniquely good at that and credit Vas, who is a medical doctor and had previously been the company's chief medical officer and its head of global drug development, for a lot of it.

The company spends \$7.5 billion a year on research and development and over the past five years has launched 14 new products of scale. The pipeline remains quite full, with five new treatments having gone through the FDA trial process and now awaiting approval. Another nine drugs are in phase-III trials. We think this kind of effective renewal of the portfolio is repeatable and will continue to be a competitive advantage.

Even pharma companies have not been immune from the recent market selloff – Novartis's stock at a recent 77.80 Swiss francs is down nearly 20% from its February high. How do you see its development prowess translating into upside for the shares?

DS: We can make the case for the stock today purely on valuation. A company with this secular growth profile, high profitability, highly productive R&D, strong management and excellent financial strength – net debt is close to zero if you net out the company's super-voting stake in fellow Swiss drug company Roche – should not trade at the current P/E on 2020 estimates of 13.5x. We think something like 18x is far more reasonable, which would take the share price above \$100.

Beyond this year we see revenues growing at least 5% per year, with operating margins for the overall company reaching the mid-30% range. With expected stock buybacks, that would translate into annual bottom-line growth closer to the mid-to high-single digits annually over the in-

termediate term. Those economics would imply a multiple of at least 20x earnings. In the meantime, while we wait for the additional share-price upside all that would entail we're earning an annual dividend on today's price of around 4%.

**Describe your ongoing optimism about the long-term prospects of luxury-goods purveyor Richemont [Zurich: CFR].**

DS: This is another company that has narrowed its areas of focus over time. I've followed Richemont since I started in the investment industry in 1993 and have seen it

evolve from a conglomerate that also sold tobacco products and had a media business into one focused almost exclusively on luxury goods. The founder, Johann Rupert, is still very much in charge and has proven to be an extremely capable, value-driven and financially conservative leader. He's an owner/operator and very much behaves like one.

Jewelry, through flagship brands Cartier and Van Cleef & Arpels, accounts for roughly half of annual revenues and close to 85% of annual profits. The company also has several luxury watch brands, including Piaget and Jaeger-LeCoultre. The

**INVESTMENT SNAPSHOT**

**Richemont**  
(Zurich: CFR)

**Business:** Global design, manufacture and sale of luxury goods – primarily jewelry and watches – sold under such brand names as Cartier, Van Cleef & Arpels and Piaget.

**Share Information**  
(@3/30/20, Exchange Rate: \$1 = CHF 0.96):

<b>Price</b>	<b>CHF 52.10</b>
52-Week Range	CHF 44.64 – CHF 87.44
Dividend Yield	3.8%
Market Cap	CHF 30.24 billion

**Financials (TTM):**

Revenue	€13.99 billion
Operating Profit Margin	13.6%
Net Profit Margin	9.6%

**Valuation Metrics**

(@3/30/20):

	<b>CFR</b>	<b>S&amp;P 500</b>
P/E (TTM)	18.8	20.1
Forward P/E (Est.)	n/a	15.8

**Largest Institutional Owners**

(@12/31/19 or latest filing):

<b>Company</b>	<b>% Owned</b>
Vanguard Group	2.9%
Norges Bank Inv Mgmt	2.5%
Gardner Russo & Gardner	1.9%
Artisan Partners	1.8%
Harris Assoc	1.6%

**Short Interest** (as of 3/13/20):  
Shares Short/Float n/a

**CFR PRICE HISTORY**



**THE BOTTOM LINE**

The "natural human tendency for people to celebrate and show that they are successful" should drive continued secular growth for the company's well-regarded and well-marketed luxury brands, says David Samra. Applying a 25x earnings multiple to his EPS estimate three years out, the stock would trade at around 100 Swiss francs per share.

Sources: Company reports, other publicly available information

third business segment is online distribution, where it is the largest e-commerce company for luxury goods, primarily through its subsidiary Yoox Net-a-Porter.

People talk about younger consumers valuing experiences over material goods, but that isn't at all what we were seeing in the company's business prior to the coronavirus issue. Outside of the value-investor community, at least, there seems to be a natural human tendency for people to celebrate and show that they are successful, which translates into very healthy secular growth for luxury goods. There's also a secular trend in jewelry from unbranded items to branded ones, which obviously benefits a company with such well-recognized and well-regarded brands like Richemont. Its top line overall has consistently grown in the mid- to high-single digits going back to 2000.

**How has e-commerce impacted the company's business?**

DS: It doesn't appear to have hurt the traditional business in a material way, but Yoox Net-a-Porter in its growth ramp up is still losing a couple hundred million dollars per year. But it continues to grow nicely and positions the company well as e-commerce in luxury goods evolves. It may be pushed out a bit now, but we were expecting the online business to break even by 2022.

**How inexpensive do you consider Richemont's stock at around 52 Swiss francs per share?**

DS: There's no question that in the short term profits will go backwards, but there's currently 2.5 billion Swiss francs in net cash on the balance sheet and we believe within the next two to three years the company can earn close to 4 Swiss francs per share. There's actually a very good private-market comp here, which was LVMH buying Tiffany late last year at a price equating to around 27x earnings. We think Cartier and Van Cleef & Arpels are more attractive and profitable businesses than Tiffany. Even at a 25x P/E the shares

would trade in a few years at closer to 100 Swiss francs.

**Now to an industry even more beleaguered than most, describe the upside you see in Canadian integrated energy company Imperial Oil [Toronto: IMO].**

DS: Imperial Oil is Exxon Mobil's Canadian operation – Exxon owns about 70% of the company – which has large businesses both upstream in oil-sands mining and downstream in refining and chemicals. The upstream/downstream balance can swing significantly, but last year

downstream generated roughly 60% of the overall-company operating profits on around two-thirds of the total revenues. That mix will change a lot this year.

There are obviously issues here. Oil prices in our view were already under the marginal cost of production at the beginning of the year, but now they've fallen much further and the entire global market – except apparently Saudi Arabia and Russia for the time being – is having to slash production in the face of significantly lower oil demand. More specific to Imperial, a lack of pipeline capacity to efficiently get the heavy oil produced in Alberta out of

INVESTMENT SNAPSHOT

**Imperial Oil**  
(Toronto: IMO)

**Business:** Based in Canada and majority-owned by ExxonMobil, integrated producer and refiner of oil and related products; reserves are primarily in oil-sands developments.

**Share Information**  
(@3/30/20, Exchange Rate: \$1 = C\$1.42):

<b>Price</b>	<b>C\$14.86</b>
52-Week Range	C\$10.27 – C\$40.59
Dividend Yield	5.9%
Market Cap	C\$9.90 billion

**Financials (TTM):**

Revenue	C\$34.06 billion
Operating Profit Margin	6.0%
Net Profit Margin	6.5%

**Valuation Metrics**

(@3/30/20):

	<b>IMO</b>	<b>S&amp;P 500</b>
P/E (TTM)	5.2	20.1
Forward P/E (Est.)	n/a	15.8

**Largest Institutional Owners**

(@12.31/19 or latest filing):

<b>Company</b>	<b>% Owned</b>
Artisan Partners	3.7%
First Eagle Inv Mgmt	3.2%
Royal Bank of Canada	1.9%
T. Rowe Price	1.9%
Vanguard Group	1.0%

**Short Interest** (as of 3/13/20):

Shares Short/Float	n/a
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IMO PRICE HISTORY



THE BOTTOM LINE

The company looks very different on a normalized basis that it does at the moment, says David Samra. He believes it can reasonably earn a 10-11% return on equity, at which point he thinks its stock should be worth a 1.1-1.2x book-value multiple. Even on the current book value of C\$32 per share, that would result in a share price of close to C\$37.

Sources: Company reports, other publicly available information

Canada has also suppressed the price of that oil relative to the WTI benchmark.

While these problems don't correct overnight, we think the leverage on the upside for Imperial's oil business is particularly attractive. Oil sands is more of a mining business than traditional exploration and production, so once the capacity has been built out – as it largely has for Imperial – mine lives are very long and there's a lot of cash-flow leverage from increased volumes. We also think the price discount on its oil narrows as two pipelines currently under construction in the region come online. So under our assumption that oil prices make their way at least back to a conservatively estimated marginal cost of production of \$65 per barrel, the company looks very different on a normalized basis than it does today.

**How vulnerable is Imperial if that process takes a lot longer than you expect?**

DS: There are a number of things giving us comfort on the downside. First of all, the refining business is highly profitable when oil prices are low. Volumes decline for it in an economic contraction as well, but in the event the upstream business suffers, the downstream business is an excellent hedge. These numbers are changing quickly, but our latest revised estimates for 2020 showed that upstream operating losses could be \$2.1 billion, while the operating profit on the downstream business could increase to C\$2.3 billion. Again, this is all quite dynamic, based on day-to-day movements in oil prices and crack spreads. The company on an accounting basis is likely operating at a loss right now.

We don't know if this is the choice it will make, but to maintain the dividend – the current yield is 5.9% – Imperial would have to cut roughly C\$800 million from its capex spending. That would only take spending back to where it was just a few years ago.

I'd also mention that while the company has net debt, it lives off of Exxon's balance sheet. The financial risk even in an extended downturn doesn't strike us as being very high.

**How would you characterize your bullishness on the longer-term prospects for oil companies, especially those with higher-cost oil-sands reserves like Imperial?**

DS: We don't think we have to be long-term bullish to see opportunity here. We do assume the shift to alternative energy sources for transportation – which drives

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## ON MIXED FEELINGS:

**I'm far better off buying at low prices than high prices ... but I'd prefer to buy cheap outside of a human calamity.**

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demand for refined oil – will be a fairly long, drawn-out process. If that turns out to be the case, we believe existing oil-sands mines with sunk costs and a steady non-declining production profile will be around and profitable for a long time. We're probably not going to see a lot of greenfield oil-sands production come online, which should work to Imperial's incremental benefit.

**How attractive do you consider the shares at today's price of around C\$14.90?**

DS: The company generated free cash flow last year of C\$2.6 billion, so the market value is less than 4x that trailing number. The price to tangible book value is less than 50%. We think on a normalized basis the company can generate a return on equity of 10-11%, which we believe is worth a book-value multiple of more like

1.1x to 1.2x. On even the current book value of just over C\$32 per share, that would translate into a share price of close to C\$37.

I don't know when things get better. When oil prices were \$80-90 per barrel, Imperial generated ROEs in the high-teens to low-20s. Suffice it to say this is a cyclical industry, but if we're close to right on the recovery from here, the outcome for shareholders should at least be satisfactory.

**Value investors during difficult times like these often express something akin to glee at the bargains they can produce. For want of a better term, how would you describe your mood?**

DS: As an investor, I'm far better off buying businesses at lower prices than higher prices. That's exciting and it's remarkable how our team has responded. We're all working from home but the level of effort, the communication, the bullet-point prioritization – it's all driving incredible productivity and output. That part is all great.

On the other hand, the human side of me sees the damage done to people's livelihoods in these environments, which is an awful side effect of being able to buy bargain-priced stocks. I'd prefer to buy cheap stocks outside of a human calamity.

One thing that motivates me even more in times like this is that we have been entrusted to preserve the savings of individuals and institutions and to grow them over time. They may not have another lifetime to replace what they lose in an economic disaster. If we can make a positive difference on the extent of any lasting damage done, that's a pretty worthwhile calling.

As for my mood, it helps to have a lot of coffee in the morning and maybe a little bit of scotch in the evening. vii



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Investment Results as of 31 March 2020 (%)						Expense Ratios
Artisan International Value	QTD	1YR	5YR	10 YR	ITD	Prospectus 30 Sep 2019
Investor Class: ARTKX	-27.46	-18.26	-1.25	5.10	9.82	1.24
Advisor Class: APDKX	-27.45	-18.17	-1.10	5.18	9.86	1.10
Institutional Class: APHKX	-27.42	-18.08	-1.02	5.32	9.99	1.01
MSCI EAFE Index	-22.83	-14.38	-0.62	1.75	6.04	

Source: Artisan Partners/MSCI. Returns for periods less than one year are not annualized. Class inception: Investor (23 September 2002); Advisor (1 April 2015); Institutional (1 October 2006). For the period prior to inception, each of Advisor Class and Institutional Class's performance is the Investor Class's return for that period ("Linked Performance"). Linked Performance has not been restated to reflect expenses of the Advisor or Institutional Class and each share's respective returns during that period would be different if such expenses were reflected.

**Past performance does not guarantee and is not a reliable indicator of future results. Investment returns and principal values will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than that shown. Call 800.399.1770 for current to most recent month-end performance.**

**Carefully consider the Fund's investment objective, risks and charges and expenses. This and other important information is contained in the Fund's prospectus and summary prospectus, which can be obtained by visiting [www.artisanfunds.com](http://www.artisanfunds.com). Read carefully before investing.**

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**Normalized earnings** are adjusted to remove the effects of seasonality, revenue and expenses that are unusual or one-time influences. **Price-to-Earnings (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. **Book Value** is the net asset value of a company, calculated by total assets minus intangible assets and liabilities. **A multiple** measures some aspect of a company's financial well-being, determined by dividing one metric by another metric. **Return on equity (ROE)** is a measure of financial performance calculated by dividing net income by shareholders' equity. **Free cash flow (FCF)** is the cash a company produces through its operations, less the cost of expenditures on assets. **Market Cap** is the aggregate value of all of a company's outstanding equity securities. **Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is an indicator of a company's financial performance which is calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization.

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