

Bonhoeffer Capital Management Q3 2023 Letter

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Fund Letters

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Summary

The Bonhoeffer Fund, LP, is a value-oriented investment partnership. The fund's objective is to grow capital at a faster rate than market indices over full market cycles and provide minimal.

Bonhoeffer Fund has replaced slower-growth firms with higher-quality, growing firms in depressed sectors and continues to identify similar opportunities.

The fund has identified opportunities in specialized construction, natural resource royalties, medical facility leasing, distributors, logistics companies, housing, and specialty finance.

The fund's largest country exposures include the United States, South Korea, United Kingdom, Canada, South Africa, and Philippines, while the largest industry exposures include distribution, telecom/media, real estate/infrastructure, and consumer products.



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Dear Partner,

We have replaced slower-growth firms with higher-quality, growing firms in depressed sectors and continue to identify similar opportunities. We have identified opportunities in the following industries: specialized construction, natural resource royalties, medical facility leasing, distributors, logistics companies, housing, and specialty finance.

Bonhoeffer Fund Portfolio Overview

Bonhoeffer's investment portfolio consists of value-oriented special situations, as well as growth-oriented firms that exhibit unique qualities when applying a value framework. We are particularly interested in companies that grow organically and/or through transition or consolidation. We also like to see active capital allocation through funding organic growth, opportunistic buybacks, and synergistic acquisitions. There were modest changes within the portfolio in the third quarter, which are in line with our low historical turnover rates. We sold some of our slower-growing investments and invested some of our cash into North American Construction, described in the detailed case study in the appendix.

As of September 30, 2023, our largest country exposures included: United States, South Korea, United Kingdom, Canada, South Africa, and Philippines. The largest industry exposures included: distribution, telecom/media, real estate/infrastructure, and consumer products.

Conclusion

This quarter, we revised the formatting of the quarterly letter to simplify the content flow for the reader. We will start with a one-page summary of the portfolio followed by a detailed description of our themes including a discussion of investment topics on which I have thoughts to share. We will end each letter with a case study covering my research thesis on a select position.

As always, if you would like to discuss any of the investment frameworks or investments in deeper detail, then please do not hesitate to reach out. As we wrap up the third quarter, I want to thank you for your continued confidence in our work.

Warm Regards,

Keith D. Smith, CFA

Investment Themes

Compound Mispricings (27.0% of Portfolio; Quarterly Average Performance -1.7%)

Our Korean preferred stocks and the nonvoting shares of Wilh. Wilhelmsen ([OTC:WLLSF](#)) all feature characteristics of compound mispricings. The thesis for the closing of the voting, nonvoting, and holding company valuation gap includes evidence of better governance and liquidity. We are also looking for corporate actions such as spinoffs, sales, or holding company transactions and overall growth.

Wilh. Wilhelmsen is amongst the fastest growing compound mispricings in the portfolio. Return on equity for the core business (Wilhelmsen Maritime Services) has increased from 6% in 2018 to 23% for 2022 with a return on incremental invested capital (RoIC) of about 30% laid out below. 2017 was the first year after Wilh. Wilhelmsen contributed its roll-on/roll-off ('RORO') assets to form Wallenius Wilhelmsen and received a 38% stake in the combined entity in return.

WWIB												
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	30.6%
Capital Invested						39	34	23	64	19	56	196
2-yr sum								57	87	83	75	
4-yr sum										140	162	
CFO						58	61	126	123	118	118	60
2yr change								68	62	-8	-5	
4yr change										60	57	
												5-yr avg
2-yr ROIIC								119.3%	71.3%	-9.6%	-6.7%	43.6%
4-yr ROIIC										42 9%	35 2%	39.0%
Equity						194	380	353	489	521	432	
RoE						49.0%	5.5%	51.8%	20.4%	19 0%	22 9%	

Wilh. Wilhelmsen's largest investment (representing 33% of Wilh. Wilhelmsen's NAV), Wallenius Wilhelmsen ([WW](#)), which Wilh. contributed its RORO fleet to in 2016, also has increased its return on equity from 7% in 2017, to 44% in 2022, with a cyclically driven RoIIC of 140% over the past five years as laid out below. The RORO market that WW competes in has seen steadily increasing demand from auto and high and heavy (H&H) exports from China and supply which is moderately growing and returning to long-term trend growth of 3% by 2025. WW is currently generating 17% RoICs in an oligopolistic industry with modest supply growth and robust demand growth. The current ship utilization is highly evidenced by fixed asset turnover increasing from 0.7 in 2019, to 0.98 currently. WW is the largest of the RORO carriers in a six-player market.

Wallenius Wilhelmsen												
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	136.8%
Capital Invested	221	33	20	147	136	359	183	144	127	136	78	668
2-yr sum			53	167	283	495	542	327	271	263	214	
4-yr sum					336	662	825	822	813	590	485	
CFO	259	199	233	213	190	538	563	840	456	825	1452	914
2yr change			-26	14	-43	325	373	302	-107	-15	1452	
4yr change					-69	339	330	627	266	287	889	
												5-yr avg
2-yr ROIIC			-49.1%	8.4%	-15.2%	65.7%	68.8%	92.4%	-39.5%	-5.7%	678 5%	158.9%
4-yr ROIIC					-20.5%	51.2%	40.0%	76.3%	32.7%	48.6%	183 3%	76.2%
Equity	535	508	543	630	505.2	2622	2647	2678	2391	2539	3153	
RoE	7%	33%	39%	10%	11%	7%	14%	26%	14%	27%	44%	

Below is an intrinsic value for Wilh. Wilhelmsen based on the value of the underlying subsidiaries they hold.

Wilh Wilhelmsen (NOK)									
NOK/\$	9.831						WW		
	<u>EBITDA</u>	<u>Mutiple</u>	<u>Value</u>	<u>% of NAV</u>	<u>Mkt Cap</u>	<u>% Owned</u>	<u>Value</u>		
WMS Ops	1,415.7	7.0	9,909.6	33%					
New Energy			479.2	2%	1,864.7	25.7%			
WWL ASA			15,369.9	51%	40,650.3	37.8%	15,369.9		
Treasure			4,101.9	14%	5,919.1	77.0%	4,557.7	10%	Hold Co Disc to FMV
NorSea	552.9	6.0	3,284.2	11%	3,317.4	99.0%	3,284.2		
Net Cash			-3,116.4	-10%	Cash less debt at Holdings & WMS & Investments				
Net Asset Value	EPS	Multiple	22,521.4		25%	Hold Co Disc to FMV			
Shares			46.5						
NAV/Share	114.9		484.3		Discount				
A Shares		3.0	340.0		-29.8%	1.424501			
B Shares		2.9	330.0		-31.9%				
Book Value/Share	430.03	77%							
Expected Dividend	45.97825	13.9%							
Hold Co Discounts									
	Est			Current					
	<u>Disc</u>	<u>Exp</u>	<u>ER</u>	<u>Discount</u>			Earnings Yield	35%	
WWI	2%	41.29	0.2%	48.9%			Bond Yield	8%	NIBOR + 3.25%
Treasure	1%	3.14592	0.1%	27.7%			Spread	27%	
	<u>10-yrs</u>	<u>5-yrs</u>							
BV & Div Growth	6%	6%							
WWIB Share	5%	17%							
NI growth		55%							
WWI NI growth	4%	26%							

What makes Wilh. Wilhelmsen and WW interesting is their high returns on equity of 30-40%, and the factors that have driven these returns-namely Chinese exports and modest increases in fleet size-are expected to continue over the next few years. The RORO market benefits from oligopolistic competition to the point that participants have even settled on price fixing charges in the past. These factors are likely to persist and should allow for high returns on equity for the next few years, if not longer. The price for entry into this oligopoly is currently only 3x EPS.

Public Leverage Buyouts (LBOs) (49.8% of Portfolio; Quarterly Average Performance -2.7%)

Our broadcast TV franchises, leasing, building products distributors, plastic packaging, and RORO shipping fall into this category. One trend we find particularly compelling in these firms is growth creation through acquisitions, which provides synergies and operational leverage associated with vertical and horizontal consolidation and the subsequent repurchasing of shares with debt. The increased cash flow from acquisitions and subsequent synergies are used to repay the debt and repurchase stock; and the process is repeated. This strategy's effectiveness is dependent upon a spread between borrowing interest rates and the cash returns from the core business and acquisitions. Over the past 12 months, interest rates have been increasing, which has reduced the economics of this strategy; but a large spread still exists if assets can be purchased at the right price. Increasing interest rates has affected the returns on public LBO firms. Some firms, like Builders FirstSource (described below), have reacted to higher interest rates by moderating their use of debt in their expansion plans.

Builders FirstSource ([BLDR](#)), a portfolio holding, is an example of a private LBO. Given BLDR's current valuation of an 11% earnings yield and, more importantly, a five-year forward earnings yield of 15%, buybacks are accretive. The net income annual growth is expected to be between 17-20% over the next four years based upon management's guidance. This net income growth would imply a 17-20% total return before changes to the current modest valuation of 9x earnings. Below is the history of BLDR's RoIC and RoIIIC.

Builders FirstSource													5-yr total
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022		109.4%
Capital Invested	12.7	12.46	94.79	1512.5	38.4	59.4	96.6	198.9	136.2	1344.6	957.5		2733.8
2-yr sum			107.25	1607.29	1550.9	97.8	156	295.5	335.1	1480.8	2302.1		
4-yr sum					1658.15	1705.09	1706.9	393.3	491.1	1776.3	2637.2		
CFO	-32.7	13.9	19	72.6	192.6	263.5	369.4	396.2	477.6	2264.7	3254.5		2991
2-yr change			51.7	58.7	173.6	190.9	176.8	132.7	108.2	1868.5	2776.9		
4-yr change					225.3	249.6	350.4	323.6	285	2001.2	2885.1		
2-yr ROIIC			48.2%	3.7%	11.2%	195.2%	113.3%	44.9%	32.3%	126.2%	120.6%	5-yr avg	
4-yr ROIIC					13.6%	14.6%	20.5%	82.3%	58.0%	112.7%	109.4%	87.5%	
Return on Invested Capital	-2.0%	12.8%	11.9%	5.4%	11.0%	13.2%	17.1%	16.0%	18.2%	28.1%	43.2%	24.5%	

From this data, the return on capital has been about 24%, with higher four-year RoIIIC driven by a synergistic acquisition and demand growth. The estimated total return for BLDR is about 40% (five-year average RoE * (one-payout ratio) + dividend yield) given BLDR's payout ratio of 0% and no dividends. The return on equity is expected to decline to the high-20%s over the next few years. Given this change, the total return would decline to the high-20%s. The DCF from this ROIC analysis, in combination with management guidance from its recent investor conference, yields:

Builders FirstSource															
					EPS Growth	19.2%									
	2021	2022	2023	2024	2025	2026	2027	2028	2029		\$ 148.00	6.58	5-yr fwd PE		7% growth PE
											11.5%	8.70	Earnings/FCF Yield		22.5
Revs	\$19,894	\$22,726	\$16,400	\$17,876	\$19,485	\$21,238	\$23,150	\$24,770	\$26,009						
		14%	-28%	9%	9%	9%	9%	7%	5%				3% organic growth		
													3% M&A		
NI	\$2,099	\$3,058	\$1,597	\$1,785	\$1,946	\$2,121	\$2,312	\$2,473	\$2,597				6% Operation Lev	Future SP	\$575.37
	10.6%	13.5%	9.7%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%				7% Repurchase	IRR	31%
													19% Total EPS growth		
EPS	\$11.67	\$17.01	\$11.50	\$14.88	\$17.00	\$19.51	\$22.48	\$25.57	\$28.68						
		46%	-32%	29%	14%	15%	15%	14%	12%						
Buyback											History	Gr Rate	IRR		
	179.8	179.8	138.9	120.0	114.4	108.7	102.8	96.7	90.5		5	26%		7%	30%
50%	0.00	40.90	18.90	5.58	5.72	5.89	6.08	6.18	6.18		10	35%	Gr Rate	9%	31%
	150	150	150	160	170	180	190	200	210					12%	34%

enX Group														
					EPS Growth	23.2%								
	2020	2021	2022	2023	2024	2025	2026	2027	2028	R11.78	5.65	5-yr fwd PE		3% growth PE
										8.9%	11.26	Earnings/FCF Yield		6
Revs	R1,950	R2,486	R3,331	R4,195	R5,034	R5,789	R6,368	R6,813	R7,154					
		27%	34%	26%	20%	15%	10%	7%	5%					
NI	R22	R52	R147	R190	R252	R289	R318	R341	R358	Price		R8.50		
	1.1%	2.1%	4.4%	4.5%	5.0%	5.0%	5.0%	5.0%	5.0%	Distribution *		R5.50	Future SP	R17.79
										Value of Remain Co		R3.00	IRR	9%
EPS	R0.12	R0.28	R0.81	R1.05	R1.38	R1.72	R2.08	R2.49	R2.97	Distribution from net equity of Eqstra sale (R1.4b)				
		131%	184%	29%	32%	25%	21%	19%	19%	* PV of 7.50 in 1-yr @ 15% rate				
Buyback														
	182	182.0	182.0	182.0	182.0	168.0	152.8	136.9	120.6					
50%	0.00	0.00	0.00	0.00	13.98	15.23	15.92	16.22	16.26					
	8.5	8.5	8.5	8.5	9	9.5	10	10.5	11					

The remain co is growing at a high rate-26% revenue growth in FY 2023 from more distribution agreements and higher demand for power generation equipment. We have assumed the growth rate will decline over the next five years. Remain co is capital light with depreciation of about R45m per year and 2023 cap-ex including growth of R119m. Therefore, over 50% of net income is available for buy-backs.

Based upon the current purchase offer by Nedbank ([OTCPK:NDBKF](#)), management's estimated value of the Eqstra assets is R2.19b. Given the estimate liabilities of R1.47b, the equity will be worth R1.05b. Given management's history of distributing cash from previous sales, the asset-light nature of the assets retained, and the historical purchase price of R7.5b implying a tax loss, most, if not all, of the proceeds will be distributed. A complete distribution of the proceeds would equal R5.73 per share.

The current price is R8.50 per share. So for R8.50 per share, you will be receiving over R5.50 per share in cash plus a growing distribution with an RoE of 16% and generating R1 per share of earnings. If the remain co is worth at least 6x earnings, then enX will be up 35% from today's price, with a catalyst playing out over the next 12 months.

The risk here is that the largest shareholder group (48% ownership) put out a take underbid of R6.51 for the whole firm after the competition commission forced them to earlier this year. So another bid may be on its way, which would most likely be less than our value estimated above.

Telecom/Transaction Processing (25.6% of Portfolio; Quarterly Performance -11.6%)

Within this theme, the increasing use of transaction processing in the markets of our respective firms- as well as the rollout of fiberoptic and 5G networks-is providing growth opportunities. Given that most of these firms are holding companies and have multiple components of value (including real estate), the timeline for realization may be longer than for more mono-industry-focused firms. We are seeing event driven situations unfold in Consolidated Communications ([CNSL](#)) and Millicom ([TIGO](#)). With CNSL, there has been an increase in the revised Searchlight offer to \$4.70 per share to be paid in Q1 2025. Some shareholders have publicly stated \$4.70 is still too low (we think so), and we have had some discussions with proxy firms stating our case. For Millicom, Xavier Niel, the firm's number-one shareholder, continues to buy shares after the Apollo bid was rejected by Millicom. Mr. Niel has also nominated board members, and Millicom has moved its CEO to the chairman position and replaced him with an associate of Mr. Niel.

Consumer Product (12.0% of Portfolio; Quarterly Performance -2.6%)

Our consumer product, tire, and beverage firms comprise this category. The defensive nature of these firms can lead to better-than-average performance. One theme we have been examining is the development of category-killer retail franchises. These firms have developed local franchises which have higher inventory turns, margins, and sales per square foot than competitors, all resulting in great unit economics and high returns on incremental invested capital. They also have some unique characteristics, such as a specialty niche (like tire stores) or doing something the competitors will not do (like selling hunting supplies).

Real Estate/Construction (32.9% of Portfolio; Quarterly Performance -5.6%)

The pricing of our real estate holdings is positively impacted by the reopening of China and Hong Kong from COVID restrictions and its effects on Hong Kong's tourism from China. The current cement and construction holdings (in US/Europe via Builders FirstSource and Vistry, and in Korea via Asia Cement) should do well as the world recovers from COVID shutdowns and governments worldwide incentivize infrastructure programs. Vistry ([OTCPK:BVHMF](#)) is a firm in the process of transforming from a traditional asset-heavy homebuilder to a capital-light homebuilder and refurbisher. The firm has reported good progress, but a major shareholder, Impactive Capital, is winding down, thus the share price is under pressure. The availability of this large stake will allow Vistry to buy back stock at a favorable price that does not reflect the transformation.

In Search of Durable and High RoIC Firms

In searching for durable high RoIC opportunities with multi-bagger potential, some industries that are currently out of favor have some interesting opportunities. Specifically, the specialty contractor industry has interesting candidates including this quarter's case study, North American Construction, which has durable moats. In the case study below, I make the case that lack of supply due to location and regulatory/ESG hurdles has created this opportunity.

In memory of Charlie Munger's death, one of his ideas that always struck me the most was to look at value growth, in addition to current valuation, in determining interesting stock opportunities. Value growth has generated much higher returns than changes in valuation over time. This is in part due to value growth being recurring in nature, whereas valuation changes are one-time events. One way to look at this is to use Morningstar ([MORN](#)) to examine how fair value estimates have changed over time versus changes to discounts from fair value for a given firm.

You can see how a firm like Old Dominion Freight Line ([ODFL](#)) has consistently grown value over time despite having a generous valuation. Over the past 10 years, Old Dominion has had a one-star (overvalued) rating from Morningstar. The value growth (33%/year growth over the past 10 years) has driven this stock's return (28%/year over the past 10 years) as the market has always been willing to pay a premium for this growth.

Contrast that to Liberty Latin America ([LILA](#)), which for much of the past 7.25 years (since the spin-off) has had an undervalued (four or five star) rating. The value growth (-11%/year growth over the past 7.25 years) has driven this stock's return (-14%/year over the past 7.25 years), as the market increasingly discounted this stock for negative growth—a classic value trap. The future value of Liberty Latin America is driven by the ability to increase its intrinsic value over time with the changes in valuation playing a secondary role.

I have done that with all of the stocks in the portfolio and have found that most of our stocks are in the category of growing intrinsic value and decent discounts to fair value. The firms we have sold over the past few years have been the ones where the growth in intrinsic value has been slow or negative over time. Over the longer term, investing in firms with slowly growing intrinsic value is challenging not only from the value trap effect described above but also from high alternative returns from fixed income securities. Recently, the returns can be as high as the low-teens for well-underwritten debt in growing firms.

Another industry with durable and high ROIC niches is the financial services industry. This is an out-of-favor industry whose participants engage in multiple businesses. Most banks have both a lending franchise and deposit franchise. The lending franchise generates value by originating creditworthy loans at interest rates that more than compensate for loan losses, impairment, and the cost of funds. Banks can have niches (SBA loans and mortgages) where parts or the whole loans are sold to third parties, and the originator retains the servicing, making the operations capital light. Some banks specialize in the purchasing of third-party-originated loans from the FDIC (in the case of failed banks) or as a result of a regulatory stipulation in a bank merger. The key KPI in the lending franchise is the total asset return or yield (yield plus fees plus principal less any losses). Losses can be estimated based upon the historical write-offs and losses incurred. Banks reserve for expected loan losses via loan loss reserves. Recent financial reporting changes have introduced the metric of criticized loans to get an idea of what loans are having problems before becoming nonperforming and actual losses. Since banks are levered firms, small amounts of losses can result in large declines in equity.

The deposit franchise will have value when a bank can generate below-market-rate deposits from a sticky customer base whose reason for choosing the bank is not deposit yield. These can be value enhancing when combined with a great lending franchise. Examples of valuable deposit franchises include prepaid gift and debit card float, transaction processing float, providing value-add service for demand deposit accounts, and catering to a specific demographic group (minority or low-income folks). The key KPI for a deposit franchise is cost of funds. Combining asset yield and cost of funds results in an important KPI- net interest margins.

Other businesses banks are in include trust services, transaction processing services, multi-family GSE origination, and import/export financing. Some of the larger banks also provide asset management and custody services, investment banking, and advisory services. Occasionally, these services are the primary services provided, with lending and deposit services acting as onramps to these other services.

All banks incur costs associated with the services they provide. One way to measure the efficiency of a bank's operations is through the efficiency ratio-another key KPI-which is equal to the non-interest expense/(net interest income plus non-interest income). The average efficiency ratio for banks is currently 56%. Many times, efficiency is culturally based. So when you find a bank with a consistently low efficiency ratio, many times they are also good stewards of the bank's resources-primarily personnel and money. Banking is a business of controlling surpluses versus generating scarce profits as found in most other industries, so stewardship as reflected in compensation is a KPI well worth reviewing.

Despite banking being a mature business, there are specific niches that have created compounder-type returns over time. Sticking with those niches and not diluting them over time with lower return opportunities is a key skill in finding a financial services compounder.

An example is United Bancorporation of Alabama ([OTCQX:UBAB](#)), a CDFI bank operating in southwest Alabama and northwest Florida. UBAB has a low-cost deposit base (0.6% annual cost of funds in Q3 2023) and is increasing its loan book at 17% annually over the past three years in a fast-growing region of the country (Gulf Coast beach communities). UBAB has a good underwriting process which has generated, as of Q3 2023, NPAs of 1.0% with corresponding loan loss reserves of 1.7% and criticized loans of 6.0% (impaired loans and loans on a watch list). UBAB's efficiency is above average at 48% for Q3 2023. UBAB has utilized the various programs available to CDFIs such as financial assistance awards, BEA Program awards, and the Small Dollar Loan Program to generate fee income, as well as the low cost of funds. UBAB has a division that focuses on low-income real estate development and utilizes the New Markets Tax Credit Program and Community Housing Capital. These programs have generated fee income of about 20-25% net interest income over time.

UBAB also participated in the Emergency Capital Investment Program, in which the government provided \$124 million of preferred equity (UBAB's common equity is \$100 million) with a yield of somewhere between 2% and 0%. This preferred equity increases UBAB's common equity to assets to 13x from 6x pre-ECIP. A key KPI for banking is return on equity. Given UBAB's net interest margin of 4.6%, non-interest income of 20%, efficiency ratio of 48%, tax rate of 22%, and leverage of 13x, the resulting return on equity is 28% ($28\% = 4.6\% \times (1.2) \times (1 - 0.48) \times (1 - 0.23) \times 13$). The price of this interesting situation is a P/E of 4.7x 2013 earnings. The key to generating these returns is finding creditworthy customers to finance. UBAB has two drivers for loan growth: 1) the growth in government subsidized community development loans; and 2) the growth in real estate development in the Gulf Coast beach communities, which is amongst the highest in the country.

Motorized Vehicle Distribution/Dealer Businesses

Motorized vehicle dealer businesses can generate excellent returns on capital over time in the United States and has been stable for over 100 years. Recently, there have been technological innovations, such as buying cars online, which have been adopted by the larger incumbents and have enhanced their franchise values. Smaller franchise dealers have been challenged the most, as they don't have the resources to build an online sales capability. Most franchised dealers have agreements with OEMs that protect both the franchisee and consumers from OEM power and direct competition from the OEM. The motor vehicle dealer market is a very fragmented market worldwide. In the US, the top 10 dealers have a 9% market share.

Dealers are in three businesses: new and used sales, service and parts, and financing, which provides recurring payments. New and used car sales are one-time sales, but service and parts, leasing, and financing are recurring. As a dealership's customer base increases over time, the amount of recurring revenue increases. The recurring revenues also vary by motorized vehicle type, with construction equipment having the higher percentage of recurring revenue versus boat dealers.

One way to differentiate dealers is the amount of recurring revenue/cash flow they generate. For dealers, most of the recurring revenue comes from service. In many cases, dealers have been around for decades and developed loyal customers who utilize dealers for service and OEM replacement parts. Another way to estimate the stability of dealer cash flows is the absorption ratio, which measures what portion of dealer SG&A costs are covered by service gross profit. In the table below, the firms on the left side of the table have lower absorption ratios and thus have more operational leverage. The firms on the right side have more recurring revenue and more margin of safety against losses.

enX Group															
					EPS Growth	23.2%									
	2020	2021	2022	2023	2024	2025	2026	2027	2028	R11.78	5.65	5-yr fwd PE		3% growth PE	
										8.9%	11.26	Earnings/FCF Yield		6	
Revs	R1,950	R2,486	R3,331	R4,195	R5,034	R5,789	R6,368	R6,813	R7,154						
		27%	34%	26%	20%	15%	10%	7%	5%						
										Price		R8.50			
NI	R22	R52	R147	R190	R252	R289	R318	R341	R358	Distribution *		R5.50	Future SP	R17.79	
	1.1%	2.1%	4.4%	4.5%	5.0%	5.0%	5.0%	5.0%	5.0%	Value of Remain Co		R3.00	IRR	9%	
EPS	R0.12	R0.28	R0.81	R1.05	R1.38	R1.72	R2.08	R2.49	R2.97	Distribution from net equity of Eqstra sale (R1.4b)					
		131%	184%	29%	32%	25%	21%	19%	19%	* PV of 7.50 in 1-yr @ 15% rate					
Buyback															
	182	182.0	182.0	182.0	182.0	168.0	152.8	136.9	120.6						
50%	0.00	0.00	0.00	0.00	13.98	15.23	15.92	16.22	16.26						
	8.5	8.5	8.5	8.5	9	9.5	10	10.5	11						

The valuation multiples for the amount of recurring revenue and return on equity generated is also favorable. In our portfolio, we have stakes in Autohellas ([OTCPK:AOHLF](#)), Asbury Automotive Group ([ABG](#)), and Ferreycorp ([OTC:FRYCF](#)). All of these have favorable recurring revenue and return on equity characteristics and are selling for modest valuations.

CASE STUDY: NORTH AMERICAN CONSTRUCTION GROUP (NOA.TO)

North American Construction ([NAC](#)) is a construction services firm that provides heavy civil and bulk earthmoving and project and mine site operations services in supply-constrained markets. NAC is typically the first contractor in and the last contractor out of project and mine sites. NAC has over 3,500 employees and over 900 pieces of equipment in its fleet operating at 30 sites. The fleet has a replacement value of over \$2 billion.

NAC was founded in 1953 as a civil construction firm. NAC has provided earthmoving services in Canada since the 1950s, in the oil sands since the 1970s, and for resources firms since the 1980s. NAC was sold to a private equity firm in 2003 and went public in Canada in 2006. A new CEO, Martin Ferron, was appointed in 2012. His goal was to increase geographic and service offering diversification and to increase return on invested capital (RoIC). In 2012, NAC sold its lower-returning and more cyclical divisions providing pipeline construction and piling-related construction, while retaining its oil sands earthworks business. Later in the 2010s, via acquisitions and partnerships with First Nations and other aboriginal groups, NAC expanded its service offerings and its geographic footprint to other geographies such as the US and Australia. Most of NAC's invested capital is in large dump trucks and other earthmoving equipment. If NAC could maximize fixed asset utilization, then ROIC would increase. An economies of scale in purchasing and maintenance moat was created by having a highly utilized large fixed asset fleet in remote geographic locations with harsh conditions. Since 2015, equipment utilization has increased from an average of 40%, to 61% in 2023. NAC has a target goal of 75% to 85% by 2024. Since 2012, NAC's RoIC has increased from -12% to 12%, with a current goal of 15%; and its return on equity has increased from -10% to 22%.

Beginning in 2018, management acquired businesses to expand NAC's geographic reach, scale, and functional capability (including equipment repair services). From 2018 to 2022, NAC acquired five firms that increased the firm's equipment utilization from 46% to 61% by 2023. The return on equity also increased to the 20%s from single-digits before 2018, and free cash flow conversion increased from breakeven to almost 40% in 2022. The business acquisitions were financed primarily by debt, which was paid down from cash flow generated from the acquired firms. Over the past five years, management has acquired six firms-three in mining services and three in equipment maintenance. The resulting unlevered RoIC (see calculation below) has been around 19%, which includes returns from both organic growth initiatives and acquisitions.

NAC has four levers for cash flow growth: 1) buying a firm in their core or adjacent market; 2) expanding within existing markets; 3) paying down debt; and 4) distributing excess cash as dividends or buying back shares. The acquired firms generate cash flows in excess of what is needed to modestly grow the firm, which are used to purchase firms in its target or adjacent markets. If no firms can be found that meet management's operational and valuation criteria, then management will buy back shares, as the shares have typically traded at modest valuations reflecting modest organic growth. NAC currently spends about 60% of operational cash flow on capital expenditures, leaving 40% for buy-backs and mergers and acquisitions. As NAC continues to grow, free cash flow conversion should increase.

The business sector in which NAC competes is subject to economies of scale from purchasing, maintaining, and selling of equipment and have route density characteristics in the provision of earthmoving and other mining services. NAC's recent acquisition of an Australian firm should expand these economies of scale to Australia.

Earthmoving and Mining Services

NAC competes in the earthmoving and mining services markets in Canada, the United States, and Australia. NAC's services are provided to four markets. First, NAC provides earthmoving services in the oil sands region to five large investment-grade clients which generated 50% of NAC's 2022 operating income. In the oil sands region, as the largest third-party services provider, NAC moves about 7% of the total volume, so the earthmoving TAM is still quite large in the oil sands. The majority of the remaining earthmoving is provided by in-house operations. Oil sands operations are expected to have a remaining life of 50 years.

Second, NAC provides services to other mining and construction operations in Canada which generated 30% of NAC's 2022 operating income. Canada currently has 200 operating mines, with an average remaining mine life of about 20 years. About 125 mines are expected to open in Canada over the next 10 years.

Third, NAC provides civil construction services and US mining services which generated 20% of NAC's 2022 operating income. This includes the Fargo-Moorehead river flood diversion project. NAC is a joint venture partner with D&B, an international construction firm. NAC is planning on bidding with its joint venture partner on future projects in Australia.

Finally, with the purchase of MacKellar, NAC provides earthmoving and mining services in Australia. MacKellar will add an additional 40% to NAC's operating income. MacKellar provides additional geographic and mining end-market diversification, adding to coal mining exposure, as well as new end markets such as gold mining. MacKellar was purchased for C\$395m and was financed by internal cash and new debt, as well as vendor financing. The purchase price was about 2.75x expected EBITDA.

Mining and civil construction demand is driven by mega-projects, which have become more numerous due to increased commodity and energy demand and US, Canadian, and Australian government infrastructure spending. Oil sands production has increased over the past 10 years and is expected to continue to grow as new pipelines are completed in British Columbia. Electric vehicles and the electrification infrastructure is expected to boost metals and mineral demand over the next decade. NAC is expected to have a project backlog of \$3.0 billion by year-end 2023. This is over three years of projected run-rate revenues.

NAC has three competitive advantages. First, NAC is the low-cost operator of earthmoving equipment. 90% of equipment maintenance is performed in-house and NAC provides maintenance services to third parties. NAC also rebuilds equipment components and has access to low-cost components. NAC has 14 equipment bays, providing over 170,000 square feet of maintenance and rebuild capacity. Over 50% of NAC's equipment has telematics capabilities, which increase fleet efficiency. Second, NAC has indigenous partnerships, which generate over 90% of the projects in NAC's pipeline. Finally, NAC has a large contracted backlog of \$3.0 billion.

NAC also has many barriers to entry including:

- the scale/cost of NAC's equipment fleet, the largest in North America, provides purchasing and maintenance cost advantages;

- one of the largest equipment maintenance capabilities in North America, which provides cost advantages and third-party equipment maintenance opportunities;

- indigenous partnership opportunities, which are limited in number (NAC has two) and are required to be competitive on many Canadian large earthmoving/mining projects;

- harsh operating environments where NAC's services are provided reduces the number of profitable scaled competitors for available projects; and

- in the medium term, long lead times and scarcity of new equipment.

As described above, organic growth in these segments is expected to be 7% annual growth rate^[1] with any other growth coming from identified growth projects, acquisitions, or share repurchases.

NAC operations have become better over time, as Martin Ferron and then Joe Lambert implemented a value-added acquisition strategy utilizing economies of scope and operations density and increased the efficiency of the core earthmoving operations. The return on equity has increased from about breakeven in 2014 to 2017, to 22% in 2022 and is expected to increase to 30% by 2024 with the purchase of MacKellar. Free cash flow conversion also increased from break-even in 2014-2017, to about 40% in 2022. The drivers included increases in net income margins from 5.2% in 2017, to 9.4% in 2022, and increases in asset turnover from 0.76x in 2017, to 0.86x in 2022. Leverage also declined from 2.2x to 1.8x EBITDA.

The incremental return on invested capital over the past five years is close to 20%, which has increased NAC's RoIC over the past five years. See the calculations below.

NOA	New CEO						Three						Mackellar	5-yr trailing
	2012	2013	2014	2015	2016	2017	Acquisitions	2018	2019	2020	2021	2022	2024	19.1%
Capital Invested	47.7	27.1	19.5	-4.7	10.5	31.5	196.4	152.9	114.5	108.1	113.9		620	685.8
2-yr sum			46.6	14.8	5.8	42	227.9	349.3	267.4	222.6	222			
4-yr sum					52.4	56.8	233.7	391.3	495.3	571.9	489.4			
CFO	0.2	77.7	48.73	37.4	45.6	56.8	95.2	149.4	155	164.5	187.5		430	130.7
2yr change			48.53	-40.3	-3.13	19.4	49.6	92.6	59.8	15.1	32.5			
4yr change					45.4	-20.9	46.47	112	109.4	107.7	92.3			
2-yr ROIIC			104.1%	-272.3%	-54.0%	46.2%	21.8%	26.5%	22.4%	6.8%	14.6%			5-yr avg
4-yr ROIIC					86.6%	-36.8%	19.9%	28.6%	22.1%	18.8%	18.9%			18.4%
Net Income	-13.7	69.2	-1.2	-7.5	-0.5	5.3	15.3	37.1	49.2	51.4	67.3		120.15	
Equity	132.6	191.8	189.6	171.6	159	145.9	150.2	180.1	248.5	278.5	305.9		402.4	
Return on Equity	-10.3%	36.1%	-0.6%	-4.4%	-0.3%	3.6%	10.2%	20.6%	19.8%	18.5%	22.0%		29.9%	

Downside Protection

NAC's risks include both operational leverage and financial leverage. Operational leverage is based upon the fixed vs. variable costs of the operations. There are some moderate economies of scale in terms of purchasing and maintenance and local economies of scale, as the business is primarily clustered in the oil sands region of Alberta, the mining regions of the Northwest Territories, Nunavut, and Western Australia and Queensland.

Financial leverage can be measured by the debt/EBITDA ratio. NAC has an average net debt/EBITDA of 2.0 versus other earthmoving contractors (like Aecon, Badger Infrastructure Solutions, Bird Construction, Granite Construction, and Sterling Infrastructure) and versus NAC's history. The history and projected financial performance for NAC is illustrated below.

NOA	New CEO						Three						Mackellar	5-yr trailing
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Capital Invested	47.7	27.1	19.5	-4.7	10.5	31.5	196.4	152.9	114.5	108.1	113.9		620	685.8
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Return on Equity	-10.3%	36.1%	-0.6%	-4.4%	-0.3%	3.6%	10.2%	20.6%	19.8%	18.5%	22.0%	29.9%		

Management and Incentives

NAC's management team has developed an M&A engine and an operationally efficient firm in profitable niches of the earthmoving and mine management industry. They perform M&A when targets are available at the right prices partially financed by debt, pay down debt, and return capital via buybacks when there are not opportunities to invest organically or via M&A.

The base compensation for the management team (the top five officers) ranges from C\$2.1 million per year for the CEO to C\$600k per year for the VP of HR. Over the past year, the top five management folks' total compensation was about C\$5.4m per year-about 5% of net income per year. The CEO and the chairman of the board (the previous CEO) currently hold 2.79 million shares and options (worth C\$60.1 million), which is more than 30 times their 2022 salaries and bonuses. The CEO's compensation is structured to include a C\$575k base pay and up to a C\$1.5 million performance bonus. Short-term management incentive pay is based upon meeting stretch EBIT and EBIDA targets and is paid in cash. Long-term management incentive paid in RSUs has two parts: 40% time-based and 60% performancebased vesting. The performance-based vesting is based upon relative total shareholder return (TSR) to a peer group and three-year target EBIT, free cash flow, and return on invested capital.

Board members have a significant investment in NAC. Martin Ferron, who was the previous CEO, owns 2.4 million shares, and the board owns 3.15 million shares, about 12% of shares outstanding. Option grants, provided to management and employees, were equal to 1.7% per year of the shares outstanding over the past three years.

Valuation

		Sensitivity Table		Price	Upside
Current Normalized Earnings	\$5.27				
7-year Expected EPS Growth Rate	15.0%		-1.6%	\$28.00	0.0%
Historical EPS Growth Rate	65%		5.0%	\$97.50	248.2%
Current AAA Bond Rate	4.3%	Growth Rate	7.5%	\$123.85	342.3%
Implied Graham Mutiplier *	38.50		10.0%	\$150.20	436.4%
Implied Value	\$202.90		15.0%	\$202.90	624.7%
Current Price	\$28.00		20.0%	\$255.60	812.9%
* (2*Growth Rate + 8.5)					

The key to the valuation of NAC is the expected growth rate. The current valuation implies an earnings/FCF increase of -1.6% in perpetuity using the Graham formula ((8.5 + 2g)). The historical fiveyear earnings growth has been 68% per year including acquisitions and the current return on equity of 26%.

Growth Framework

Another way to look at growth and the valuation of companies is to estimate the EPS five years into the future and see how much of today's price incorporates this growth. Using the same revenue described above results in a 2027 EPS of \$9.62, or 3.1x the current price. If we assume a steady-state average growth rate from 2027 on of 7%, then this results in a fair value Graham multiple of 22.5x, or \$173 per share, similar to the five-year-forward valuation above of \$202.90 per share.

Comparables and Benchmarking

Below are the construction and specialized construction firms located in the United States, Canada, and Australia. Most of NAC's competitors are private firms. Compared to these firms, NAC has debt on the high end of the range with adequate coverage and has better growth prospects and a below-average multiple. NAC also has the one of the highest RoEs and the highest five-year growth rates.

NAC Comparable Firm Analysis												
	Price	Book Value	Earnings	Asset Turns	EBITA Margin	5-yr EPS Growth	Backlog Years	RoE	P/E	P/BV	Debt/EBITDA	EBITDA Int Coverage
Aecon	11.11	15.00	0.47	1.32	2.2%	0.4%	1.29	3.1%	23.6	0.74	2.43	1.95
Badger Infrastructure	40.14	10.04	1.95	1.07	6.1%	1.2%	N/R	19.4%	20.6	4.00	1.34	6.90
Bird Construction	12.02	5.66	1.32	1.93	3.2%	26.0%	1.17	23.3%	9.1	2.12	0.47	9.18
Granite Construction	45.38	24	2.66	1.52	2.4%	6.2%	1.70	11.1%	17.1	1.89	0.13	2.34
Mader Corp	6.47	0.78	0.26	2.40	9.1%	26.0%	N/R	33.3%	24.9	8.29	0.48	6.00
North American Construction	26.46	11.92	3.13	0.79	9.3%	68.0%	3.18	26.3%	8.5	2.22	2.00	5.22
Sterling Infrastructure	64.31	18.83	3.5	1.23	9.9%	50.0%	1.00	18.6%	18.4	3.42	0.00	N/A

Risks

The primary risks are:

slower-than-expected acquisition growth (currently projected to be 50% of the historic acquisition growth rate);

lower-than-expected growth in NAC's end markets offset by the small market share NAC has in its markets; and

a lack of new investment opportunities (mergers and acquisitions) coupled with higher stock prices making buybacks less accretive.

Potential Upside/Catalyst

The primary catalysts are:

higher-than-expected acquisition growth;

faster growth in NAC's end markets or higher penetration into these markets; and

increased local scope or purchase of local scale in new markets.

Timeline/Investment Horizon

The short-term target is \$95 per share, which is almost 75% above today's stock price. If the continued acquisition/consolidation thesis plays out over the next five years (with a resulting 15% earnings per year growth rate), then a value of \$188 (midpoint of the two methods described above) could be realized. This is a 46% IRR over the next five years.

Footnotes

[1] Based upon analysts' estimates of 7% and five-year historical organic revenue growth of 16%. The total five-year revenue growth rate has been 21%.

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