Value Investor INSIGHT

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Investor Insight: Chris Pavese

Broyhill Asset Management's Chris Pavese explains which "speed bumps" companies hit that are more likely to attract his attention, how he processes the risks and opportunities from disruption in certain top holdings, the thematic hedge he's employing today, and why he believes Universal Music, Dollar General, Nintendo and Philip Morris are mispriced.

INVESTOR INSIGHT

Chris Pavese
Broyhill Asset Management

Investment Focus: Seeks companies where fears around operational or strategic disruption appear exaggerated and there are clear catalysts for value realization.

He's largely self-taught as a value investor, but Chris Pavese's style has also been influenced by working since 2005 for the Broyhill (of furniture fame) family office: "Priority #1 is long-term capital preservation," he says. "But when you're aiming to provide a consistent payout each year, volatility also matters. In individual stocks we often look past the short term, but at the portfolio level we try to minimize downside all the time."

That dynamic has contributed to strong results. The fully-invested equity strategy Pavese started in 2015 – now open to outside investors as the Broyhill Partners Fund – has earned a net annualized 13.4%, vs. 10.1% for the MSCI AC World Index. Among areas he finds interesting today: music, videogames, tobacco and dollar stores.

Some investors credit mentors for the development of their investment philosophy and others describe themselves more as self-taught. Where would you fall on that spectrum?

Chris Pavese: I started my career at J.P. Morgan in 1998 and made my way to a research analyst position in its asset management business. I have nothing negative to say about any of that and always had phenomenal resources at my disposal, but almost everything I read and learned was about how J.P. Morgan thinks and how J.P. Morgan does things.

The development of my own philosophy and strategy really started after I joined the Broyhill family office in 2005 and started reading everything I could get my hands on from the best value investors out there. At the top of the list were Warren Buffett investor letters and interviews. Anything and everything from Seth Klarman at Baupost Group. For an introductory lesson in value investing there may not be a better book than Joel Greenblatt's *The Little Book That Beats The Market*, and everyone should also read his *You Can Be a Stock Market Genius*. For me, and probably for a lot of value investors, these would be the types of mentors I learned the most from.

A significant number of our successful ideas fall into what might be considered the classic model: a good business hits a speed bump and investors predictably extrapolate that speed bump into perpetuity when in fact it's a short-term issue. Once the ship is righted, if you've bought the stock on depressed earnings at a depressed valuation and then both of those things revert, you benefit in two ways on the upside.

Can you generalize about the speed bumps that are more likely to catch your eye?

CP: There's a perception in the industry that the more unique and esoteric your ideas the better the investor you are. We take no pride in ownership, which means ideas can come from anywhere and that our value-add, as Steve Jobs used to say about creativity, is primarily in connecting things that others aren't.

Often the speed bumps are very much in plain sight. A representative example would be McKesson Corp. [MCK], the drug distribution company we've owned since the height of the opioid crisis. Its stock price had already been weakening due to a pullback in overheated generic-drug pricing, but then it fell much further as McKesson was targeted as a contributor to the opioid crisis and faced constant negative publicity and an increasing threat of financial penalties. We took the view based on our research that even in the worst case the potential hit to the company's earnings was nowhere near what was priced into the stock. We started buying at a single-digit P/E, which is where the valuation stayed for a long time until the company finally started to put the opioid-related negatives behind it and the market price again started to reflect the strong and improving fundamentals of the business and the fact that almost half the outstanding shares were retired over the previous seven years.

People argue against letting your thesis evolve, but that's what has happened for us in this case. The valuation has improved – [at a recent price of around $422 the stock trades at 15.5x consensus forward earnings] – but the shares still trade at a material discount to the broader market that we don't believe is warranted given what's going on in the business. Today 75% of operating profits come from low-margin pharma distribution, but that mix is changing as two higher-margin businesses – what they call Prescription Technology Solutions and Medical Surgical Solutions – grow incrementally faster. As those businesses account for a greater share of the pie, we expect that to incrementally benefit both the company's financial performance and the valuation put on its stock.

Another example of a high-profile speed bump that attracted our interest is Charles Schwab [SCHW], which we had never looked at particularly closely until the failure of Silicon Valley Bank in March caused the market to turn a very critical eye on the banking sector in the U.S. Schwab's stock fell 40% in three days and given what we did know about the business, it seemed like a case where the baby was maybe being thrown out with the bathwater.

Everyone probably has their own version of this, but once we've identified something as potentially interesting we take what we call a "first look." We start out by making sure we understand the business well enough that we can explain to a fifth grader how the company makes money. Next we want to be able to hone in on the one or two questions that are most critical for us to answer about the business and the stock, and to honestly assess whether we've correctly identified what those are and if we can figure them out. With Schwab, we concluded the two most important questions were around the risk of deposit flight and whether anything that was happening had fundamentally changed the long-term earnings power of the company. We thought we could develop an opinion on both of those questions, and as we dug in further decided the market had overreacted and that the stock was trading at an inordinately depressed multiple on an inordinately low level of earnings power. [*Note*: Schwab shares, at $82 at the beginning of 2023, fell to as low as $45 in March and currently trade at just under $60.]

ON NON-U.S. INVESTING:

We seek out ideas in businesses we know well that translate better abroad, or translate as well but are much cheaper.

You've owned Walt Disney [DIS] in the past – have its recent travails piqued your interest at all?

CP: You're right that this is the type of thing we might look at, but we haven't really done so as the stock over the last two years has steadily declined. I think there's no question the assets of the company have tremendous value, but the questions you have to answer today seem a lot more difficult than the ones we had to answer during Covid when we last bought the stock. Then it was largely about recovery in a number of businesses as the pandemic eventually receded. Today it's more about figuring out the economics as the transition from the cable bundle to streaming continues. I wouldn't say those are questions we can't answer, but for the time being we haven't chosen to try.

In describing your investment last year in payments technology firm Fiserv [FI], you challenged what you considered the market's perception that it was a stodgy, legacy provider competing with "sexy, rapidly growing disrupters." Is that type of situation a common source of ideas?

CP: A good story can outweigh fundamentals in the short term, so popular narratives can drive an unusually large gap between price and value. One of our important jobs as investors is to recognize when these gaps open up and position ourselves to capitalize when reality eventually closes them.

When I first came into the investment business in the late 1990s there was a tremendous amount of excess capital going to the fastest growing businesses, with no attention at all paid to earnings power. As a result capital was often ignoring more mature businesses that were still compounding at healthy rates and generating tremendous amounts of cash flow. That's very similar to the environment that peaked in 2021 in a lot of areas, including the payments sector. It's a massive market with high margins and a very nice growth profile, so that makes it very attractive for potential disrupters.

While I think we had – and have – a healthy respect for the new competition, we didn't think the market was accurately calibrating the actual impact new entrants would have on Fiserv's still strong franchises and still attractive growth prospects. Prior to the pandemic the stock traded at a mid-20s multiple of earnings and a significant premium to the market, but in 2022 it fell to 12-13x earnings and a material discount to the market. Even with all the noise about new competition, the company this year is on track to add another year to its uninterrupted 32-year track record of double-digit earnings growth. A defensive business with that kind of growth profile should not trade [at the current price of $122.50] at a 20% discount to the market. At least a 20% premium would be more reasonable.

Describe the typical geographic mix of your portfolio.

CP: I don't know if there is a typical mix, but we have in recent years generally found valuations to be more stretched in the U.S. than anywhere else in the world. That's resulted in more non-U.S. names, so that today we're probably 50/50 U.S. vs. non-U.S.

We regularly seek out ideas in industries and businesses we know well that translate better abroad or translate equally well and are significantly cheaper. Ex-

amples of that in recent years that we still own are both Coca-Cola bottlers (like Coca-Cola FEMSA [KOF]) and airports (like Grupo Aeroportuario del Centro Norte [OMAB]) in Latin America. We started looking at airports early in the pandemic and just found the stocks there egregiously mispriced relative to global peers. The same has been true with bottlers, where because of the highly fragmented distribution systems in many LatAm countries the companies play a more important role and add more value.

How many portfolio positions do you generally hold?

CP: Today we have 23 positions, which is toward the high end of my comfort level. I think this is a question of personal preference and it's something investors have to figure out over time. For me if I hold 10 names or fewer, I start losing sleep thinking I'm putting too many eggs in one basket. When I get too far beyond 20 positions, I worry I'm not as close to each name as I should be.

The Broyhill Partners Fund you've made available to outside investors will run fully invested and won't short individual stocks, but it will hedge at times. What does that hedging look like?

CP: We will implement tactical hedges using indices to reduce net exposure from time to time and also when we think attractive risk-adjusted returns are available in doing so. Today our hedges are only in equity and consist primarily of being short proxies for what we consider junk. That could include, for example, something like an index of non-profitable tech companies. Or an index that tracks meme stocks. In frothy markets, it could be something that tracks IPOs. These types of things cratered in 2022 but so far in 2023 we've seen the bubble reinflate very fast in certain areas. Overall our net long exposure today is about 80%. Beta-adjusted, given the types of things we're short and the quality of our longs, that exposure is closer to 35%.

Describe your broader investment case today for Universal Music Group [Amsterdam: UMG].

CP: We have followed the music industry for the last five years since Spotify [SPOT] went public, and don't think it's an understatement to say that subscription music services led by it have changed how the world experiences music, turning an industry in secular decline into one generating a rapidly growing, recurring revenue stream. We initially thought Spotify would be the way to play that because it had changed the power structure in the industry, strengthening artists and itself at the expense of music labels.

As we continued our diligence we changed our minds. Unlike in video where you subscribe to Netflix to get access to what Netflix produces itself and has in its library, in music you log on to Spotify and expect to hear everything that you have and will ever want to hear. Distributors have to carry all the music, the rights for which are mostly owned by record labels that have what we consider enduring relationships with artists and that play a critical role in nurturing talent, marketing music and, now, negotiating with the

INVESTMENT SNAPSHOT

Universal Music
(Amsterdam: UMG)

Business: Discovery and development of musical artists and songwriters and the marketing, distribution, sale and licensing of the audio and audiovisual content they produce.

Share Information
(@8/30/23, Exchange Rate: $1 = €0.91):

Price	**€23.15**
52-Week Range	€16.65 – €24.52
Dividend Yield	2.2%
Market Cap	€42.15 billion

Financials (TTM):

Revenue	€10.75 billion
Operating Profit Margin	13.6%
Net Profit Margin	10.8%

Valuation Metrics
(@8/30/23):

	UMG	S&P 500
P/E (TTM)	36.1	20.2
Forward P/E (Est.)	25.2	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Pershing Square Capital	10.2%
Fidelity Mgmt & Research	3.0%
Vanguard Group	1.5%
Norges Bank Inv Mgmt	1.4%
BlackRock	1.3%

Short Interest (as of 8/15/23):

Shares Short/Float	n/a

THE BOTTOM LINE

Chris Pavese believes investors aren't fully recognizing the established strength of the company's competitive position in a rejuvenated and still nicely growing market. Modeling different scenarios for growth and margins over the next five years, with no change in the current valuation he expects to earn a 15-25% IRR on the stock from today's price.

Sources: Company reports, other publicly available information

streaming platforms. That gives labels like Universal, in our opinion, more leverage rather than less to dictate terms in an industry where content is king.

Much of this eventually wasn't lost on the market and UMG shares peaked at 30x EBITDA before investors turned their attention to a number of challenges. The stock fell by a quarter earlier this year due to such concerns as AI-generated music, artists capturing a larger slice of the pie for themselves, and record labels losing share across streaming platforms. We saw that as an opportunity to initiate a position in one of the highest-quality businesses we've ever owned.

Walk through some key risks and why you expect Universal to rise above them.

CP: I'll start with the threat of AI, since we think it's played the biggest part in the recent share decline. We agree that AI is likely to reduce barriers to entry for content creation, but the fact of the matter is that the quality of the input matters. That means using original, copyrighted songs, the rights to which are owned by the labels. It's hard for us to imagine established distributors of music cutting the artists and labels out of the value chain if AI-generated music ends up having any value. We also believe lower barriers to entry mean higher barriers to success, which we expect will make the role record labels play in developing and promoting content to be even more important.

Another threat is that the biggest artists have more negotiating power and are going to get a larger slice of the pie from labels. Taylor Swift, in particular, has remade earlier songs to which she no longer owns rights, and an artist of her stature probably can renegotiate contracts with labels to chop off the right tail of the earnings distribution. But how many Taylor Swifts are there? UMG's business is well diversified, with their top 50 artists accounting for less than 17% of total revenue last year. It's also important that something like three-quarters of listening time on streaming services is music that is at least a few years old. The economics on that back catalog is unlikely to change and is a gift that keeps on giving to labels well into the future.

Spotify bulls argue that it is poised to capture a larger piece of the economics going forward as it's less reliant on labels for content. Here we don't think it's any less reliant on labels for valuable content, and we believe the mutually beneficial "we're all in this together" relationship it has forged with the industry is a healthy and sustainable one. If Spotify were to try to disrupt that, we don't think it has the leverage to come out ahead.

ON DOLLAR GENERAL:

Over the past year a number of things have gone wrong ... to us this is a perfect example of a temporary dislocation.

Beyond the risks, we think there are multiple catalysts on the horizon to the upside. Apple Music and Amazon Music raised prices last year and Spotify just announced its first price increase in the U.S. The labels' share of those price increases will go straight to the bottom line. Music pricing also still has room to rise, likely adding to Universal's historical high-single-digit to low-double-digit annual organic revenue growth. Other revenue sources like YouTube, Peloton and Meta are also growing rapidly and we expect a new industry deal to be struck with TikTok, which would be material given that it currently pays the music industry almost nothing.

The shares have recovered much of their losses from earlier in the year. What upside do you see from today's price of just over €23?

CP: Management has given guidance for high-single-digit percentage annual sales growth and for operating margins to increase to the mid-20s over the mid-term, both of which – given the positive catalysts we see – strike us as reasonable if not conservative assumptions. Modeling different scenarios for growth and margins over the next five years – and assuming the shares continue to trade at the multiples of earnings and EBITDA they earn today – from today's price our expected IRR on the stock is 15-25%. If the market comes to see this more as a predictable, high return on capital consumer-staples business, which actually has much better growth prospects than the typical consumer-staples company, there would be additional upside from there.

Dollar General [DG] shares have gone from highly regarded to far less so over the past year. Why do you think the market may be overreacting?

CP: We first got involved in the dollar-store space in what we refer to as the "Peak Amazon" period in 2017, when shares of retailers across the board were falling out of concern that Amazon was going to take over everything. In many ways it was a rather simple story: Dollar General's stock went from trading at a premium to the market to a discount, but we thought the ongoing potential for new store openings, same-store-sales growth and a little bit of operating leverage translating into double-digit EPS growth with minimal cyclicality was still fully intact. We thought the shares would again eventually reflect that.

That's largely what happened, and we ended up selling out of most of our position in the company a year ago when the stock got expensive against what we considered inflated earnings from the pandemic. Since then a number of things have gone wrong. Management, which historically has been incredibly adept at managing inventories and logistics, let inventories get out of hand. There were supply-chain disruptions and cost inflation began to bite. Core customers started hurting due to inflation, and the government's ending of emergency support payments tied to Covid took additional money out of their pockets. It's been ugly – quarterly results have been worse than expected, manage-

ment is taking down guidance, and analysts are cutting estimates.

We believe this is a perfect example of a temporary dislocation. The growth algorithm I described earlier is still largely in place, but the market today seems to be extrapolating more recent results that look much worse. We don't believe management has suddenly turned incompetent and expect the operating issues to be worked out. As pandemic impacts recede further, we also expect the resiliency of the company's business model in good and bad economic times to return to form. There is a legitimate "show me" element with respect to management and we don't expect everything to turn on a dime from here, but we think the fundamentals of the business and the company haven't changed even though the stock price might be indicating otherwise.

Is the perception that competitor Dollar Tree may finally be getting its act together, particularly with respect to its Family Dollar division, a concern for Dollar General?

CP: Dollar Tree does appear to be improving under CEO Richard Dreiling, who by the way turned Dollar General around after it was taken private by KKR and then came back public in 2009. But Family Dollar having gotten more competitive is not a big issue for Dollar General. They tend to operate in different markets with different store footprints and we consider Dollar General's value proposition and its market leadership to still be very much in place. We'd argue that Dollar General's troubles of late don't have anything to do with Family Dollar making progress.

Dollar General shares got slammed just today when the company again took down guidance. How are you looking at valuation at the current price?

CP: While store growth can't go on uninterrupted forever, management's expectation for the company's store count at maturity has consistently trended upward over time. Over our five-year horizon we still expect 5-7%% annual top-line growth from new stores and same store sales. We're also more optimistic than the Street that operating margins improve from current depressed levels. The company was arguably overearning as margins topped 10% during Covid, but we think normalized levels closer to 8-9% remain well within reach.

The stock historically has traded at as much as a 25-30% premium to the market, and as low as a 25-30% discount. At today's 15x P/E, it's now at the bottom of that range. We think this is an above average quality business that deserves an above average valuation multiple. If we just assume shares trade back to 18x our estimates five years out – still a two-point discount to the market's current multiple – we're looking at a double in the share price over that time.

There has been talk of local regulations seeking to limit the expansion of dollar stores in certain areas, due to such concerns as predatory pricing and the predominance of processed foods sold in the stores. Do you see this as a risk of note?

CP: Not really. For one, I would bet that anybody talking about predatory pricing

INVESTMENT SNAPSHOT

Dollar General
(NYSE: DG)

Business: Self-described "America's neighborhood general store," with some 20,000 stores selling consumer products often with low price points and small package sizes.

Share Information (@8/30/23):

Price	**157.66**
52-Week Range	151.27 – 261.59
Dividend Yield	1.5%
Market Cap	$34.58 billion

Financials (TTM):

Revenue	$38.44 billion
Operating Profit Margin	8.6%
Net Profit Margin	6.2%

Valuation Metrics
(@8/30/23):

	DG	S&P 500
P/E (TTM)	14.8	20.2
Forward P/E (Est.)	15.5	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Capital Research & Mgmt	12.1%
BlackRock	8.5%
Vanguard Group	8.3%
State Street	4.4%
T. Rowe Price	3.7%

Short Interest (as of 8/15/23):

Shares Short/Float	1.9%

DG PRICE HISTORY

THE BOTTOM LINE

There's been no shortage of bad news for the company this year, but Chris Pavese expects the perceived dislocations to prove temporary rather than permanent. Driven by organic revenue growth, increasing margins, and multiple expansion beyond today but still discounted to the market, he believes the stock can double over the next five years.

Sources: Company reports, other publicly available information

at DG has never actually stepped foot in one of their stores. The core customer can't afford the organic wagyu beef or black truffles sold at higher-end stores like Whole Foods. DG provides its customers, who are often buying groceries paycheck to paycheck, with affordable options and convenience not available anywhere else.

From dollar stores to videogames, describe your significant interest today in Nintendo [NTDOY].

CP: This is a company we had admired from afar given its culture of innovation and the value of its intellectual property, but we'd never gotten comfortable with its relatively low-margin and highly cyclical dependence on selling the hardware to play its games. But while most of the Street seems to consider the stock dead weight until the next-generation console is released, we actually believe the company's business model is evolving in a way that is more balanced, more profitable and less cyclical. If we're right about that, the stock at today's levels should prove to be quite attractive.

The crux of our thesis is incremental growth in high-margin, recurring software and services revenues. Game revenues continue to shift toward digital sales that have naturally higher margins. The company has also opened its ecosystem to third-party game developers, creating a fast-growing source of revenues that should accelerate with the increased processing power of the next-generation Switch console making the latest third-party hits available on its platform. We also see significant upside in subscription-service pricing. Nintendo Switch Online currently has roughly 36 million users paying $3.99 per month, compared to top-tier subscription services for Xbox and PlayStation priced at $14.99 to $17.99 per month.

We also think the nature of the company's hardware business has changed for the better. Nintendo has taken a different approach with the Switch, looking to extend the life of the platform by making more regular updates and by making past, present and future versions of blockbuster games available on all generations of the hardware. That's not to say hardware innovation isn't important, and on that front we're giving the company the benefit of the doubt that the next generation of hardware will come out, will be exciting to users, and will result in increasing games sold per console. Our base case assumes the next-gen Switch is available for the 2025 holiday selling season and we think there are good odds it happens sooner.

A third element of our thesis that is somewhat harder to forecast is what seems to be an increased willingness by the company to capitalize on its uniquely valuable intellectual property. *The Super Mario Brothers Movie* released earlier this year has become the second highest-grossing animated movie of all time. Themed Super Nintendo World areas have opened at Universal Studios' theme parks in Japan and Hollywood and are planned for the parks in Singapore and Orlando as well. We think it's a big deal that the first American named to the board, Chris Meledandri, is the founder and CEO of film producer Illumination. We expect Nintendo to be measured and responsible in mining its intellectual property, but the

INVESTMENT SNAPSHOT

Nintendo
(OTC ADR: NTDOY)

Business: Producer of videogame software – franchises include Mario, Pokémon,The Legend of Zelda and Animal Crossing – and videogame hardware such as the Switch.

Share Information (@8/30/23):

Price	**10.60**
52-Week Range	9.26 – 11.99
Dividend Yield	3.7%
Market Cap	$49.11 billion

Financials (TTM):

Revenue	¥1.76 trillion
Operating Profit Margin	33.5%
Net Profit Margin	28.2%

Valuation Metrics
(@8/30/23):

	NTDOY	S&P 500
P/E (TTM)	14.6	20.2
Forward P/E (Est.)	17.0	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Public Inv Fund (Saudi Arabia)	9.6%
BlackRock	6.3%
Nomura Asset Mgmt	4.5%
Bank of Kyoto Asset Mgmt	4.2%
Sumitomo Mitsui Trust	3.8%

Short Interest (as of 8/15/23):

Shares Short/Float	n/a

THE BOTTOM LINE

The company's business model continues to evolve in a way that should result in more balanced, more profitable and less cyclical performance in the future, says Chris Pavese. Were the stock on his estimates five years' out to trade at what he would consider a still-conservative 10-12x EV/EBITDA, the share price would at least double from today's level.

Sources: Company reports, other publicly available information

potential is quite high and, given the margins, can move the needle on performance over time.

The U.S. ADRs at a recent $10.60 are down about 35% from their highs in early 2021. What return potential do you see from here?

CP: Here we're again looking out five years, at which point we expect revenues to be approaching ¥3 trillion yen and operating margins to have risen another 10 points as the business mix continues to evolve. While videogame peers have historically traded at mid-teens multiples of EBITDA, even if we assume a more conservative 10-12x EV/EBITDA, the stock on our estimates would at least double over the next five years.

I'd mention that another knock on the company is its opacity and seeming lack of regard for shareholder interests. One manifestation of that is the ton of cash it holds on the balance sheet, accounting for roughly 25% of the current market cap. We don't need to assume any change in that approach to like the stock, but we'd likely benefit as shareholders if the company takes a more proactive approach to capital allocation.

As a long-time investor in tobacco companies, why is Philip Morris [PM] your favored choice in the industry today?

CP: The accelerated decline in the demand for combustible cigarettes as various lower-risk alternatives increasingly come to market has made it debatable today whether price increases – as has been the case for a long time now – can continue to offset the decrease in unit sales volumes. Given that, it's critical to differentiate in the sector between those who are best positioned in alternatives and those who aren't. We believe Philip Morris is by far the leader in this regard, without a close number two.

The company over the past decade has invested over $9 billion in developing what are known in the industry as reduced-risk products, the most successful of which is its "heat not burn" technology called IQOS. This product has rapidly increased its market share in a number of developed markets outside the U.S., and eight years after its launch has over 25 million customers globally even though it's barely available in the world's two largest nicotine markets – the U.S. and China. Gross margins for it are about 75%, roughly 10 points above the already high levels for combustible cigarettes.

IQOS hasn't really been marketed in the U.S. That's somewhat of an historical artifact due to the spilt long ago between Philip Morris and Altria along geographic lines, with Altria owning the rights to Marlboro and other company brands in the U.S. and Philip Morris owning them outside the U.S. Philip Morris had licensed the domestic rights to IQOS to Altria, which put only a haphazard effort behind it, leading Philip Morris to buy the rights back last year.

Another key part of the story is Philip Morris' acquisition announced late last year of Swedish Match, which is the biggest global player in smokeless tobacco and also has a homerun developing brand called ZYN, a non-tobacco product that delivers nicotine to users through a tiny

INVESTMENT SNAPSHOT

Philip Morris
(NYSE: PM)

Business: Global sale of cigarettes and smoke-free alternatives such as heat-not-burn, e-vapor and oral nicotine products; top brands include Marlboro, IQOS and ZYN.

Share Information (@8/30/23):

Price	**96.76**
52-Week Range	82.85 – 105.62
Dividend Yield	5.3%
Market Cap	$150.20 billion

Financials (TTM):

Revenue	$33.17 billion
Operating Profit Margin	37.0%
Net Profit Margin	24.3%

Valuation Metrics
(@8/30/23):

	PM	S&P 500
P/E (TTM)	18.7	20.2
Forward P/E (Est.)	15.0	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Capital Research & Mgmt	17.8%
Vanguard Group	8.8%
BlackRock	6.1%
State Street	3.8%
T. Rowe Price	2.2%

Short Interest (as of 8/15/23):

Shares Short/Float	0.5%

THE BOTTOM LINE

The company is "without a close number two" in developing reduced-risk products that will differentiate winners from losers in the tobacco industry going forward, says Chris Pavese. He expects a combination of earnings growth, dividend payouts and share buybacks to translate into at least a mid-teens IRR on the stock over the next five years.

Sources: Company reports, other publicly available information

white pouch that's put between your teeth and gums. Volume growth for ZYN has been off the charts, and we think that only gets better as Philip Morris puts its global marketing and distribution power behind it. We have argued that this is one of the best strategic acquisitions we have ever come across.

Absent new negative regulatory news, which is always possible, our base case for the traditional cigarette business is still that volumes continue to decline – more slowly outside the U.S. – but the impact of that decline on overall financial performance is mitigated for the most part by price increases. With Philip Morris, that side of the business becomes less important more quickly given the growth in reduced-risk products. Management may be aggressive in expecting legacy tobacco to only make up 50% of total revenues by 2025, but we don't think that's far off.

How do you see all this translating into share value from the current stock price of $96.75?

CP: The full U.S. launch of IQOS combined with expanded global distribution of ZYN we think can drive consistent, double-digit earnings growth for the next several years.

With respect to valuation, while Philip Morris trades at a premium to the rest of its sector, we don't consider the rest of the sector the correct benchmark. As reduced-risk products over time make up a larger percentage of revenues and generate comparable or even better profitability, we believe the stock should trade at a premium to the market and on par with what are perceived to be high-quality consumer-staples stocks. Even without multiple expansion, with a 5%-plus dividend and free cash flow directed to debt reduction and share buybacks, we think we easily can meet our target of at least a double in the share price over the next five years.

You spoke in your latest investor letter about two frustrating investments, Anheuser-Busch InBev [BUD] and Bayer [Frankfurt: BAYN]. How in each case are you handling the frustration?

CP: The problems at A-B InBev began in April when its marketing relationship with transgender influencer Dylan Mulvaney for Bud Light ignited a fiery backlash against the brand in the U.S. The resulting U.S. numbers are still ugly, but given that investor sentiment is in the gutter, we think the particular Bud Light issue is more than priced in. Despite U.S. headwinds, the company is still likely to hit its numbers for this year as other markets make up for trouble in the U.S. and management continues to aggressively deleverage the balance sheet. As you mentioned, it has been frustrating. It may say something that while we haven't reduced our position at all, we haven't added to it either.

ON KEEPING BUSY:

Many of the valuation dislocations that we saw open so wide before last year have returned in force.

Bayer has just been very slow in getting back on track following the disruption – and extensive legal-liability issues – stemming from its ill-fated acquisition of Monsanto. Things had seemed to be improving, but the company's earnings results and guidance this year have been negative, attributed mostly to deterioration in demand for glyphosate-based weed killers. But the lower guidance probably also reflects the new CEO who took over in June looking to reset the bar lower after taking a good first look under the hood. In any event, we still believe the asset value is there and there's material upside based on normalized earnings power. Our base case sum-of-the-parts estimate pegs the company's fair value at nearly twice the current level [at today's share price of just over €50]. Considering recent comments from CEO Bill Anderson that "nothing is off the table," we think a spinoff of the company's pharma or agricultural business would go a long way towards realizing that value.

Does the optimism in the market for much of this year make you nervous?

CP: Markets generally seem to be priced as if we're going to have a safe landing or no landing at all for the economy, so anything other than a best-case scenario probably sets things up for disappointment, in the economy and in the equity market.

That doesn't mean we don't have plenty to work on. Many of the dislocations that opened so wide before last year – between how speculative businesses were valued relative to cash-generating but maybe boring ones – have returned in force. As those correct again, that should play to our strengths. VII

ABOUT BROYHILL

Broyhill Asset Management is a boutique investment firm, initially established as a family office in 1980 and guided by a disciplined value orientation. Founded in the foothills of North Carolina's Blue Ridge Mountains, we operate outside of the fray and invest with a rational, objective, long-term perspective.

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