3G Capital Management Way: From Theory to Practice

Center for the Advancement of Value Investing Education
Seminar on Value Investing and the Search for Value
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- *3G Capital's performance figures presented herein represent net return of 3G Capital Partners LP ('Original Fund') from its global strategy inception date until the inception date of 3G Capital Partners II FGR ('Parallel Fund'), and net returns of the Parallel Fund subsequent to that date. Net return reflects the experience of an investor who came into the Original Fund at inception, subsequently transferred into the Parallel Fund at its inception, and did not add to or withdraw during his entire tenure*
- *Global strategy inception date is January 1, 2009 as prior to that date the Original Fund's geographic focus was largely limited to North America*
- *The returns for 3G Capital and for the MSCI ACWI ex USA Index are presented before foreign dividend tax withholding*

3G Capital at a Glance

- Private investment partnership that invests in undervalued securities around the world – frontier, emerging, and developed markets
- Seek to invest at single-digit multiples in a small collection of industry-leading businesses
  - Investing Focus: Good Business, Good Management, Good Price (3 'Gs')
- Over 19 years in business – founded in 2004
- Track record of significant market outperformance (net of fees through May 31, 2024):

	3G CAPITAL	MSCI ACWI x US
Year-to-Date (USD)	**26.2%**	6.1%
Since strategy inception, per annum (USD)	**12.9%**	7.5%

Investment Philosophy – Good Business

- Competitively entrenched
  - Occupies a leading position in an easy-to-understand industry
  - The industry has a long-term historical track record of leadership sustainability
  - Reasons behind historical leadership sustainability can be easily identified and are likely to persist in the future
  - Ideally, the industry is highly fragmented to allow for above average growth potential
- Above average returns on invested capital
  - In excess of 15% over the cycle
- Strong financial condition
  - Debt Payback period (Debt/FCF) of less than 3-5X (depending on an industry)

- **Current look-through ROE for the portfolio exceeds 20%; three-quarters of portfolio holdings have excess cash on their balance sheets, the remaining quarter have debt paybacks below 3 years**

Investment Philosophy – Good Management

- Skillful operators and capable capital allocators
  - Track record operational excellence
    - Quantitative as well as qualitative assessment
  - Willing to return money to shareholders through dividends or share repurchases (when shares are undervalued) when attractive return projects are not found
    - Mitigates risk in the event that the market does not recognize the rising intrinsic value of the business
- Proper alignment of incentives
  - Shareholder-aligned bonus structures
- Skin in the game
  - Ownership stake – implicit or explicit

Investment Philosophy – Good Price

- Low absolute valuation – typically under 4-10x earnings – is the key ingredient of our investment philosophy
  - Relative valuations do not provide a sufficient margin of safety and are inappropriate when pursuing a strategy of absolute returns
  - Exact multiple depends on the growth profile and returns on capital of the underlying business
- Focus on "normalized sustainable" earnings rather than "current period" earnings
  - Earnings are normalized to reflect mid-cycle economic conditions
  - Items that are one-time in nature – whether positive or negative – are excluded
- **Current look-through earnings multiple for the portfolio is approximately 6X with a corresponding dividend yield of over 7% vs. 16X and 3%, respectively, for MSCI ACWI ex USA**

Portfolio Construction

- Long only and typically unleveraged
  - We typically strive to maintain conservative stance to ensure additional protection from permanent loss of capital
- The Fund has between 10 and 12 positions
- Top 5 holdings generally make up 60%-70% of the Fund's assets
- Maximum position size at purchase is 25% of the Fund's assets
- Minimum position size at purchase is 5% of the Fund's assets
- The average expected holding period is about 3 to 5 years for core positions
- Sell discipline – we normally sell a stock if:
  - Price of the security reaches or exceeds its intrinsic value
  - Better investment opportunities become available
  - The original characteristics of the security, such as underlying business and/or management are no longer present

Research Process – Qualitative

- Due to our private equity orientation our research process tends to be very intensive
- Our approach is to become “local experts” before investing in a market
  - We use our extensive network of on-the-ground contacts around the world in order to gain unique insights into various businesses available in a given market
  - We regularly speak with customers, distributors, suppliers, competitors, and industry insiders related to various businesses in Asia, North and South America, Eastern and Western Europe, Middle East, and Russia
  - We get to know management, either through local sources or personal contact, and we carefully examine their track record with the help of our on-the-ground network
- Our multi-geographic approach of studying a given industry across a number of countries provides us with a better sense of analytical perspective compared to “purely local” fund managers
  - For example, having in-depth knowledge about the economics of banking businesses in Canada, Brazil, Russia, and the United States helped us develop a better understanding of strengths and weaknesses of banking businesses in other geographies, such as China and Turkey

Research Process – Quantitative

- Examine financial statements
  - Review up to 10 to 20 years of data
  - Consider margins/ROC, growth rates, cash flow generation vs. cash flow uses, and applicable industry-specific KPIs
  - Compare the above KPIs to historical levels, peer levels, and theoretical levels implied by the competitive position
- Prepare a basic ‘forward’ financial model
  - Focus on “normalized sustainable” figures rather than “current period” figures
  - Adjustments are made to reflect mid-cycle economic conditions
  - Items that are one time in nature are excluded
  - Err on the side of conservatism at each step of the adjustment process
- Assess attractiveness from a quantitative standpoint
  - Compare relative to other names from our list of potential investments
  - Weigh potential returns implied by the model against our absolute return target of 15% per annum

Risk Management

- We define risk as the permanent loss of capital rather than short-term fluctuations in the market quotes for our portfolio
  - Focus on establishing the *range* for underlying asset value with a high degree of certainty
  - Aim to purchase assets at a significant discount to the lower boundary of the *range*
  - We avoid 'risky' prices, not 'risky' assets !
- Risk management techniques include:
  - Focus on buying easy-to-understand businesses at a discount to value
  - Position size
  - Industry and country exposure limits
  - Monitoring correlations between positions
  - Using leverage sparsely and limiting the maximum to the portfolio dividend yield
- Constantly monitor and update the gap between the price of our holdings and their respective intrinsic values

Real-life Example – Genomma Lab Intl

- Based in Mexico City, Mexico

- One of the largest providers of OTC pharmaceuticals and personal care products in Latin America
  - Brands occupy leading positions in their respective categories
  - Company's presence spans 18 countries, primarily in Latin America
  - Income split 50/50 between pharma/personal care and 40/50/10 between Mexico/LatAm/USA

- Valuation at purchase – less than 5.5X NFY EPS and a 6.5% NFY dividend yield

Genomma Lab Intl – Product Lineup

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OVER-THE-COUNTER PRODUCTS

PAIN RELIEF

CAUGH & COLD

GASTRO & ANTI-HEMORRHOIDS

ANTI-MYCOTICS & SEXUAL HEALTH

ANTI-FLU

ISOTONIC BEVERAGES

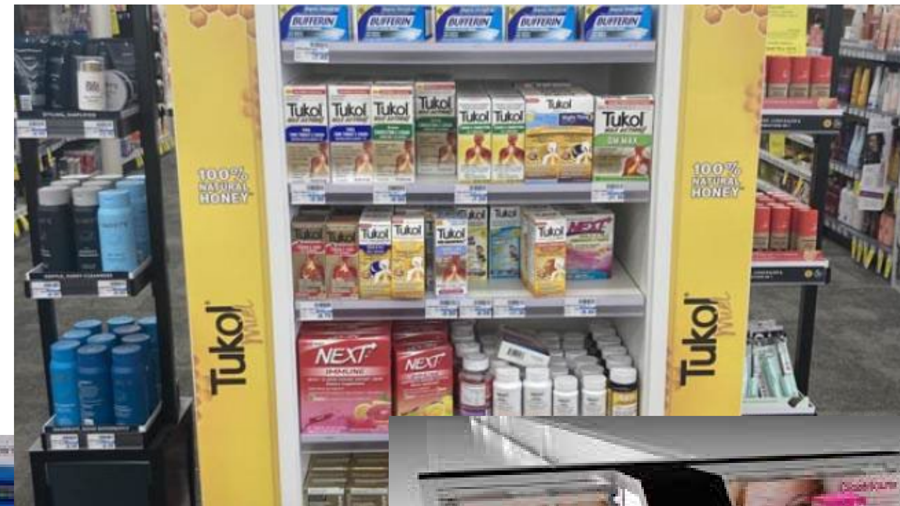
NEW CATEGORIES

ANTIBACTERIAL

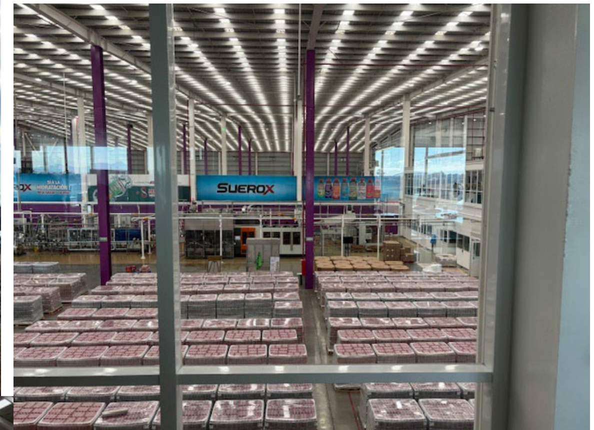
MALE CARE & GROOMING

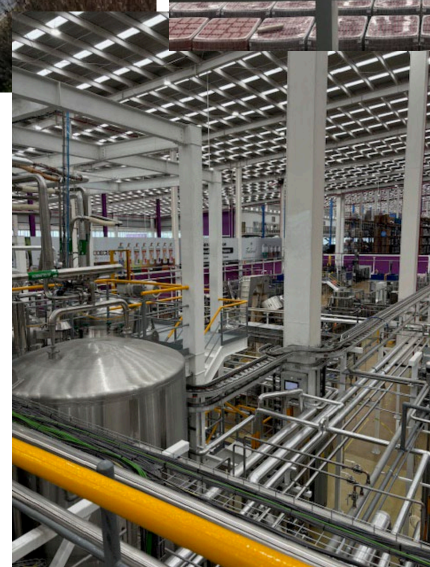
INFANT NUTRITION

Genomma Lab Intl – In-Store Presence



Genomma Lab Intl – Production Facilities





Genomma Lab Intl – Good Business

- Strong competitive position
  - The company's brands occupy leading positions (#1/#2/#3) in their respective market segments across Latin America
  - Brand name and distribution create formidable entry barriers
    - Strong brand presence spanning both traditional and digital media
      - Largest multi-media content developer in Latin America
      - #1 TV advertiser in Latin America
      - #1 digital brand awareness in Latin America (digital followers/revenue)
    - Distribution network spans over 500,000 points of sale across Latin America with 80% served on a DSD-basis
    - Replicating LABB's brand reach and distribution would likely cost well over MXN50 billion – not worth trying
  - The history of FMCG reveals enduring leadership sustainability – think *P&G, Unilever, Colgate, J&J, Reckitt Benckiser*

Genomma Lab Intl – Good Business (Cont'd)

- Above average returns on equity while employing minimal debt
  - Earns approximately 30% on tangible equity
  - Produces 20%+ operating margins and requires minimal capital investment
  - Go-forward returns should improve as the company's new facilities come on-stream
  - Debt payback (Debt/FCF) is less than 2 years; AA+ rating from Fitch
- Long-term competitive sustainability
  - The history of the FMCG industry reveals enduring leadership longevity, thus LABB's advantage and resultant profitability should persist going forward
- Future growth potential
  - Meaningful growth opportunity as the company's end markets are large and promise solid growth potential
    - Population of over 650 million people growing at 1% (for reference USA population is ½ that growing at 1/10 of 1%)
    - GDP/capita is 1/5 of that of the USA but catching up
  - Should be able to grow revenues and profits at mid- to high-single digits by enjoying the end market growth and by continuing to use its expertise to introduce new products in target market segments

Genomma Lab Intl – Good Management

- Running the business
  - Current management team took over in 2014 after the company fell on hard times due to the lack of institutionalization and insufficient industry-specific expertise
  - Decades of FMCG expertise accumulated across best-in-class enterprises such as Procter & Gamble, Pepsico, L'Oreal, and McKinsey
  - LABB was unprofitable when current management team came on board in 2015; this year the Company is on track to generate over MXN18 billion in revenues and over MXN3.5 mil in EBIT vs. MXN11 billion and negative MXN70 million, respectively, at the time of joining in 2015
    - Grew sales by putting the resources behind the most profitable and the biggest brands. Reduced the brands/SKUs from 62/430 to 18/211 while increasing sales by well over 50%
    - Cut costs by optimizing infrastructure footprint. Shrank warehouse space from 165,000 sqm to 36,000 sqm, office space from 6,000 sqm to 3,000 sqm, without negatively impacting revenues
    - Reduced CCC from 150 days to well below 100
- Allocating capital
  - Reinvest in the business to improve its competitive standing
    - Example: improving supply chain to include insourced manufacturing infrastructure. Raises profitability, increases cash flow by shrinking NWC, improves customer service through better supply chain visibility
  - Due to the capital-light nature of the business there is plenty of cash left over
    - Largely spent on dividends and share repurchases (50/50)
    - Acquisitions are generally eschewed due to high valuations; growth via partnerships preferred as a low-risk alternative minimizing capital outlay
- Shareholder alignment
  - Chairman Founder owns a 30% stake in the equity of the company

Genomma Lab Intl – Good Price

- Attractively priced on both absolute and relative basis
  - 5.5X NFY EPS and 6.5% NFY Dividend Yield
  - EV/Sales > 1X
  - Compares to:
    - Own historical NFY PE ratios averaging 15X (ranging from 10X to 20X)
    - Publicly-traded global peers trade between 16X NFY EPS and 22X NFY EPS
    - MSCI World Index trades at 18X NFY EPS
    - Private buyout multiples in the global FMCG space averaging 4.5 EV/Sales (ranging from 2.5X to 6.5X)

Genomma Lab Intl – Risks

- Economic slowdown
  - Company's products enjoy low price elasticity providing for sales stability even in a weak economics environment
- Currency Risk
  - Essential low-ticket nature of the company's products enables LABB to raise prices in line with FX depreciation if the event it occurs
- Corporate Governance
  - The company appears to be monetizing the economics to the full extent
  - The bulk of the cash flow is returned to the shareholders via dividends and share repurchases
  - Founder/controlling shareholder was instrumental in effecting the major strategic value-creating pivot 10 years ago by institutionalizing the business through bringing on board professional management with relevant expertise
- Geopolitical
  - Mexico is firmly lodged within the American geopolitical orbit, making any strategic and lasting conflict with the United States highly unlikely

Genomma Lab Intl – Outcome

- Proceeded to buy LABB as it cleared the 3G checklist
- Sized position close to our target weight
  - Approximately 10%
  - The business quality and price are in line with our model average without significant deviations either on the upside or the downside
  - No industry or country correlations with the other portfolio holdings
- Performance since purchase
  - Stock price increased approximately 30% since initiating position last year
  - Management continued to deliver on their plans to improve profitability
  - Despite the increase LABB remains undervalued at less than 7X EPS and a 5% Dividend Yield
- Action
  - Maintain position

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