ValueInvestor INSIGHT
The Leading Authority on Value Investing
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Investing in Crisis

Warren Buffett captures an essential truth about investing when he says, "It's only when the tide goes out that you learn who's been swimming naked." The market tide has certainly delivered its share of eye-opening moments over the past two months. Here, 12 best-in-class investors from around the world describe how they're navigating the roiling seas.

INVESTOR INSIGHT

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The Cure for Low Prices

Given relative valuations, many U.S.-based investors see more opportunity in the midst of the coronavirus crisis outside the U.S. than in it. On the lookout for deep-value opportunities anywhere, Álvaro Guzmán and Fernando Bernad of Azvalor Asset Management offer their perspectives on that and also describe the upside they see today in one of their favorite companies based in their home country of Spain.

Value investors aspire to have portfolios that hold up well when trouble hits. How has yours fared on that front so far?

Álvaro Guzmán: We've performed a bit better than our peers overall since the market meltdown started, but the differences within the portfolio have been quite dramatic. We've been generally negative about market valuations for the past two or three years, so had gravitated to a fair degree into more depressed areas like cyclically sensitive names, energy and other commodities, where valuations in many cases were half the levels of eight or nine years ago. Since the pandemic crisis hit, the 30% of our portfolio in precious-metals miners and uranium has done quite well, but our oil-related stocks have been crucified.

We've been trying to do what Benjamin Graham taught us and take advantage of volatility. For us that mostly means rebalancing from things that are doing relatively well into those that aren't. If you identify sustainable businesses and partner with managers who have skin in the game and aligned incentives, low prices should eventually be the cure for low prices. Good things happen when you buy cheap.

There are certainly low prices in energy. Why do you consider Maersk-spinoff Drilling Company of 1972 [Copenhagen: DRLCO] a worthy destination for your capital?

Fernando Bernad: We call it Maersk Drilling because it was spun off in April 2019 from Maersk Group as the parent was streamlining its corporate profile to focus more on its big container-shipping business. Maersk Drilling owns and operates offshore drilling rigs – floaters for deep water, jackups for shallow water. When it came public it traded relatively expensively compared to peers, but we started buying it in the last two months as energy stocks collapsed.

There's no question this is a distressed sector and the company's stock is down 75% from the highs of last year. Almost the entire equity peer group – including Transocean, Valaris and Seadrill – is priced for bankruptcy. Our basic view is that Maersk Drilling has the balance sheet to weather the current market storm, and that the current market storm will actually reconfigure the global oil-supply balance in a way that will benefit offshore exploration and production. U.S. shale, which we consider to have been a giant misallocation of capital, will likely not come back to former levels. It won't happen overnight, but offshore oil and gas – now roughly 30% of total global supply – will have to reverse historical levels of underinvestment to meet normal global demand. That should benefit survivors in the sector like Maersk Drilling.

The company this year should still generate $300 million or so in EBITDA, so it's not burning cash. If we normalize to what we consider reasonable day rates for its equipment – still below what you'd need to incent a new build – we think the stock today [at around 160 Danish kroner] trades at 3x cash flow. If you normalize to a level where a new build would happen – which seems like a stretch today but we think can happen sooner than most think – the cash-flow multiple is 1.5x. That's cheap. If the stock returned to its first-day closing price from last year – when the sector was already depressed – it wouldn't be far from a four-bagger from here.

From one battered sector to another, explain why you're betting on an eventual rebound at Meliá Hotels [Madrid: MEL].

ÁG: One could say the modern resort-hotel business was invented by the Spaniards in Mallorca, and Meliá was an early pioneer. The company, founded in 1956 and now run by the second generation of the Escarrer family, owns and/or operates more than 350 mostly resort hotels in 40 different countries, prominently in Spain, Mexico and the Dominican Republic. It's been public since 1996.

There's plenty not to like about the hotel business right now. Travel and leisure is obviously at the center of the current storm and most of the company's hotels are closed. This year will be a significant loss year, and it's difficult to assess the speed and magnitude of the rebound. There also are other secular issues that were weighing on the share price even before the virus, in particular the long-term impact on hotel profitability from online travel agents [OTAs] like Booking.com and Expedia, as well as the rise of new competition from Airbnb and others like it.

The first question to answer is about staying power. We have stressed the company's balance sheet with scenarios materially worse than what we think will actually happen, and believe it has plenty of flexibility to ride out a long storm. Most of its debt maturities are later than 2025. Debt covenants don't appear to us to be an issue. Maybe most importantly, the company has considerable capacity if necessary to take out loans against a large portfolio of unencumbered owned real estate. When things return to normal – and we do believe for them that it's when, not if – Meliá will be there to take advantage.

Which gets to the company's strengths against the two big secular threats. We think it becomes less rather than more dependent on OTAs, due to its strong brand and customer base. Meliá has 11 million members in its loyalty program, which on a member-per-room basis is around 110, not far from levels at much larger chains like Starwood and Marriott. Almost one-third of the company's bookings are direct, and that percentage is increasing. We think that protects it better than people seem to think from ongoing margin pressure from the OTAs.

The threat from the Airbnbs of the world also strikes us as overdone. First of all, we think those companies are much less competitive with resort-hotel operators, who offer much more than a clean, affordable and convenient place to stay. That advantage for resort hotels is amplified by what we consider the very customer-friendly culture of Meliá. While the company centralizes the right things to be cost efficient and take advantage of scale, it's decentralized at the hotel manager level, where the managers behave as if the hotel is their own and their first job is to serve the customer.

How are you valuing the stock, now trading at just over €4.30 per share?

ÁG: We have two valuations for this. Because they own and operate a large percentage of the hotels, one method assigns value on a gross hotel-by-hotel basis, then subtracts all debt, pension and other centralized overhead costs to arrive at a net asset value for the owned hotels. Then we look at the leased and managed hotels and apply a conservative 15x multiple to their normalized free-cash-flow stream. With this valuation method we get €14 per share in value for the owned hotels and €4

INVESTMENT SNAPSHOT

Meliá Hotels
(Madrid: MEL)

Business: Owns, operates, franchises and manages more than 350 primarily resort hotels located in 40 countries; top markets include Spain, Mexico and the Dominican Republic.

Share Information
(@4/29/20, Exchange Rate: $1 = €0.92):

Price	**€4.33**
52-Week Range	€2.51 – €8.85
Dividend Yield	3.4%
Market Cap	€896.0 million

Financials (TTM):

Revenue	€1.79 billion
Operating Profit Margin	12.3%
Net Profit Margin	6.3%

Valuation Metrics
(@4/29/20):

	MEL	S&P 500
P/E (TTM)	8.1	22.5
Forward P/E (Est.)	11.9	21.0

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

Company	% Owned
Norges Bank Inv Mgmt	3.1%
Global Alpha Capital	3.0%
Financiere de L'Echiquier	1.6%
Dimensional Fund Adv	1.6%
Vanguard Group	1.6%

Short Interest (as of 4/15/20):

Shares Short/Float	n/a

MEL PRICE HISTORY

THE BOTTOM LINE

Álvaro Guzmán believes the company has the financial wherewithal to ride out the current storm as well as the competitive strengths and culture to prosper when some normalcy returns to the travel and leisure industry. Valued both on net assets and on estimates of normalized free cash flow, he believes the stock price will return to 3-4x its current level.

Sources: Company reports, other publicly available information

per share on the leased or managed ones, for a total of €18.

The other valuation is based purely on free cash flow. The company generated roughly €160 million in free cash flow in 2019. This year we assume they'll lose €100 million, but we expect that to start to rebound next year, back to around €80 million. For our normalized number – call it the "vaccine" number – we think by 2022 or 2023 free cash flow can get back to where it was last year, or €160 million. Applying what we consider a reasonable 17x multiple to that and then adding back the value of non-core assets, we arrive at a market value of around €3.3 billion, or €15 per share.

This is a stock that over the past 17 years has gone from as low as €3, back to €18, down to €3 again, back to €13, and now collapsing again to €4. We think this is the third great opportunity over that time to partner with a best-in-class company, with a bargain-priced stock, in an industry that will be there and grow nicely over time. We don't get these types of opportunities that often, so we should be prepared to take advantage. VII

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