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A Cheat Sheet on Holding Companies for Value Investors

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Investing is a crowded field, filled with many intelligent, industrious bargain hunters who often compete away most exceptional opportunities available in plain sight. Holding Companies ("HoldCos"), however, tend to fall under the radar of those who focus their efforts exclusively on "pure plays" or on quantitative screens of accounting-derived statistics (*e.g.*, earnings or book values). In part because they are overlooked by many, HoldCos can sometimes provide fertile grounds for discerning value investors in search of attractive opportunities. In the following essay we will outline Moerus Capital Management's approach to investing in HoldCos.

For the purposes of this discussion, a HoldCo is a company that has partial or complete ownership of multiple entities (assets or businesses) that are either public (listed), private (unlisted), or both. "HoldCos" refer to neither an industrial sector nor a type of business, *per se*, but rather the term refers to an ownership structure of one or more businesses, which could include disparate, and usually separable entities. Berkshire Hathaway is perhaps the most well-known example of a HoldCo, but many others exist, operating in relative obscurity. Amongst the attractions of the HoldCo structure are its usually disparate and separable components that lend themselves to opportunities to build and crystallize value, which we explore in the following.

The first order analysis followed by most investors in HoldCos entails a simple arithmetic exercise – adding up the value of the HoldCo's component assets and netting out its liabilities to arrive at an aggregate net asset value that, when divided by the shares outstanding, yields a Net Asset Value per share ("NAV"). The NAV is then compared with the stock price to judge whether the stock is trading at a premium or a discount to its NAV, and if the latter, whether the discount is attractive enough to warrant purchase.

Although not mathematically incorrect, we at Moerus believe that such an analysis is insufficient to arrive at a considered investment judgment, and that relying upon a premium/discount calculation alone could be quite misleading and lead to the wrong conclusions. Consider a hypothetical situation with two HoldCos, one valued at a discount of 20%, and another at a discount of 35% of their respective NAVs. Clearly, if measured by discount alone, the latter would ostensibly appear to be a more attractive investment candidate. However, this overly simplistic line of reasoning ignores a variety of important factors, *inter alia*, the nature and valuation of the underlying businesses, the potential for growth, and the likelihood of realizing these estimated values – items we explore below.

Although it falls far short of telling the whole story, what the HoldCo discount does tell you is *what you are paying for what you are getting*. That is, in the case of a 35% HoldCo discount, you could buy $1.00 worth of assets for $0.65. Alternatively, the ratio of assets (what you get) to equity (what you pay) indicates "leverage" of 1.54x (or 1.00/0.65). One can think of this as being akin to owning the underlying securities on margin through shares in the

HoldCo – because you would be buying $1.00 of assets while paying only $0.65 "out of pocket" – but without any interest charges or the possibility of a margin call! Curiously enough, when the underlying holdings are out of favor (and by implication more cheaply valued), it is possible that the HoldCo discount to the depressed values of the underlying holdings might also widen, increasing the operating "leverage." Conversely, improving valuations of the underlying holdings (when they come back into favor) are often associated with a reduction in the discount at which the HoldCo trades, adding to the potential upside in the HoldCo's share price.

However, an arithmetic calculation of the HoldCo discount does not tell you anything about the standalone valuation or the attractiveness (or lack thereof) of the HoldCo's *underlying holdings*. Accordingly, a careful analysis of a HoldCo entails at least two layers of analytical understanding – first, that of the underlying companies/entities, and second, that of the entity that "holds" them (the HoldCo) – with the analytical insight afforded by this work being reflected in the ultimate investment decision.

There are a number of elements to this exercise, including the following:

- First, understanding the investment attraction of the underlying holdings: Are these businesses one might wish to invest in, preferably for the long run?

- Second, cheapness: Are the underlying holdings valued attractively, i.e., are they individually cheap on a standalone basis? Is the HoldCo trading at enough of a discount to a conservatively estimated NAV to constitute an attractive investment? The idea behind buying shares in a HoldCo is to buy attractively valued underlying holdings at a further discount via the HoldCo, with a view of benefiting from the appreciation of the underlying holdings along with a shrinkage in the HoldCo discount.

- Third, financial strength: Are the underlying holdings financially and operationally strong enough to cope with periods of adversity without requiring access to external financing sources (be they capital markets, banks, or reliance on the HoldCo)? In addition, a relatively under-levered balance sheet and low operating costs at the HoldCo level are sine qua non for investing in a HoldCo. In our view those attributes are a must, given that the bulk of cash generation usually takes place not at the level of the HoldCo, but rather at the level of its underlying holdings – typically dividends received from its underlying holdings are what allow a HoldCo to meet its own expenses, both operating and financial. During periods of adversity, these dividends may be curtailed or eliminated, potentially putting at risk the HoldCo's ability to meet its expenses, hence it is important that the HoldCo be under or preferably unleveraged and parsimoniously run. Excessive costs, compensation or otherwise could erode shareholder value over time, even absent adverse events.

- Fourth, the quality of the dominant or controlling shareholder's stewardship: Are they creating value for HoldCo shareholders or destroying it? Given that the control of many HoldCos is vested in a family or a group of related parties, usually for historic reasons, it is of paramount importance to gauge the quality of the controlling shareholder's stewardship of the holding company and the entities it controls. At one end of the spectrum, a HoldCo might have a very engaged owner who has built and realized value over the years through opportunistic purchases and sales of businesses, or alternatively has invested in and grown companies owned by the HoldCo organically. This would be the preferred controlling shareholder we would seek to partner with.

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> Less desirable are controlling shareholders who do little other than collect dividends, and whose presence in the company represents another operating expense. Quotidian expenses aside, the greater damage from such ownership is the cost of foregone opportunities in this mode of “do-little/nothing” ownership. Even less benign, are control parties who engage in self-serving, related-party transactions between the HoldCo and other outside entities in which the control party also has interests, to the detriment of minority shareholders in the HoldCo. We endeavor to identify and invest with thefirst type of shareholder, and strive mightily to avoid the latter two.

Successful value investing sometimes requires going off the beaten path and looking under rocks for opportunities that few choose to stop and consider. For many investors, HoldCos – which by their nature have disparate holdings and a tendency for latent value to sometimes be obscured by accounting convention – do not lend themselves well to analyses that are heavily focused on screens and easily modelled forecasts of future earnings.

However, for us at Moerus, HoldCos represent an attractive area to search for bargains. For one, a HoldCo structure lends itself well to Moerus’ asset-based analysis: an investment approach focused on the assets/businesses, notably on the valuation side of the individual constituent businesses, along with the Holding Company itself. Also, within the right HoldCo structure, with multiple businesses/assets owned in the hands of a skilled owner, ample value creation or realization opportunities are apt to present themselves over time.

You can read more about this approach to investing in our essay on this topic.