

Leucadia: Strategic Transactions Highlight Value

This article is authored by MOI Global instructor Patrick Brennan, portfolio manager of [Brennan Asset Management](#).

As we have discussed in past letters, we followed Leucadia for years from a distance. While we were greatly impressed with value legends Joe Steinberg and Ian Cumming, we did not own the name until after the company purchased Jefferies and subsequently became deeply unpopular with its historical investor base. After examining Jefferies' record over multiple market cycles, as well as evaluating some of the team's early capital allocation decisions (including the HRG investment which we also own), we believed there was substantial upside in the company's asset base and we believed the team could drive further value in the years to come. This viewpoint contrasted with the more negative consensus sentiment which essentially argued some combination of the following:

- Joe and Ian created all the value...Rich and Brian are New York investment bankers/traders/ mercenaries and therefore are genetically incapable of being value investors (or something to that effect)
- Jefferies and National Beef are lower quality assets and will unlikely earn much over an economic cycle
- Investment banking is in cyclical decline
- LUK has tons of assets, often looks weird on a GAAP basis and the entire business is far too complicated - who wants to simultaneously follow bonds, cows and car dealerships?

Well, the path has been far from smooth and both the beef business and bond business have faced greater challenges than we anticipated over the past couple of years. Both businesses, however, produced record results in 2017 with nearly \$1 billion in pre-tax income between them. Importantly, Jefferies has also started upstreaming dividends to the parent company to repurchase shares or to acquire other businesses. Yes, there will be volatility associated with these dividends, but last time we checked, the wind sometimes blows in unexpected ways for property and casualty insurers who invest underwriting profits. National Beef struggled far more than we anticipated, but its earnings have also rebounded far faster and ultimately higher than we ever would have guessed. We won't detail every LUK investment decision over the past 3 years, but we would argue that the hits (HRG, FXCM rescue, KCG sale, Jefferies turnaround, partial National Beef monetization) far outweigh any misses. These early results (not to mention Handler's track record when Jefferies was a standalone company from 2000-2013) might suggest that it is not a metaphysical impossibility for certain bankers to be decent capital allocators. So, given the favorable Jefferies/National Beef results, Jefferies dividends and market rumors concerning a National Beef sale, investors (naturally) sold and drove shares down -14% in the first quarter.

Given the number and variation in holdings, many investors typically look to book value (~\$27) and tangible book value (~\$20) as a rough approximation of value. But, this range of values considerably understates the favorable risk/reward in the name, considering the low or nonsensical marks of some of the businesses. By far the most glaring discrepancy was National beef, which was marked at -\$37 million on a tangible book basis despite earning over \$500 million in EBITDA during 2017. It does not take hours of studying herd levels to

ascertain a discrepancy. While not as large as National Beef, other investments (Berkadia, Garcadia, Linkem, Homefed) were marked at levels sometimes 50% or more below realistic market values and even HRG, which team LUK successfully liberated, looks cheap relative to the possible value of Spectrum Brands. As the quarter ended, shares traded below our best estimate of liquidation value and nearly 50% below fair value. And of course, this would be a static estimate. What happens if LUK's management finds other opportunities? In our opinion, enormous buybacks were warranted.

In early April, LUK simultaneously announced the following:

- Selling 48% of its National Beef business for \$900 million in cash plus an additional \$150 million in recent profits/acquisition adjustments. LUK retained 31% of the business (Implied value of over \$1.9 billion vs. -\$37 million tangible book value).
- Selling Garcadia (\$425mm equity value vs. \$200 million marked tangible book value)
- \$190 million acquisition of Bakken assets by Vitesse Energy Finance, doubling its asset size
- Increased buyback program to 25 million shares from 12.5 million. Pro-forma for the transactions, LUK will have a whopping \$2.8 billion of liquidity at the holding company
- Jefferies announced preliminary Q1 results (during a rocky market period) of ~\$120 million pre-tax
- Proposal for a name change to Jefferies Financial Group Inc. (New ticker JEF)

The sales were obviously far above marked book value and suggest that other assets (Berkadia/Linkem/HomeFed) may very well have meaningful upside to marked value. More importantly, the moves confirm that management is attempting to create a more focused company and narrow the gap between price and value. The National Beef transaction was a complete homerun as LUK paid \$868 million to acquire 79% of National Beef, received cash of \$1.6 billion and still retains a 31% interest. LUK has jumped since the initial announcement, but it is still down for the year and trades roughly 25-35% below our best estimate of current value, which gives no credit to possible value creation optionality. If shares continue to languish, we hope LUK quickly exhausts its buyback program.