

Selected Investment Ideas in Eastern Europe

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One of the first questions an astute prospective investor in Firebird usually asks is, "What differentiates your firm's investment approach?" Since our firm has been around for over 23 years, the answer usually boils down to "experience," but the bigger meaning of that answer has evolved over time.

Firebird started investing in Eastern Europe in 1994 with investments in Russian voucher privatizations. The goal was to take advantage of an extreme valuation gap between the real value of the Russian economy and the price put on it in voucher auctions - \$9 billion for 1/6 of earth's land surface was comparable with the amount paid by the Dutch to the natives for the Manhattan Island.

While our initial success can be attributed to that extraordinary opportunity, the fact that our initial investors have made over 49x their money has a lot to do with how Firebird's thinking has evolved over the years. Our initial investments were primarily asset-based and satisfied Jim Tisch's "\$5 million test." The firm focused on world-class resources available for pennies on the dollar because they were either unknown, misunderstood, or both. The exciting part was watching these businesses and management teams evolve, and ideas that are key to long-term success take hold. The companies in our region only started learning about capitalism twenty-five years ago. The fact that it took a while to internalize the benefits of reasonable capital allocations and proper minority rights protection is one of the most overlooked positive changes to the regional investment environment.

Macroeconomic analysis remains a crucial pillar of our investment process, but improvements to corporate decision making and reporting allowed us to apply what we call "incentive-based investing." Most companies that are cheap are trading at low multiples for a reason. Market participants have pre-conceived notions about an aspect of the business that makes current profitability unsustainable or suspect. We dig deep into these situations to try to understand incentives of key stakeholders involved, and whether market concerns are justified.

One example of a company we like is Sberbank (SBER LI. Sberbank is by far the largest bank in Russia, with 46% market share of retail deposits. It is the inheritor of the Soviet banking monopoly, with over 300,000 employees and the largest branch network in the country. The perception against the company has always been that due to its size and importance to the overall economy it would be called upon to make bad loans to uneconomic projects, jeopardizing the bank's balance sheet. However, the reverse seems to be true. While other Russian state-owned banks (VTB, VEB) are routinely saddled with inherently bad loans, SBER's "obligations" are minimal.

The Russian leadership clearly understands that its credibility would be shaken if an institution holding the deposits of almost every "babushka" suddenly went under. With nearly

half of the domestic deposits and a balance sheet equal to 30% of the Russian economy, Sberbank is too big to fail. The bank routinely generates ROE in the range of 20% to 25%, grows loans at about 5 to 15% per annum, and trades at 1.5x BV. A bank making similar returns in the west would be trading at double the price.

Another company that we like is GazpromNeft (GAZ LI), a 95% owned subsidiary of Gazprom. Gazpromneft was acquired by the mother company in 2005 with the idea of creating a subsidiary to develop its significant oil reserves. After the acquisition, a small free float remained, listed in Moscow and London. Owing to its small free float, Gazpromneft is not part of any Russian or EM indices, and is sparingly covered by the sell-side. While Gazprom itself is a byword for poor capital allocation, GAZ seems to be one of the best capital allocators in the oil & gas space. Since 2012, the company was able to grow its production by 44% while spending about 95% of its free cash flow on CapX. By comparison, Exxon spends 75% of its free cash flow on capex, yet its production barely grows. Currently GAZ's production growth is capped by the OPEC production agreement, but the company has been cutting its least profitable barrels, which makes the restrictions cash flow positive.

We believe that the market is missing the fact that Gazprom depends on its oil subsidiary to generate the cash necessary for its own dividend, which it is pressured to pay to contribute to the Russian state budget. Since most of the money is upstreamed via dividends, we as minority shareholders get to participate alongside the parent. Moreover, GAZ's independence depends on its superior execution – if the management ran the company as inefficiently as Gazprom's does, their *raison d'être* would disappear and the sub would likely be absorbed. As a result, we own a high-quality business with young upstream assets, and a profitable downstream business driven by highly complex refineries, that is valued at just 4x EV/EBITDA and a 7% dividend yield.

Outside of Russia, an example of a company that we think is misunderstood is Olympic Entertainment Group (OEG1T ET). Olympic is an Estonian listed operator of gambling halls with operations in six different countries, including Latvia, Estonia, and Italy. Olympic differentiates from most of the other offerings as a provider of a high-quality entertainment. With spacious halls, attractive bar areas, and modern slot machines, they offer the type of experience that gives people a reason to spend more time and money in their establishments. As a result, they generate higher gross gaming revenues per machine and higher margins.

Olympic was listed in 2007 and at the time was determined to grow at all costs. The company used IPO proceeds to buy operators in Ukraine, Romania, and Poland. With the 2008 crisis came a moment of reckoning and operations in these countries were shut down, generating significant losses for the company. In the process, the share price went down 90% and the founders, who still own the majority of the company, were forced to sell a portion of their shares at a rock-bottom price to satisfy margin calls. This experience proved profoundly painful for them, and they realized that they needed to bring in professional management and change their capital allocation priorities.

Since 2009, Olympic's capital allocation framework has changed dramatically. Most of the new investments were made in existing markets where the company already had significant operating experience and enjoyed good government relationships. New markets that were entered, such as Italy, were developed with small incremental investments in a JV format. As a result of these investments, Olympic has been growing revenues and EBITDA at 11% and 17% per annum since 2010. Its ROIC typically ranges between 40% and 60%. Despite the firm's success, most market participants still view it through the prism of poor decisions

made almost ten years ago. This is one of the reasons why we are able to own this high-quality growth stock at 5.5x EV/EBITDA and a 5.5% dividend yield.

About five years ago, we decided to see whether our cash-flows and incentives focused investment approach could be applied outside of our core markets. Because of our experience in Eastern Europe emerging markets, we knew that success in places like India, Brazil, and China would depend on having similar in-depth knowledge of the market as we do in Russia and other countries in the region. Without the relevant experience, we risked being the proverbial “patsy at the table.” Counterintuitively, we thought that the most natural place for us to try our approach was the United States, where credible company information is widely available and so knowledge of the local players is less crucial, yet our experience in picking companies based on fundamental attributes should be just as relevant.

We wanted to see if we could build a portfolio of U.S. companies that generate high returns on invested capital and growth, and trade at a low multiple of free cash flow. After an initial screen yielded Apple, Microsoft, Harley Davidson, and other high-quality names, we decided to create a standalone portfolio and have been investing in the U.S. market ever since.

One of the companies we currently own is AMC Entertainment (AMC), the largest owner of movie theaters in North America and Western Europe. 2016 was a year of rapid growth for the company. As a result of three significant acquisitions, financed with debt, AMC’s movie theater base more than doubled. Unfortunately for the company, 2017 turned out to be a weak year at the box office, with a number of titles underperforming their initial projections. Also, the market became concerned with the possibility of studios changing the exclusivity window that currently allows theaters to show movies for up to 90 days before they become available through alternatives. After a couple of disappointing quarters, market sentiment turned firmly negative and AMC shares fell by two thirds.

Because of the proliferation of alternatives like Netflix, Amazon, and others, North American movie theaters are perceived to be in decline. The reality is slightly different. While viewership fluctuates based on the quality of the movie slate, annual visitor numbers have been surprisingly steady, with 2016 North American attendance approximately equal to 1996. At the same time, revenues for movie theater companies have been growing as a result of increases in ticket prices and concession sales. The average ticket price since 1996 has almost doubled, and concession sales have grown at a similar pace. Big chains, such as AMC, are investing in improving the quality of the offering through the installation of recliners, pre-assigned seating, broader concession offerings, and other changes. Despite the increase in prices, a night at the movies remains one of the more affordable family entertainment options.

Shortening of the exclusivity window is possible, yet an in-depth look at the incentives of the players suggests that significant adverse changes are unlikely. The U.S. movie theater industry has been consolidating around three major players (AMC, Regal, and Cinemark) which together represent approximately 50% of available screens nationwide. In addition to controlling half the market, these companies are also cooperating through a number of JVs designed to increase purchasing power. Since the movie theater industry is more concentrated than the studios, negotiating power seems to lie on the side of theaters, and any changes to the exclusivity window are more likely to result in improvements, rather than deterioration, of industry performance. The results of European movie theaters, where the exclusivity window is shorter but EBITDA margin is higher, support this hypothesis.

Thanks to a recent two-thirds drop in market value, AMC is trading at a 30%+ free cash flow

yield. Most of the free cash is invested in theater upgrades, which lead to increased revenue per screen and typically generate ROIC's of 25% or higher. AMC's acquisitions of Carmike and Odeon, which had not been investing to upgrade their theaters, added a number of properties where improvements should yield returns even better than that.

Both in Eastern Europe and in the U.S., we look for companies with superior cash flow generation and a strong track record of investing capital in high return projects. By concentrating on cash and analyzing a company's positioning through Porter's five forces framework, we are finding companies that can consistently generate mid-teens returns without any growth in market multiples. When the market does decide to change its opinion about these companies, the multiple goes up and the value of our companies increases exponentially.