# Exclusive Interview with VNB Wealth Management: Catalyst-driven Value Investing

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We had the pleasure of interviewing Mark Meulenberg and Jimish Gandhi of VNB Wealth Management recently. The firm operates as a subsidiary of Virginia National Bank and is based in Charlottesville, Virginia. The team is led by Glenn Rust, President, and Mark Meulenberg, Chief Investment Officer. Since 2000, VNB Wealth Management has provided families and institutions with investment services focused on long-term results.

**Please tell us about the investment mandate of VNB Wealth Management within Virginia National Bank.**

The main product offering is our Enhanced Core Strategy which has an absolute return focus. The secondary investment objective is to provide an annualized after-fee return 5+% above the S&P 500 over every rolling 3-year period. VNB Wealth offers a fee structure for separately managed accounts that includes a fixed fee plus incentive fee, typically 0.75% and 20% of the profits, respectively, so we are intensely focused on trying to avoid losses, particularly those that are permanent. We operate under the mantra of "putting capital to its highest and best use" which charges us with finding securities throughout the capital structure with the most favorable risk/reward. It has always seemed intellectually distasteful to have to invest in a certain security, say the common equity of a company, due to some artificial mandate, while the bonds of that company may be offering the best risk-adjusted return.

For any investment we make we are targeting a 15+% internal rate of return (IRR) via a combination of current free cash flow or earnings yield plus growth, along with any projected increase in multiple, as well as any dividends accrued. If we can't get to the 15% IRR number with a high degree of confidence, we don't invest. Unofficially, we are looking to double our clients' money every 5 years which ties in with the 15% IRR target.

**How would you describe your value-based, catalyst-driven investment discipline?**

We make investments in a wide variety of securities and financial instruments in the public markets both domestically and abroad. The financial instruments used include common stocks (from micro cap to mega cap), preferred stocks, corporate bonds, bank loans and other debt securities, convertible securities, ETF's, options, warrants, and cash and cash equivalents.

Core investments are made in those companies that have high and increasing returns on tangible capital, recurring revenues and generate substantial free cash flow. The Enhanced portion of the portfolio includes investments throughout the capital structure in undervalued securities of companies undergoing various types of corporate events: refinancings, mergers and acquisitions, balance sheet restructurings, earnings, divestitures, spin-offs, litigation, etc. A particular emphasis is placed on micro cap securities in this portion of the portfolio.

An identifiable catalyst is a key component in almost all of our investments. The catalyst can be 'soft' or 'hard.' We tend to think of a 'soft' catalyst as representing inflection points in the way a company is valued maybe via a change in multiple or in the trajectory of their operating results. A 'hard' catalyst for us is aligned with the traditional definition of a targeted corporate event.

We utilize inverse ETF's and options to hedge at the portfolio, sector or individual security level.

The strategy is managed using a concentrated approach investing in typically no more than 30 securities. This approach allows us to focus on our 'best ideas.' Additionally, we believe our experience and expertise in conducting fundamental analysis combined with our ability to identify catalysts gives us the potential to deliver our desired returns

on a consistent basis.

The goal is to structure a portfolio of securities exhibiting specific characteristics in meaningful concentrations (Core) and to supplement those securities with smaller positions that have a substantially higher return profile (Enhanced). The size of individual holdings is commensurate with the risk/reward profile of each position.

The investment process is fundamentally driven and our bottom-up fundamental research and analysis drives all of our decisions. We actively seek to identify securities with asymmetrical return probabilities – limited downside with the potential for substantial upside.

We also take into consideration the degree of bearish perceptions about a company. When a company has met all of our criteria for investment we prefer there to be poor market perceptions about its business or industry. In essence, we try to answer the question, 'what are we seeing that the market is not?' We call this our 'differing perspective'. If we can nail this with a certain degree of confidence, our return prospects increase substantially.

Before an investment is made we take into account the experience and orientation of management. If we can find truly outstanding operators and capital allocators, we tend to be much more willing to 'ride' those investments for many years. We recognize how rare a find it is to uncover a truly great corporate leader and we are content to absorb some bumps in the road to hang on to our position.

Below is our schematic of the construction guidelines for our portfolio:

| | Positions | | Characteristics | Target % | Min % | Max % |
|---|---|---|---|---|---|---|
| **Long** | 20 - 30 | | | | | |
| | 10 | Core | Recurring revenues, high free cash flow yields, high and increasing ROIC; to include sum-of-the-parts, spin-offs or stand-alone opportunities. Typically, a catalyst is present | 5-8% | 5% | 10% |
| | 10 - 20 | Enhanced | Event-driven situations including warrants, LEAPS, liquidations, balance sheet restructurings, sum-of-the-parts and spin-offs; high yield and distressed debt and micro cap stocks | 2% | 1% | 5% |
| **Hedge** | 0 - 5 | | Options and inverse ETF's can be utilized to hedge out certain portfolio risks | No target | 0% | 25% |

**What are your key stock selection criteria, and what types of businesses have you favored historically?**

We break the portfolio down into two distinct parts; the Core section and the Enhanced section. The selection criteria and types of securities in each differ greatly between those two buckets.

Companies must generally meet the following criteria to be included in the Core Portfolio:

Business Characteristics:

- Essential nature of product or service offering
- Generates high and increasing returns on tangible capital
- Currently generates, or has the potential to generate, substantial free cash flow
- Leadership in an attractive market niche or industry

- Understandable business
- Absence of key risks and variables that are outside of managements' control

Intangibles:

- Positive signals from management – – open market purchases of company stock by directors & officers
- Integrity of management
- Managements' ability to execute and to allocate capital
- Catalyst is present

The Enhanced portion of the portfolio has the following characteristics:

- The investment opportunity is generally small and most institutions are not able to capitalize on the situations due to the small size or their unwillingness to invest in non-traditional investments
- They can be complicated and many public and private investors are not interested or equipped to analyze and invest in them
- The securities are many times mischaracterized as having a perceived higher level of risk due to their liquidity and size (micro caps for instance).
- They typically exist due to non-economic reasons (and imbalance of supply and demand) and include spinoffs, liquidations, warrants, post-bankruptcy securities, distressed debt, etc.

Generally speaking, our Core criteria has led us to subscription-based businesses in a variety of industries (cable, satellite radio, SAAS, home security) but really it includes any type of business that we deem an essential product or service. If consumers repeat purchases with regularity or renew subscriptions at high rates we get interested at the right price.

The securities in the Enhanced portion are much more of the variety of 'lose a little make a lot.' These tend to be 'uglier' and in industries such as ship building, steel, oil and gas discovery, turnaround stories in retail, and micro cap stocks in virtually any sector. In addition, we usually gravitate towards the orphan security in a spin off – the one sold by larger investors who treat it as an appendage they can't or are unwilling to own.

**How do you generate investment ideas?**

At this point in our careers we have a decent pipeline of idea flow from our colleagues at different investment houses and brokerage firms. Probably one of the more fruitful places for us has been to identify other managers that we believe think like us or at least where we have some commonality in holdings. Many times at first glance, we'll look at something and can't figure out why anyone would think it's a profitable idea. Some of our best investments have come from answering the question, 'what are they seeing that we are not?' If we can fundamentally understand the story ourselves we will invest. In this business there's no pride of authorship! We are a small shop with somewhat limited capacity. It pays to be efficient and resourceful.

We also look for discounted prices due to factors such as analyst downgrades, forced selling by hedge funds or other investment institutions, media reports that cast the company in a negative light, points of maximum pessimism, changes in management or strategy, or disdain due to an industry crisis.

Of course, the standard scouring of investment publications (MOI, Value Line, Value Investor Insight), Wall Street Journal, Value Investors Club (one of our former analysts works for John Petry's fund), business magazines, investment blogs, hedge fund letters and screens is a must and usually offers up an idea or two each year.

**Would you outline the summary thesis behind one or two of your best ideas at this time?**

Our summary thesis for two of our Core positions and one of our Enhanced positions can be found below:

**DISCK/DISCA** (Core)

Discovery is a niche content producer with a focus on non-fiction programming that is popular across cultures and countries. Its business model is unique in that it allows Discovery to leverage content produced for a given market on a global scale. Additionally, unlike other media companies it owns most of its content. This provides tremendous flexibility in terms of content distribution and is a crucial differentiator in the OTT world. The traditional video ecosystem is under some pressure from OTT aggregators (NFLX, AMZN, Hulu, HBONow) and therefore, poses a significant threat to weaker networks in the cable bundle. However, we believe Discovery's strong brand, unique content, and solid network ratings will enable it to thrive in a world where there is a shift in the value chain from distributors to content creators. Moreover, while Discovery's share of viewership in the U.S. is 12% its share of wallet is only 5%. The probability that its networks are kicked out of the bundle is very low. In the case where Discovery's networks are not part of the cable bundle, Discovery can choose to do a direct OTT offering to consumers since it owns almost all of its content.

The superior economics of Discovery's business model are affirmed through its average return on tangible capital in excess of 50% and an average FCF margin of around 20%. Recently, margins in the international business have decreased as Discovery has been investing heavily in content in Europe. Once this investment phase is complete, we expect Discovery to gain significant subscribers and EBITDA margins in the international business to revert back to its long-term average of ~40%.  Currently, The Street is concerned about the softness in the U.S. TV advertising market caused due to shift in advertising dollars toward digital. We believe this concern is overblown and is a result of the inadequacy of the current viewership measurement system to capture viewership across multiple platforms and access points. Management of multiple media firms have communicated this issue to investors on earnings calls and are diligently working with network rating companies to resolve it. In our view, Discovery's strong presence in international markets serves as a hedge against any potential weakness in the U.S. DISCK is currently trading at an attractive valuation of 15.0x-16.0x forward FCF multiple. Its management team led by CEO, David Zaslav, has been prudent in taking advantage of its undervalued stock from time to time via share buybacks and has reduced share count by 29% over the last four years. Management has also been opportunistic in buying content globally to further strengthen its IP portfolio and grow its market share. We take solace in the fact that Dr. John Malone, a cable industry veteran and an outstanding capital allocator, owns 5% of the common and is also a board member. Based on our estimates, we think DISCK can produce FCF per share of $2.50 – $3.00 in the next 2-3 years driven by high single digit to low double digit EBITDA growth and share buybacks. This results in an intrinsic value estimate of $45-$50 per share or an IRR of 16% – 20% on the current price.

**SIRI / LMCA** (Core)

Sirius XM is one of the few businesses that is well-positioned to grow its FCF per share at 15% – 20% per annum over the next several years via a combination of share buybacks and growth in free cash flow fueled by subscriber growth in the used car market, lower Subscriber Acquisition Costs (SAC), operational leverage, lower capital expenditures, and $5.5 billion in net operating loss carryforwards. What separates Sirius from other audio entertainment companies is its exclusive non-music content and long-term relationships with the auto OEMs. Despite playing in a highly competitive audio entertainment industry, SIRI has proven the value of its service offering through successfully executing in the new vehicles space and consistently growing its subscriber base over the past several years. We believe the used vehicles market is an even bigger opportunity for SIRI as the number of satellite radio

enabled vehicles increase from 70 million today to roughly 120 million by the end of this decade. However, it seems that the market is overly concerned about increasing competition from various streaming services and is currently pricing SIRI at 15.5x-16.0x forward FCF multiple.

Our variant perception is that SIRI will continue to dominate the paid auto infotainment space through its broad array of differentiated content and a deeply entrenched position with the auto OEMs. The connected vehicle technology, which is considered a threat to SIRI's business model, will in fact strengthen SIRI's competitive position by enabling it to better understand its customers' listening preferences and subsequently improving the conversion rate and reducing the churn rate. We are pleased with Jim Meyer and his team who has maintained their focus on expanding Sirius' moat through investments in unique content and making strategic acquisitions. Management is wise in adopting a growth strategy that is focused on expanding the subscriber base and maximizing free cash flow versus an ARPU-driven growth strategy. Since the initiation of share buyback program a little over two years ago, SIRI's management has retired over 20% of outstanding shares. We believe an investment in SIRI at current prices will result in a 15% – 20% IRR over a three-five year period. A subscriber based recurring revenue business with increasing high returns on capital, high free cash flow generation, and a unique entrenched position in the auto entertainment industry, certainly has the characteristics of a business we would like to own over the long term. Insteac of making a direct investment in SIRI, another way to own SIRI is through an investment in Liberty Media (LMCA/LMCK), a 57% owner of SIRI that trades at a 15%-20% discount to its net asset value.

**RST** (Enhanced)

Rosetta Stone is a classic example of a business with a sub-par management team that destroyed economic value while chasing growth at any cost. To put things in context, over the last four years RST's management has spent on average 55%-60% of revenues on sales and marketing while growing revenues and bookings at a CAGR of 0.3% and 2.5% respectively. Despite this lackluster performance, RST has had consistently high gross margins of around 80% and a rock-solid balance sheet with net cash balance of ~$2 per share or 25% of current market capitalization.

The current substantial undervaluation of RST's stock is a result of an overreaction by Mr. Market combined with peculiar security characteristics (lower market-cap and liquidity) that prevent large institutional investors from owning the name. We saw this as an opportunity to invest in a business that has a strong and valuable brand (in the software-based language learning space) with significant growth opportunities and minimal downside risk. RST recently announced the appointment of John Hass as its new interim CEO and also laid out its new strategy of pursuing profitable growth in the Global Enterprise and Education segment and restructuring the consumer segment to focus on the more serious learner. We believe this is a big positive for the business and should drive out non-productive costs and improve margins and cash flow.

Currently, activist investors (Osmium Partners, Nierenberg Investment Management, Roumell Asset Management) have a combined ownership stake of 20%. RST announced in its latest press release that it has received an expression of interest from RDG Capital Fund Management, a private investment firm in New York. Subsequently, in a recent 13D filing, Osmium Partners laid out its investment thesis on RST and stated that a strategic buyer of RST should at least pay $16 per share (100% upside) based on recent industry acquisition multiples. We believe we have the recipe for a successful investment in that: a) if managed correctly the operating business has many appealing characteristics b) there is a margin of safety via their recurring revenue, potential takeout offer and strong balance sheet c) a collection of shareholders are seeking to drive the stock price to match the intrinsic value of the business. Our FCF-driven conservative estimate of intrinsic value is $12-$14 per share, an upside of 50% – 70% over the next 2-3 years or an IRR of 15% – 20%.

**How do you assess the quality and incentives of management, and what CEOs do you admire most?**

In our view, the most important responsibility of a CEO is capital allocation. We have been surprised over the years that a vast majority of CEOs do not fully appreciate the significance of this aspect of their job and the impact it has on the future profitability of their company. We also want the CEO to have an 'owner mindset'. We admire CEOs who think like owners and who are continuously striving to widen the moat of their business and create long-term shareholder value. Management quality is an intangible attribute, which is hard to assess in wide-moat businesses. The inherently strong economics of a good business may fully or partially mask the weaknesses of an average CEO. We read shareholder letters of past several years and transcripts of earnings calls and various investor conferences to better understand management's thought process on competition, drivers of growth and value, operational issues (if any), and capital allocation. Going back several years allows us to see if management has fulfilled past promises, paid up for acquisitions, or bought back shares at inflated prices. We also closely study the proxy statement to learn about the backgrounds and compensation structure of the executive management team and the board of directors. Typically, we like to see significant insider ownership in our portfolio companies and a compensation structure that is directly linked to the long-term operating performance of the business. We are wary of management teams that focus on acquisition-driven growth strategy, constantly increase share count via issue of excessive stock options, and are compensated based on short-term stock price appreciation.

It is important to keep in mind that most good CEOs are either shrewd business operators or strong capital allocators. CEOs possessing both of these attributes are rare. We think Gregg Maffei and Mike Fries at John Malone's Liberty empire, Tom Rutledge at Charter, Mark Dankburg at ViaSat and Brett Roberts at Credit Acceptance, are among the few CEOs that belong to a rare breed.

**To what extent do you engage with the management teams of the companies you own?**

We firmly believe in assessing management based on their actions and the operating performance of the business. Most CEOs and members of the executive management team possess good marketing skills and it's easy for investors to get unduly influenced by their sales pitch. As a result, we interact with the management only when we are seeking clarity on specific aspects of their business or need a better understanding of their view on an ongoing operational issue.

**What is your take on portfolio concentration, and how does it reflect your philosophy on risk?**

Compared to most traditional investment shops we run fairly concentrated portfolios. While it is certainly not to the level of some hedge funds, it is generally higher than what is typically seen. Our clients are aware they may experience more volatile results than a diversified portfolio in the short term but in the longer term the return prospects should be more favorable. We believe that the ability to make large commitments to well-researched opportunities across the capital structure gives us a competitive advantage and provides for the potential for outsized returns. Internally, we have set limits on individual securities (less than 10%) and industry concentrations (less than 40%) with both limits viewed on a combined basis throughout the capital structure.

We tend to group our positions in the Enhanced portion into different buckets and think of them as one position. For instance, we have a few stocks that trade at deep discounts to book value. For instance, if there are 4 or 5 of those at 50 bps each we view that as a 2 to 2.5% position in total.

While we are not foolish enough to think the following factors will fully insulate the portfolio from losses in a substantial broad market decline we do feel a comfort level in their existence.

- We purchase each security at a significant discount to our estimate of intrinsic value
- The identification of a catalyst (hard or soft) should, in theory, eliminate some of the market risk
- A Margin of Safety is established in each investment
- A consistent review of each business and their financial results is performed to determine if the original investment thesis still holds true

- We operate exclusively within our circle of competence and expertise

**Can you recommend one or two recent books that have given you new insights into the art of investing?**

I would say the most influential book I've read recently actually had almost nothing directly to do with managing money, but the crossover to how we think about investing was significant.

*This Explains Everything* is a compilation of replies to a question put online on the *Edge* website by the publisher and editor of the book, John Brockman. The question posed was, 'What is your favorite deep, elegant or beautiful explanation?' Brockman writes, 'the common thread is that a simple and nonobvious idea is proposed as the explanation for a diverse and complicated set of phenomena.'

To the open-minded and inquisitive the answers offered and then collected by Brockman from thoughtful, well-educated and accomplished people in their respective disciplines provide a treasure trove of applications to investing.

The following was taken from our 2014 year-end letter and we hope offers an example of how to apply seemingly disconnected disciplines together in an advantageous way. The commentary below was written from ideas presented in Brockman's book:

*Any attempt to predict the appropriate level and direction of oil prices, the general stock market, interest rates or even the profitability levels of certain companies causes us to operate in a world of probabilities.*

*Satyajit Das, the author of The Master of the Universe and the Cult of Risk, writes, "Inexactness undermines scientific determinism, implying that human knowledge about the world is always incomplete, uncertain and highly contingent." In 1927 Werner Heisenberg, a German theoretical physicist, showed that uncertainty is inherent in quantum mechanics. He developed the Uncertainty Principle which, in essence, states that the exact position and momentum of an atomic particle can only be known within certain limits. Thus, we have to work with probabilities and inexact information. At the Memorial Solvay Conference in Brussels in 1962 he stated, "Causality law has it that if we know the present, then we can predict the future. Be aware: in this formulation, it is not the consequence but the premise that is false. As a matter of principle, we cannot know all determining elements of the present."*

*We believe investing has parallels to the conclusions made by both Das and Heisenberg. So, in holding that belief, how then should we act? What risks should we underwrite if it's impossible to have all of the information? The price of oil has dropped more than 55% from its peak in 2014 as of this writing. Has worldwide demand shrunk so significantly? Has supply increased that much in such a short period of time? Production and demand levels over the past year do not point directly to such a significant drop in oil prices. It's evident to us that market participants do not have perfect information. Clearly, those in the oil and gas business did not have all the determining elements of the present in June of 2014, as crude began its relentless and very steep drop.*

*This concept is so important to understand as investors. Knowing that we live in a field of inexactness, we have chosen to invest in a way that allows us to better quantify and calculate our risks. We avoid hard-to-value scenarios. We don't try to value indices like the S&P 500 but rather individual securities. We don't attempt to predict things like oi prices but rather seek to understand the effect oil prices will have on the fundamental results of the securities we own.*

There is beauty in recognizing and applying simple truths to complicated problems. We also realize we don't get paid more for a complex investment idea than a simple one. As investors, we should endeavor to improve our investing acumen in any way we can. Embracing the "Deep, Beautiful, and Elegant Theories of How the World Works", and applying the concepts to how we think and invest, is a very beneficial exercise.

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