ValueInvestor INSIGHT

The Leading Authority on Value Investing

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Less is More

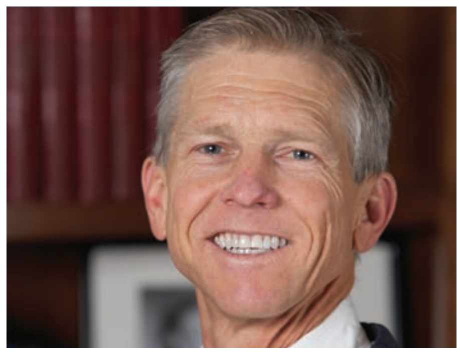
Successful investing requires buying and selling at emotionally the most difficult times, something Steve Leonard appears to have very well in hand.

If activity were the measure of competence, Steve Leonard wouldn't earn the highest marks. "Probably 10% of the time stocks are cheap enough to buy and 10% of the time they're expensive enough to sell," he says. "So most of the time we're holding what we own, avoiding what we don't, and patiently waiting for opportunities to arise."

That deliberate playbook has produced quite exciting returns for his Pacifica Capital investors. Since the firm's 1998 founding it has earned a 12.6% net annualized return, vs. 5.7% for the S&P 500.

While generally finding more in today's market to short than to buy, Leonard does see unrecognized value today in such areas as diversified holding companies, insurance and homebuilders. See page 10

INVESTOR INSIGHT



Steve Leonard
Pacifica Capital Investments

Investment Focus: Seeks high-quality companies when solvable specific concerns or excessive industry or overall-market fears unduly hit their share prices.

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American Express, Asahi Holdings, Chipotle, Greencore, Goldman Sachs, Mayr-Melnhof Karton, Michelin, Netflix, Noodles & Co., Praxair, Salesforce.com, ServiceNow, Staples, Starbucks, U.S. Bancorp, Wells Fargo

Investor Insight: Steve Leonard

Steve Leonard and Kari Pemberton of Pacifica Capital Investments explain the practical constraints they put on their circle of competence, how they determine if management is worthy of their trust, which industry is producing their most-interesting short ideas, and why they see unrecognized value today in Leucadia, M.D.C. Holdings and CNA Financial.

You had a thriving real estate career when you decided to turn your attention to stocks in the late 1990s. What was the rationale behind that?

Steve Leonard: Part of it was that I just didn't want to be invested in real estate at the time. Real estate is very cyclical and the cycle in my primary market in Denver had been heading toward its peak, so it was a much better time to be a seller than a buyer.

That also gave me a chance to think about what I really wanted to do and where I thought the opportunities were. I've always had a passion for the stock market and generally trying to figure out where capital can be put to the best use. In real estate, markets are pretty homogeneous – if the Denver market is expensive, almost everything there is expensive. But that was less true in the stock market. The telecom and Internet sectors were terribly overvalued then, but other sectors like property/casualty insurance were terribly undervalued. I'll have more to say about this later, but generally I appreciate with stocks that there's more flexibility to move to where the opportunity is at any given moment.

What translated very well from my real estate experience was the importance of focus. When we were doing industrial real estate in Denver, we lived it and breathed it to the extent that we knew what was a good value and what wasn't. In equity investing we know that there are a limited number of areas we can be expert in, so we limit ourselves to finding the best houses in a select number of neighborhoods, so to speak.

What neighborhoods do you frequent?

SL: We rarely venture outside of consumer goods and services, retail, restaurants, banking and insurance. These are areas we have tangible experience with, both personally and professionally. That's pretty central to what we do. We need to be able to go to the store and see how crowded it is and how we're treated. We need to be able to talk to management and people in the industry to understand how loans are being made, say, or insurance underwriting is being done. Having been customers of all these types of businesses, we think we're better able to do that.

ON FOCUS:

We rarely venture outside of areas in which we've had tangible experience, personally and professionally.

The decision tree for our investments is pretty simple. Is the business within our sphere of understanding, intellectually and financially? Does it have reasonable prospects for growth and an attractive and sustainable return on invested capital? Is the management team one we would trust with our money? Does the current market price represent a discount to intrinsic value? If we can answer yes to those four questions, we're willing to buy.

Describe how Starbucks [SBUX] – which you recommended at a split-adjusted $12.50 last time we spoke [*VII*, June 30, 2010] – is illustrative of your strategy.

SL: Starbucks is one of the strongest consumer brands in the world, which has translated into tremendous customer loyalty, excellent store-level economics and a very long runway for global growth. Businesses with those attributes are rarely available at discounted prices, but in this case the stock right after the financial crisis hit had fallen 75% from its earlier-year highs. Part of that was company specific, as performance flagged due to what we thought were poor but fixable capital-allocation decisions around growth and the balance sheet. Part of it was just the blanket fear that affected the entire market. We thought that combination of the micro and the macro gave us a tremendous opportunity to buy into a world-class business at a bargain-basement price. Basically our success rests on having the discipline to wait patiently for opportunities like that to present themselves and then having the courage to run towards them when everyone else is running away.

You pride yourself on having a long time horizon. What do you think of Starbucks now at $52, up seven-fold from your average cost?

SL: We typically hold only ten stocks at a time and favor those we expect to sustainably compound value over a long period. But inevitably the market will get ahead of itself and price in expectations that go well beyond what we consider reasonable. That's pretty much the case today with Starbucks, so we've sold most of our shares, especially in non-taxable accounts. We'd certainly be buyers again, but only at a much lower price.

Valuation matters. Chipotle [CMG] fits all the criteria of a business we like, with an efficient operating model that results in favorable labor costs and great store-unit economics. Earlier on – when I missed it – you could have paid almost any price for the stock because the growth opportunity was so high that they'd easily grow into the valuation. But now that the company is starting to mature, I can't imagine paying something like $12 million per store to own it when the cost to build a new store is only $800,000 to $900,000. It's hard to call that a bargain.

So what's the next Starbucks or Chipotle?

SL: We haven't found it. We looked at Noodles & Co. [NDLS], a fast-casual restaurant chain with more of a pasta-based menu, after the stock came back to earth after a big post-IPO increase. We think it's a viable business, but it just can't produce the unit returns and margins you see at Starbucks or Chipotle. We'd buy it at the right price, but it would still have to come down quite a bit from the current level. [*Note*: As high as $35 a year ago, Noodles shares currently trade at $14.50.]

One recent buy was been office-products retailer Staples [SPLS]. Does it fit the quality profile you've been talking about?

SL: They wouldn't be our biggest positions, but we will at times invest more on valuation than on long-term potential. Staples is in a business we understand and has proven itself to be the best operator with the highest margins in the category. The office-supply sector has been significantly impacted by changing technology, partly by the continued shift to online selling, but even more by reducing demand for a lot of items they sell. People don't need as much copy paper or file folders or printer toner. That had set off a much-needed consolidation in the sector, with Office Depot agreeing to merge with OfficeMax, and the retail square footage overall beginning to be sharply reduced.

Our premise was that as the consolidation happened, the profitability of the business would return to near-historical levels. We thought we could make reasonable estimates for Staples' revenues and earnings as the consolidation worked its way through. When the stock fell to the $10.50 to $12.50 range last year we found it very cheap relative to our normalized estimates. The thought process was almost identical to what we'd used the year before with good result in Best Buy [BBY].

As it turns out, Staples stock started going up and then spiked above $18 earlier this year on the announcement it was buying Office Depot. That was on the high side of our estimate of what it was worth, so we've been selling and are now almost entirely out of the position. That's not typical for us in terms of holding period, but for this type of idea in particular you have to strike when the iron is hot.

Describe how you determine if management is worthy of your trust.

SL: It starts with touching and feeling how the business is operated. Do they have good locations? Are employees well trained? Do customers value the product? That should translate into more objective evidence, like strong returns on investment and incrementally better profitability.

ON RED FLAGS:

We won't partner with boastful management, people who I wouldn't even want to have over to my house for dinner.

We put emphasis on how management talks about the business over time. Is the game plan consistently and well articulated? Do they do what they say they're going to do? Do they acknowledge mistakes rather than make excuses, and explain why they're changing direction if they are? We'll talk about this later when we discuss shorts, but we won't partner with management that is boastful and condescending. These are people I wouldn't want to have over to my house for dinner, let alone entrust them with our money.

We also look carefully at compensation. Warren Buffett sits down with the managers who run his businesses and comes up with something very simple, clean and logical, typically doing it once and it's forever there. He doesn't reevaluate it to help out when somebody misses a goal. If you have the right compensation plan, you tend to attract the right people and keep them focused on the right things.

We have three core holdings in financial services, Goldman Sachs [GS], Wells Fargo [WFC] and U.S. Bancorp [USB]. They have different areas of focus, but in each case over many years we've developed very high confidence in the management teams. They say the right things, they do the right things, and however the world spins and the industry evolves you believe they're going to come out ahead. That's very important to us.

On the subject of financials, has your long-held enthusiasm for American Express [AXP] waned?

Kari Pemberton: This is also something, like Starbucks, we bought heavily when the financial crisis gained traction in 2008. We highly value the brand and expect the ongoing global shift from cash to credit and debit cards to benefit them for a long time. That said, we think there's increasing uncertainty about how Amex will be impacted by evolving technology, especially in mobile payments. It's also unclear how the recent court ruling in the U.S. that makes it easier for merchants to promote usage of one card over another might impact them. Amex is appealing, but there's likely to be continued downward pressure on the discount rate it collects. Overall we find it harder to forecast future growth, which makes us hesitant on the stock even though it's sold off a bit over the past year.

Your investor letters have been heavy on macro reasons why the market overall is pricey. How does that translate into your portfolio's current makeup?

SL: We do worry about things like increasing global debt levels and unsustainable spending and monetary policies that are likely to have unintended negative consequences over time. We worry that corporate profits relative to the size of the economy are at what is probably an unsustainable peak. It concerns us that on metrics like the S&P 500 index versus trailing 10-year average earnings, or the "Buffett Indicator" that compares corporate market values to gross national product, we're currently approaching two standard deviations above historical levels. It also concerns us that interest rates are at generational lows and that equity values have historically had an inverse relationship to interest rates.

If we're feeling less comfortable about overall market values we're inclined to be less aggressive in buying and we're more willing to sell. We'll talk about Leucadia [LUK], which is something we recently bought and could see ourselves holding for a very long time. Were we less pessimistic about the market, we almost certainly would have taken an even bigger stake than we did. If the market falls 20%, Leucadia may or may not fall less than that, but it's going to go down.

Being less willing to buy and more willing to sell means we're holding a lot of cash – 45-50% in non-taxable accounts and maybe 25% in taxable accounts. We sleep well at night because we believe the companies we own will be doing well in five or ten years in most any predictable economic environment. But our top priorities are to minimize risk from overvalued investments and have dry powder available for the next time the market offers bargains. We would hate to be out of cash after six years of a bull market.

In 2008 we were down around 14%, which wasn't great but was a lot better than the market. A big reason for that was that our three biggest positions going into the crisis were cash and two companies that were uniquely positioned to weather the storm, Fairfax Financial [FFH] and Berkshire Hathaway [BRK-A]. Those are still our three largest positions today.

Describe the Leucadia bull case.

KP: This is a company Steve has followed for a long time that went through a major change in 2013 when it bought out investment bank Jefferies Group – in which it had long held a stake – and Jefferies' CEO Richard Handler became CEO of Leucadia. Jefferies is now the largest business, but the company also owns large stakes in a number of other financial and operating businesses, including National Beef Packing, the fourth-largest beef processor in the U.S., HomeFed Corp., a real estate developer, and Berkadia, a 50/50 joint venture with Berkshire Hathaway that offers commercial-mortgage financing.

Leucadia is run as a holding company, regularly buying and selling businesses and assets in order to realize value for shareholders. It had been raising cash by refinancing debt at lower rates as well as divesting certain assets in order to position itself to take advantage of better future investment opportunities. The divestments lowered operating profits, which was exacerbated by weak performance at National Beef and certain energy-related investments, causing the stock to fall into our buy range in the latter part of last year.

Has there been any change in strategy since new management took over?

KP: The culture at Leucadia has always been to make opportunistic investments, quickly if necessary, and that has very much continued. Two of the biggest investments since the management change have been in currency brokerage FXCM, when it was under threat of insolvency after the Swiss National Bank removed the cap on the Swiss franc earlier this year, and in additional shares of Harbinger Group, an investment holding company that had a cloud over it because of its connection

INVESTMENT SNAPSHOT

Leucadia
(NYSE: LUK)

Business: Holding company with large positions that include investment bank Jefferies, beef processor National Beef and commercial mortgage lender Berkadia.

Share Information
(@5/29/15):

Price	**24.63**
52-Week Range	20.96 – 26.78
Dividend Yield	1.0%
Market Cap	$9.03 billion

Financials (TTM):

Revenue	$12.57 billion
Operating Profit Margin	13.6%
Net Profit Margin	3.9%

Valuation Metrics
(@5/29/15):

	LUK	S&P 500
P/E (TTM)	19.3	21.5
Forward P/E (Est.)	n/a	18.2

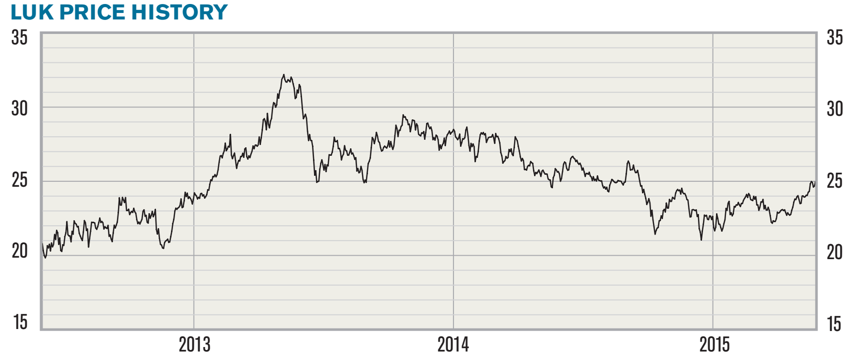
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Vanguard Group	6.7%
Fairholme Capital	3.8%
State Street	3.7%
BlackRock	3.6%
Capital Research & Mgmt	2.7%

Short Interest (as of 5/15/15):

Shares Short/Float	1.8%

LUK PRICE HISTORY



THE BOTTOM LINE

While its performance has been impacted by cyclical weaknesses in certain holdings and the fact that it has divested assets to raise cash for future investments, Kari Pemberton believes the market is mispricing both the current assets and management's ability to compound their growth. Her estimate of intrinsic share value is 40% above today's price.

Sources: Company reports, other publicly available information

to Philip Falcone, the former hedge-fund manager who got in trouble with the SEC. The January FXCM deal consisted of a $300 million loan that came along with ownership rights. In its latest financials, Leucadia valued those two FXCM pieces at almost $950 million.

The key here was getting comfortable that the company under new management could prosper as it had under Ian Cumming and Joseph Steinberg, who had run it since 1978. While their record wasn't as long, Rich Handler and his #2, Brian Friedman, had an equally impressive run at Jefferies, producing a 22% annual return for shareholders during their 22-year tenure. We also liked that they took the vast majority of their compensation in stock, which they only sold if they had to fund a tax obligation or if they made a charitable gift. We probably won't take as large a position as we can until we have even more experience with the new team, but so far we're quite comfortable they are acting in our best interest.

With Leucadia shares at a recent $24.60, how are you looking at valuation?

KP: One operating positive we expect is for results at National Beef to improve. Drought conditions in the southwestern U.S. have limited supply to its plants, but that seems to be easing, putting downward pressure on beef prices that should result in more business for beef processors. We wouldn't be surprised if in the next up cycle management took the opportunity to sell this asset.

For the overall company, coming at it through a sum of the parts or a traditional discounted-cash-flow analysis, our estimate of intrinsic value today is in the mid-$30s. With book value currently right around today's share price, we think the risk/reward is very much in our favor.

Are you somewhat playing the cycle in home-builder M.D.C. Holdings [MDC]?

SL: Home building isn't generally a high-return business. It's competitive and it's cyclical. But it is an industry I know fairly well and having lived in Denver, where MDC is based, I also got to know quite a bit about the people who run the company and how it's managed. It's in markets with good long-term potential, and it navigated better than most of its competitors through the housing slump because management had taken its foot off the pedal somewhat as markets were overheating. They missed some of the upside, but they were better protected from the downside.

They also haven't been as aggressive as many of their competitors in buying home sites over the last few years. That's hurt margins because of the lack of inventory, but we appreciate management's cautious nature. Now that demand is slowly increasing, MDC with its very strong balance sheet has increased its lot supply and is once again growing its community counts. As single-family housing starts eventually return to historical norms, we believe there is plenty of runway for MDC to increase sales, margins and profits.

Is there a risk housing starts don't return to historical norms?

SL: The housing market has been slow to come back. A deep cycle down often

INVESTMENT SNAPSHOT

M.D.C. Holdings
(NYSE: MDC)

Business: Provider of home building and financing services targeting first-time and first-time move-up buyers primarily in the Western, Southern and Middle-Atlantic U.S.

Share Information
(@5/29/15):

Price	**27.96**
52-Week Range	23.67 – 30.86
Dividend Yield	3.6%
Market Cap	$1.37 billion

Financials (TTM):

Revenue	$1.76 billion
Operating Profit Margin	5.6%
Net Profit Margin	3.4%

Valuation Metrics
(@5/29/15):

	MDC	Russell 2000
P/E (TTM)	22.7	80.3
Forward P/E (Est.)	16.4	19.1

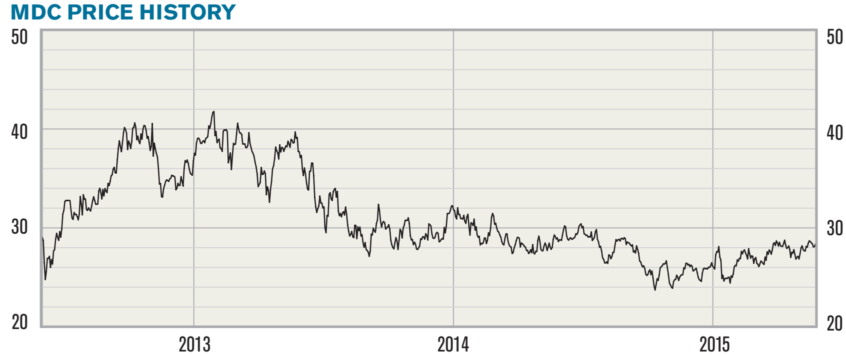
Largest Institutional Owners
(@3/31/15):

Company	% Owned
BlackRock	9.1%
TCW Asset Mgmt	8.1%
Dimensional Fund Adv	7.5%
State Street	7.5%
Heartland Advisors	5.9%

Short Interest (as of 5/15/15):

Shares Short/Float	18.0%

MDC PRICE HISTORY



THE BOTTOM LINE

Steve Leonard believes the company will prosper if the sustainable number of homes built and consumed in the U.S. returns to even one million units per year. At 12x his $3 EPS estimate at that housing-start level, the shares would trade at $36. The upside should be much higher if his estimate on starts proves as conservative as he expects.

Sources: Company reports, other publicly available information

means it takes longer for the cycle to turn back up. But just looking at basic demographics you can arrive at a sustainable average number of homes that should be built and consumed in the U.S., which we believe is at least one million units a year. That's not close to the crazy years – housing starts averaged nearly twice that from 2004 to 2006 – but we think there's plenty of demand for more houses to be built and sold by the MDC's of the world in the next few years than there has been in the last few years.

Longer-term what will be particularly important to watch is what happens with the so-called millennials, or baby-boomers' kids. They've so far been driving the re-urbanization of many cities, living in small apartments where they don't spend more than nine hours a day, mostly just sleeping and washing. They often don't have kids, pets or even a car. The biggest number of millennials are in their mid-20s, but what happens when they turn 30 and start getting married and having kids? Some people believe they'll stay put, maybe move to a bigger apartment nearby. I don't know, but I think there's a good chance they start looking for a single-family home further out from the city. This isn't a factor in why we own MDC today, but if that happens, it would be well positioned to benefit.

What upside do you see in MDC's shares, now trading at around $28?

SL: There's a bit less capital and competition in home building today, so if demand moderately improves and MDC gets its share, we'd expect its margins to improve as well. Without a boom or a bust, then, we think it can easily earn $3 per share. At a modest 12x multiple, that would result in a share price in the mid-$30s. If housing starts due to pent-up demand happen to go materially higher than one million units overall – which would not at all surprise us – there should be plenty of upside from there to both earnings and the stock price.

In terms of downside, book value today is just over $25 per share and we see no reason to believe that's not a solid number. Given our trust in management and belief that they're just less likely to make mistakes, if the share price went below book value, we'd very likely be adding to our position.

CNA Financial [CNA] has a much lower profile than your other insurance-related holdings. Why do you consider it to be mispriced?

SL: CNA is one of the larger direct property and casualty insurers in the U.S., 90%-owned by Loews Corp. It ran into trouble during the financial crisis because of severe declines in the value of its alternative-investment portfolio, but under a new CEO who took over in 2008 the company has done a very good job of repairing its balance sheet, improving underwriting, and getting out of businesses in which it wasn't competitive, including annuities and long-term care.

We would not make the case that the company is a better-than-average underwriter. On the investment side, which is handled by Loews, we'd also say they do an OK job, but nothing special like Warren Buffett at Berkshire or Prem Watsa at

INVESTMENT SNAPSHOT

CNA Financial
(NYSE: CNA)

Business: Commercial property and casualty insurance, primarily in the United States; majority owned by diversified investment holding company Loews Corp.

Share Information
(@5/29/15):

Price	**38.66**
52-Week Range	35.68 – 43.65
Dividend Yield	2.6%
Market Cap	$10.45 billion

Financials (TTM):

Revenue	$9.58 billion
Operating Profit Margin	13.7%
Net Profit Margin	9.5%

Valuation Metrics
(@5/29/15):

	CNA	S&P 500
P/E (TTM)	11.5	21.5
Forward P/E (Est.)	11.1	18.2

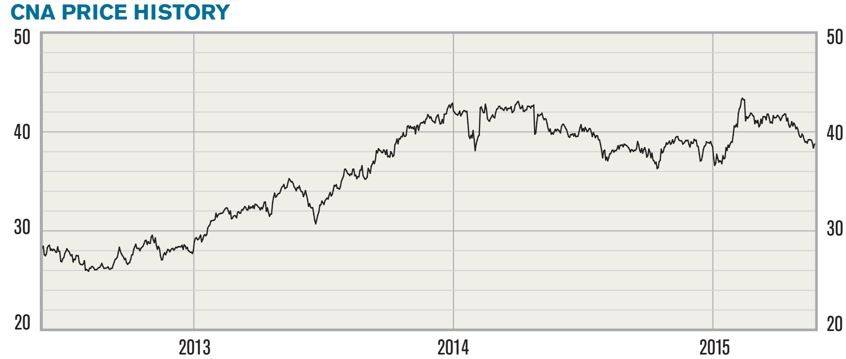
Largest Institutional Owners
(@3/31/15):

Company	% Owned
Loews Corp	89.7%
T. Rowe Price	2.3%
Donald Smith & Co.	0.8%
BlackRock	0.6%
Kiltearn Partners	0.6%

Short Interest (as of 5/15/15):

Shares Short/Float	0.2%

CNA PRICE HISTORY



THE BOTTOM LINE

While he doesn't consider the company better than average as an underwriter or an investor, Steve Leonard believes that if Loews Corp. didn't own a 90% stake in it – which "doesn't really make sense," he says – its stock would be priced at a 10-20% premium to book value. On today's book value that would result in a low- to mid-$50s share price.

Sources: Company reports, other publicly available information

Fairfax. The story for us here really comes down to valuation. CNA's share price had historically followed changes in its book value, but since the financial crisis it's been stuck well below that level. [*Note*: CNA shares currently trade at just under $39. The company's book value as of March 31 was $47.39.]

Is that discount primarily due to the lack of maneuverability given the size of Loews' ownership stake?

SL: That would be the most obvious reason, but we don't consider that a permanent issue. It doesn't really make sense for Loews to continue to own 90% of CNA – they should either buy it all or sell it all. In either event, we'd expect that to happen at least at a 10-20% premium to book value. That would put the share price in the low to mid-$50s.

In the meantime, the company has more capital than it needs, so over the last two years in addition to paying a regular annual dividend – now $1 per share – it has paid out special dividends as well. Last year it was an additional $1 per share and early this year it was another $2 per share. That's not a bad return from dividends on a $40 stock. They may not continue to pay special dividends at those levels, but they have the cash flow to do so.

This to us is a little like buying a piece of commercial real estate. Once you fix it up it's only worth so much, because if the price goes up higher than what it costs to duplicate it, somebody will just build a new one rather than pay that price. That said, we believe the limit on what this is worth is in excess of book value. If we're right, this may not be a multi-year home-run, but it should turn out perfectly well for us.

You run a separate hedge fund that takes short positions. Given your views on the overall market, where are you most active today on the short side?

KP: The main theme we've found for shorts is almost anything related to cloud computing, where we find values totally out of whack. The stocks trade on revenue increases, even though profits often don't scale up alongside the revenue. We're just not convinced that most of these businesses can ever earn a good return on the investments they're making. People talk about operating leverage as the businesses grow, but we're not seeing much.

We also think it's ridiculous the amount of stock these companies give out as compensation, while arguing all along that investors shouldn't include that in assessing performance when, in fact, it's clearly a real cost of doing business. Steve also alluded earlier to the types of managers we try to avoid, who make grand pronouncements and are dismissive of any tough questions. There's a lot of that here.

ON CLOUD COMPUTING:

This area is not unlike other bubble-type situations we've seen in the past, around the Internet, telecom, housing.

Given our general view on the space, we're short one ETF, SKYY [First Trust ISE Cloud Computing Index Fund], as well as Salesforce.com [CRM] and ServiceNow [NOW]. In addition to exhibiting all the other what we consider unsustainable characteristics of players in the industry, ServiceNow is being sued by Hewlett-Packard and other large competitors for patent infringement. It's still in the courts and may take a long time to play out, but it's something we're watching closely.

How big do you consider the risk of takeovers here, as has been rumored with Salesforce.com?

SL: We actually thought going in that one advantage of shorting one of the bigger players was that not only did it have terrible earnings numbers, but it was also so big and overpriced that nobody would be foolish enough to try to take it over. We still believe that, but we'll see.

This area to us is not unlike other bubble-type situations we've seen in the past, around the Internet, telecom and housing. Cloud computing is very easy to oversupply and everyone from the pure plays to the big boys like Amazon, IBM and Microsoft are trying to stake out their claims. These things always goes on longer than you think, but we can't imagine how there's not going to be a giant shakeout in this industry.

Another company on the outside edge of the cloud-computing phenomenon that we're short is Netflix [NFLX]. While it was first and has done a great job of creating a market, we don't believe Wall Street is anticipating correctly the competition that is coming in delivering entertainment to whatever device people want. It seems like every day somebody new is entering the category with content supply, which can't help but force Netflix to make bigger and bigger investments to keep its relative position.

The market's convinced that operating leverage is going to kick in and the company will make all this money, so the stock price goes up even though profitability is going down and the company is pushing more and more of its very large content investments off the balance sheet, currently to the tune of over $12 billion. Again, we expect there to be a giant shakeout in this industry as well – only so many people can watch entertainment so many hours a day on so many devices.

Holding a lot of cash has hurt your relative performance in recent years. Is that uncomfortable?

SL: It's never easy and certainly we hear from clients when performance lags. Most people need more immediate gratification than value investing typically offers up. We just say we're not going to do with your money what we wouldn't do with our own, and we think that there's too much risk right now to be aggressive. Over the long term the way to build wealth is to make fewer and smaller mistakes. That means to us not being aggressive after six years of a bull market. VII