Value Investor INSIGHT

The Leading Authority on Value Investing

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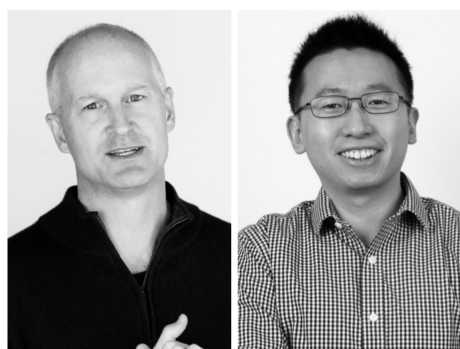
In Transition

Vinson Walden and Jong Lim of City Different Investments explain why "paths to success" can be more important than business quality in sourcing new ideas, where they're finding opportunity related to the global energy transition, why their portfolio has become more concentrated, and why they think Golar LNG, Valaris and Despegar.com are mispriced.

INVESTOR INSIGHT



City Different Investments
Vinson Walden (l), Jong Lim (r)

As the manager of City Different Investments' Global Equity strategy, Vinson Walden gravitates toward companies or industries under stress or in transition. "Where uncertainty is higher," he says, "so is the possibility that the conventional wisdom incorporated in a company's share price isn't accurately reflecting fundamental reality."

By deftly navigating uncertainty, the Thornburg Global Opportunities Fund Walden co-managed from 2006 to 2019 beat the MSCI ACWI index by 315 basis points per year, while his City Different strategy since January 2022 has earned a net annualized 14.8%, vs. 5.3% for the same benchmark. He's finding mispriced value today in such areas as online travel, offshore drilling and liquefied natural gas.

You've said you're putting more emphasis on seeing "paths to success" in your investments. Describe what that means and why you consider it so important.

Vinson Walden: The building blocks of our approach haven't changed over the past 20 years. Of course we're interested in quality companies. Of course we're interested in valuation. But investing is a competitive exercise and if everyone is looking for quality, that becomes a potential problem when the market has a tendency to overpay for it. I won't contest that high-growth technology and Internet business models produce some of the best equity outcomes, but it's not so simple as to say Amazon and Microsoft have done so well so why buy anything else. There's enormous survivorship bias in the data – yes, the big names have turned out awesome, but how about all the other companies that were competing with them, tried to become them, and failed? Buy and hold wouldn't have worked well in those cases.

What's important to us are companies or industries in transition where we see those paths to success. You can call them inflection points or catalysts, but we want to see clear reasons why an undervalued asset can revalue upward. The companies may not grow particularly fast or have the highest returns on capital, but they're solid businesses with staying power. If you understand the changes under way and their potential impact, our experience suggests you can improve your odds of a positive investment outcome.

Your largest holding, Talen Energy [TLN], would seem to be a good example where you've identified positive transition both at the company and in its industry.

VW: When we started looking at Talen there was a lot to recommend it at the micro level. It's a regional power producer with most of its plants in the Northeast and had come out of bankruptcy in 2023 with a sound balance sheet, a streamlined cost structure and a plan to consolidate its assets around its natural gas-fired plants and its crown-jewel nuclear plant in Pennsylvania. At a macro level, we believe electricity is now a growth sector, driven by the increasing penetration of electric vehicles and the rise of artificial intelligence, which is very energy intensive. We expect nuclear to be an important, clean energy source necessary to meet higher demand.

We saw many paths to success. One was increasing profitability from a streamlined business operating good assets in a growing sector. Talen also built a 960-megawatt data center next to its Pennsylvania plant, which in March it sold to Amazon for $650 million, with a contract to supply the plant with power. With the balance sheet fixed, they're buying back shares. The stock uplisted to Nasdaq, and from no sell-side coverage it now has many analysts following it. All these have been catalysts for revaluation and while we've taken some profits, this remains one of our highest-conviction ideas. [*Note*: Talen shares at a recent $216 trade at 11.5x trailing earnings.]

Your enthusiasm for MercadoLibre [MELI], Latin America's closest analog to Amazon, would indicate you're not averse to high-growth technology companies.

VW: If we can buy them right we're not averse to exceptional businesses. MELI started 25 years ago as an online marketplace and today is the leading e-commerce and fintech company across Latin America, with their biggest presence in Brazil and Mexico. The consumer value proposition is quite clear. The last time I was in Sao Paolo I used MELI to buy a backpack, headphones and a pair of shoes. All three were delivered to my door in one of the most congested cities in the world in less than 24 hours, saving me a lot of money and a lot of time – a real no brainer.

The shares were under pressure in 2022 – off by two-thirds from their highs in 2021 – due to the post-pandemic hangover that hit e-commerce companies. The term "flywheel" may be overused today, but we think it applies here to the company's business. In markets where e-commerce is underpenetrated and can grow at least 10% per year for many years, MELI consistently broadens its product selection, offers a wider range of services, gets better at logistics, and keeps prices low to attract and retain customers and consistently gain market share. Returns on capital are very high and we expect margins to march upward over time. We generally want to believe our holdings can generate at least a 15% IRR over the next three to five years, and despite the share-price increase since we bought it that is still the case here. [*Note*: At a recent $2,100, MELI shares have returned to their 2021 highs.]

Can you generalize about what tends to be going on at companies or in their industries that makes them attractively priced?

VW: It can be related to an industry cycle. Europe's air travel market was weak this summer, for example, which led to poor results at discount carrier Ryanair [Dublin: RYA] and a sharp decline in its share price. That got our attention because we believe the company is competitively advantaged and will continue to take share in a consolidating industry with solid growth over time. Operating margins are lower right now, but have been over 20% and we think earnings power is at least €2 per share. The stock on that number at today's price [of around €18.35] is at just over 9x earnings. For a growing, high-quality business that's quite attractive.

One broad area of interest for us today revolves around the global energy transition. There are structural changes underway in how energy and power are produced and consumed and we think markets are being reshaped in ways that will work to the advantage of certain companies involved in areas such as nuclear power, natural gas and offshore oil services. Given the uncertainty around all that, we're finding opportunities where we think the future potential isn't appropriately incorporated into share prices.

ON IDENTIFYING NEW IDEAS:

What's important to us are companies or industries in transition where we can see clear paths to success.

Describe why Golar LNG [GLNG], which we've spoken about before [*VII*, May 31, 2022], fits that bill.

VW: Golar's main assets are two Floating Liquefied Natural Gas (FLNG) facilities that enable offshore production, liquefaction and storage of natural gas for transport to customers worldwide. These assets cost roughly $2 billion each to build and allow for gas to make its way from remote areas where the resource is plentiful to populated areas where gas is scarce.

Central to the case here is our belief that natural gas will play an important role as a cleaner energy source in the energy transition. Combustion of natural gas emits half as much carbon dioxide as coal and 30% less than oil. Global LNG demand is expected to grow 5% per year between now and 2030, driven by demand from high-growth Asian economies and also Europe, which wants to reduce its dependence on piped Russian gas while also transitioning to a lower carbon footprint.

We first invested in Golar's stock in January of 2022 at around $11 and the business has continued to develop in a number of ways that should enhance its valuation. The first FLNG vessel, called Hilli, is now operating off the coast of Cameroon at only 60% of capacity, but will redeploy in 2027 at close to 100% of capacity off the coast of Argentina. That shift could boost Golar's EBITDA by $100 million per year. We also think it's positive that the current primary client of Hilli, the Anglo-French energy group Perenco, in June bought a 10% stake in Golar on the open market.

Jong Lim: The second vessel, Gimi, has 10-15% more capacity than Hilli and was delivered last month from its Singapore shipyard to begin service off the coast of Africa under a 20-year contract with BP. The deployment was a year late, but the facility will be fully operational and generating significant revenue and EBITDA over the next couple of quarters.

The other big news since we established our position is that Golar has greenlighted another even bigger FLNG, called "Mark II," on which it's already spent $400 million in development. Management is in advanced contract negotiations for it, with deployment expected by the end of 2027. This would increase the company's liquefaction capacity by roughly 70%, with a commensurate impact on earnings power.

I'd also mention that with the new contract for Hilli and the deployment of Gimi, each of those should be refinanced at a lower cost of debt. That would reduce annual interest costs and unlock capital to be put to more productive use.

Is anyone else building FLNGs?

VW: It's a favorable sign that since we last spoke Golar is still the only proven, at-scale player that can provide "Liquefaction-as-a-Service" to major E&Ps. We think that speaks to their expertise in taking on these massive, technically complex projects. They've proven out the value proposition and it appears the moat may be even wider than we expected.

INVESTMENT SNAPSHOT

Golar LNG
(Nasdaq: GLNG)

Business: Designs, owns and operates marine infrastructure for the liquefaction of natural gas and the regasification, storage and offloading of liquefied natural gas (LNG).

Share Information (@11/26/24):

Price	**39.51**
52-Week Range	19.94 – 41.54
Dividend Yield	2.4%
Market Cap	$4.12 billion

Financials (TTM):

Revenue	$274.1 million
Operating Profit Margin	10.4%
Net Profit Margin	4.9%

Valuation Metrics
(@11/26/24):

	GLNG	S&P 500
P/E (TTM)	52.2	24.7
Forward P/E (Est.)	27.9	23.4

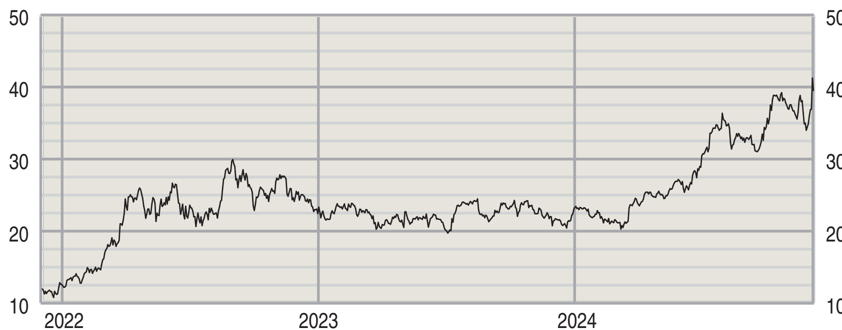
Largest Institutional Owners
(@9/30/24 or latest filing):

Company	% Owned
BlackRock	5.4%
Cobas Asset Mgmt	4.9%
Morgan Stanley	3.5%
Donald Smith & Co	3.1%
Millennium Mgmt	3.0%

Short Interest (as of 11/15/24):

Shares Short/Float	2.5%

GLNG PRICE HISTORY



THE BOTTOM LINE

Vinson Walden expects the company to benefit from natural gas playing a more important role in the global energy transition and from the planned redeployment and expansion of its fleet of Floating Liquefied Natural Gas (FLNG) facilities. At 10x EBITDA on an enterprise-value basis, the stock based on his 2028 estimates would trade at around $75.

Sources: S&P Capital IQ, company reports, other publicly available information

How are you looking at upside for the stock from today's price of just under $40?

JL: We're comfortable with management's guidance that by 2028 Gimi and Hilli combined can earn close to $515 million in adjusted EBITDA, before commodity exposure. For Mark II, they're aiming for $500 million in annual EBITDA. You should always put an asterisk on the timing, but we believe by the end of 2028 the run-rate annual EBITDA will be around $1 billion from these three assets. At what we would consider a fair 10x EV/EBITDA multiple, assuming $2 billion or so of debt and the current shares outstanding of nearly 105 million, that would translate into a share price of at least $75.

VW: Golar could be a Cinderella story. The field in Argentina where Hilli will be deployed is enormous and could support multiple Hillis in coming years. We don't think Golar stops at three of these vessels.

Why are you high on the prospects for energy-services company Valaris [VAL]?

VW: Everyone wants a stable climate, clean air and clean water. I would personally be delighted if fossil fuels were obsolete today. But in the real world there are tradeoffs, and we believe conventional sources of energy will remain essential to human life for some time. While we as a world shift oil demand and build out alternative energy sources, we're going to need fossil fuels, the more economically and environmentally produced the better.

Valaris is in the glamorous field of offshore oil drilling. While hardly a business with a wide moat or powerful network effects, offshore drillers have consolidated over the years so that there are now four global players: Valaris – which has the most rigs and the newest-technology drillships – Seadrill [SDRL], Transocean [RIG] and Noble [NE]. The major customers are those most active offshore such as Shell, Norway's Equinor and Petrobras in Brazil.

There are two headwinds impacting the shares, which trade around a two-year low. One is softness in the oil market, as prices per barrel have fallen into the high-$60s from the mid-$80s earlier this year, impacting drilling volumes. Specific to deepwater, there's been an airpocket in demand and contracting activity in 2024. That's a result of a number of factors in addition to weaker oil prices, including equipment shortages and regulatory-approval delays, but we believe the projects underway are deferred, not cancelled. These are complex projects costing billions of dollars that are years in preparation, and they are highly likely to happen because offshore oil reserves are plentiful and among the lowest cost to extract. The industry axiom is that 50% of offshore projects would be profitable even at $30-per-barrel oil, while 90% are profitable at the $70 or so oil of today. That's as good or better than U.S. shale, where the average breakeven oil price is in the low-$50s and all shale fields except the Permian are in decline. The maturation of U.S. shale is one factor boosting the level of activity offshore.

What are you assuming in your models for oil prices?

VW: To be conservative, we're assuming the current status quo for both oil prices

and day rates for drillships, which today are around $450,000 per day. As we assess supply and demand going forward – taking into consideration declining production from shale in the United States, the potential for supply disruptions in the Middle East, and increased capital discipline at the big oil companies – we could make the case for normalized oil prices well into the $80s or $90s. But we don't need to assume that to see attractive value in Valaris.

How attractive is that value at today's price of around $46?

JL: We think the catalysts here will be the backlog starting to turn up and new projects ramping and impacting the P&L. If we assume the oil prices and day rates Vin mentioned and that 9 of the company's 13 drillships are deployed, we arrive at a mid-cycle estimate of annual EBITDA around $1.3 billion. We think a reasonable mid-cycle EV/EBITDA multiple on that would be 5-6x, which translates into at least a $90 share price within the next two to three years.

VW: One of the largest shareholders here is the Norwegian shipping tycoon John Fredriksen, who owns a more than 8% stake. He's been buying shares on the open market as recently as last quarter. This is someone who understands cycles and takes a long-term view. We're happy to see his involvement.

Turning to another Latin American Internet platform, describe what's driving your enthusiasm for Despegar.com [DESP].

VW: I've followed the company since its 2017 IPO at $26 per share. Operating under several brand names, it's the leading online travel agency in Latin America, with a presence across the region but with Brazil, Mexico and Argentina – in that order – as the most important markets by a wide margin.

Despegar's early years as a public company were characterized by far too much competition in its markets, leading to low and unstable margins that sent the overvalued stock from a high of $30 to as low as $5 last year. We invested this year because we believe the business has hit an inflection point and has a long runway of profitable growth ahead.

One key catalyst is that the industry structure has improved, through growth in demand but especially due to consolidation of suppliers either through acquisition – Despegar bought a number of them – or companies going out of business. Despegar now has the #1 share in the region overall and has two primary competitors, Booking.com and the Brazilian company CVC Brasil. The changing industry dynamics have already bolstered the economics of the business and we expect Despegar's margins and returns on capital to continue to improve from here.

That's in the context of a lot of structural industry growth. Air travel and hotel stays are underpenetrated in Latin America but are growing at above-GDP rates, fueled by things like the increased prevalence of lower-cost airlines and the cultural trend toward Instagram-worthy experiences. There's an additional tailwind from the growth in online penetration of travel bookings in general. Roughly 50% of bookings are now done online in the

INVESTMENT SNAPSHOT

Valaris
(NYSE: VAL)

Business: Through a fleet of drillships, semi-submersibles and jackups, provides offshore drilling services to multinational energy exploration and development companies.

Share Information (@11/26/24):

Price	**46.00**
52-Week Range	45.97 – 84.20
Dividend Yield	0.0%
Market Cap	$3.27 billion

Financials (TTM):

Revenue	$2.26 billion
Operating Profit Margin	12.7%
Net Profit Margin	47.5%

Valuation Metrics
(@11/26/24):

	VAL	S&P 500
P/E (TTM)	3.1	24.7
Forward P/E (Est.)	8.7	23.4

Largest Institutional Owners
(@9/30/24 or latest filing):

Company	% Owned
BlackRock	10.9%
Vanguard Group	9.0%
Orbis Inv	7.3%
Fidelity Mgmt & Research	6.4%
Lingotto Inv	5.0%

Short Interest (as of 11/15/24):

Shares Short/Float	13.3%

VAL PRICE HISTORY

THE BOTTOM LINE

The company has the assets and technology to be a prime beneficiary of increased offshore energy exploration and development over time, says Vinson Walden. Assuming current oil prices and drillship day rates, he estimates mid-cycle annual EBITDA at $1.3 billion – a 5-6x EV/EBITDA multiple on that would result in a share price of at least $90.

Sources: S&P Capital IQ, company reports, other publicly available information

region, while in developed markets that's in the 70s or higher.

Despegar also continues to strengthen its ecosystem. They're improving the loyalty program, growing app downloads and investing in technology that improves the customer experience and saves costs. This is a business where AI is a legitimate plus, and the company says its AI "consultant" Sofia is having a positive impact already on improving closure rates and driving the top line.

The final catalyst is a bit of a wildcard, but we think Argentina has the potential to go from a long-time economic basket case to something much better than that under new President Javier Milei. It still looks bad now, but there are green shoots that may indicate the worst for the economy is in the rear-view mirror. That free option on Argentina is very appealing and is one of the things that led us to Despegar.

Are you comfortable with the corporate governance here?

VW: Damián Scokin was a top airline executive and a partner at McKinsey prior to becoming Despegar's CEO in 2017, and we think he runs it like the large shareholder he is. The reporting transparency is up to the standard of their New York Stock Exchange listing. We also like that Expedia still owns a more than 10% stake in the company, giving us further comfort in the oversight.

How are you looking at valuation from today's $18.15 share price?

VW: Our base case is that revenue can grow at a near double-digit rate for some time, with operating leverage bringing EBIT growth into the mid-teens. We estimate EBIT within two years could be $170 million, which at a 13x EV/EBIT multiple would translate into a share price of roughly twice today's level. The 13x multiple is based on peers and we think reasonable – that's about where Expedia trades, for example, which has significantly less growth potential.

The short interest, at over 13%, is a bit elevated. What would the bear case be?

VW: It's difficult to know for sure, but I imagine it would be a bearish call on Latin America, which has a history of challenges with respect to politics, inflation and interest rates. To us, the secular factors here are much more important than the macroeconomic ones. At this valuation we're comfortable in taking the macroeconomic risk.

You've narrowed over time the number of positions you typically hold. Why?

VW: We now target 20 to 30 names, down from 30 to 40 early on. I think that's been a natural evolution of sharpening the framework of what's a good idea and using more and better filters to eliminate ideas that don't qualify. I've learned, for example, to be more circumspect about balance sheets. The younger me was more apt to say hey, this isn't an investment-grade balance sheet but I'm an analyst and I'll figure it out. These days I sleep better at night without risky balance sheets.

Another example: I used to be more attracted to acquisitive companies, either rolling up an industry or making "bolt-

INVESTMENT SNAPSHOT

Despegar.com
(NYSE: DESP)

Business: Latin American online travel agency founded during the dot-com bubble and now operating in 19 countries, most importantly Brazil, Mexico and Argentina.

Share Information (@11/26/24):

Price	**18.14**
52-Week Range	7.83– 19.00
Dividend Yield	0.0%
Market Cap	$1.41 billion

Financials (TTM):

Revenue	$756.3 million
Operating Profit Margin	15.6%
Net Profit Margin	4.5%

Valuation Metrics
(@11/26/24):

	DESP	S&P 500
P/E (TTM)	n/a	24.7
Forward P/E (Est.)	14.7	23.4

Largest Institutional Owners
(@9/30/24 or latest filing):

Company	% Owned
Expedia Group	12.4%
L Catterton	10.3%
Neuberger Berman	7.1%
No Street GP	6.0%
BlackRock	4.5%

Short Interest (as of 11/15/24):

Shares Short/Float	13.5%

DESP PRICE HISTORY

THE BOTTOM LINE

The company is strengthening its position in an increasingly consolidated, secular-growth market, says Vinson Walden, providing it with a longer runway of profitable growth than the market seems to recognize. At what he considers a reasonable multiple of his operating-earnings estimate two years out, the shares would roughly double from their current level.

Sources: S&P Capital IQ, company reports, other publicly available information

on" acquisitions. I won't say I'd never invest in such a company, but I've found the strategy introduces significantly higher downside risk than I previously believed. As a result of these efforts to hone our process, I can eliminate more companies more quickly and can have more conviction in the ones that make it through.

Describe any ideas of late that haven't worked out and lessons learned as a result.

VW: Last quarter we exited an investment in Skyworks Solutions [SWKS], which manufactures radio-frequency chips. We first invested three years ago, attracted to its position in an industry that we thought had good tailwinds from the rollout of 5G wireless technology and the increasing development of Internet of Things applications. Given the sustainable uplift in revenues and profits we expected, the valuation at the time seemed compelling.

Quite a few forces conspired against us. The company is heavily reliant on Apple as a customer – accounting for close to 50% of revenues – and it lost some important iPhone business. The business in China was weaker than expected. The 5G and Internet of Things tailwinds weren't panning out. As the margin and EPS expectations came down, so did the share price. Without obvious paths to success, we sold the shares and moved on.

Another top-of-mind regret was raising money – eventually used to buy Talen Energy – by selling Meta Platforms in the fourth quarter of 2022. The shares had done very poorly and while I still had reasonable confidence in the long-term story, I used it to take the tax loss. In this case or with Skyworks I can't say there were big lessons to learn – more than anything they're reminders that we're human and that it's important to stay humble. VII