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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Buying Value-Stable Companies When the Time is Right

MCGAVOCK DUNBAR joined Vulcan Value Partners in 2010. Prior to joining Vulcan Value Partners, McGavock worked as an Associate in the investment banking department at Susquehanna International Group. McGavock earned his MBA from the University of Virginia Darden School of Business. He also has a Master of Education and Bachelor of Arts from the University of Virginia, with a double major in History and Religious Studies.

SECTOR — GENERAL INVESTING

TWST: Please introduce us to Vulcan Value Partners, how it's structured, and what your key products are.

Mr. Dunbar: Vulcan Value Partners was founded by C.T. Fitzpatrick in 2007 after he left Southeastern Asset Management in Memphis, where he served as a Portfolio Manager for 17 years. We opened to outside investors in 2010, and that's when I joined the firm. Today we manage over $14 billion across five strategies, with most of the capital in the Large Cap and the Small Cap strategy. The other strategies, All-Cap, Focus and Focus Plus, are a subset of the same names that are in Large Cap and Small Cap. The Large Cap strategy is in the top 1% of performance versus peers since inception, and the Small Cap strategy is in the top 2% of performance versus peers since inception. We are very proud to have delivered those long-term results to our clients.

One more thing that's worth mentioning, and that is somewhat unique to Vulcan, is that all employees are required to invest 100% of their public equity investments in Vulcan Value Partners vehicles. This aligns us with our clients, and we believe it is the right thing to do.

TWST: Tell us about your guiding strategy and related investment philosophy.

Mr. Dunbar: We have just one guiding strategy, and that is to identify really high-quality businesses that have inherently stable values, and then wait for an opportunity to buy them at a discount to intrinsic value. We are value investors, but we don't look for cheap stocks. Instead, we spend our time looking for good businesses with inherently stable values and follow them very closely. Then we wait for the market to give us the opportunity.

TWST: Beyond your strategy of buying value-stable companies when the time is right, what other factors have contributed to the strategy's topline performance?

Mr. Dunbar: A significant factor to our performance is to our long-term mindset. We filter each investment we make through a long-term lens, around five years for every investment. In the short term, stock prices can be volatile as they react to what we often consider "noise in the market." If you simply step back, however, and take a long-term view to the investments that you make, it can provide an exceptional opportunity to take advantage of that volatility. In addition to that, we feel very fortunate that we have had long-term-minded clients who have joined us as partners. Their long-term patient capital is what provides us with a competitive edge, and it is what allows us to take advantage of some of the short-term volatility in stock prices.

TWST: Given your long-term view, what, if any, are macroeconomic factors, areas of regulatory reform, or any other kinds of change that you might take into account?

Mr. Dunbar: Rather than take a macro position in the portfolio, we spend our time looking for great companies with the idea that they will remain strong in any environment. So while none of our companies are immune to the business cycle, we expect our companies to remain strong and produce very robust and stable free cash flow. That way, they are able to use that cash flow to their advantage and perhaps come out of a recession even stronger relative to their competitors.

Of course, we do pay attention to the macro environment. We spend about 10% of our time discussing the macro environment, which we ultimately incorporate into our valuation analysis of individual companies. I would say the current macro environment appears to be quite strong, but that is not to say that it couldn't change quickly. There are a lot of variables out there that could push the economy off course. Again, our job is to have already completed our homework on the businesses we would like to own at the right price, because then, even volatile macroeconomic events can present us with great opportunity.

TWST: Tell us about some of your best performers in both your large-cap value and small-cap strategies. Where are you finding value and seeing the best opportunity going forward?

Mr. Dunbar: One of our better-performing stocks in Large Cap is **Oracle Corporation** (NYSE:ORCL); it has contributed the most performance year to date. **Boeing** (NYSE:BA) is another one which we just exited this year, due to it reaching our estimate of intrinsic value. **MasterCard** (NYSE:MA) has been a long-term holding for us, and we've really benefited from the compounding of intrinsic value in that case.

In Small Cap, **Select Comfort**, now **Sleep Number** (NASDAQ:SNBR), has been our top contributor year-to-date. **Ituran Location and Control** (NASDAQ:ITRN) has been the next best performer for us, and then **ACI Worldwide** (NASDAQ:ACIW), which is a bank software company.

TWST: Are there any sectors where you have found the largest concentration of best-performing stocks?

Mr. Dunbar: Boeing is an interesting example because you have growing demand for a refresh in the aircraft market. We have allocated to **Boeing** a couple of times in our history. We added to it recently when we thought it was very much discounted to intrinsic value and that the market didn't recognize it as such. This year it has been one of our best performers, and in fact, I think **Boeing's** stock is probably one of the best performers in the S&P this year. So that's one example.

Going back a little farther, we have owned several hotel companies: **Hilton** (NYSE:HLT), **Marriott** (NASDAQ:MAR), **Starwood** and **InterContinental Hotels Group** (NYSE:IHG). We actually have owned all of these at one time, going back two or three years ago when we observed they were growing very quickly both in units and RevPAR, as demand for rooms was growing a lot more quickly than there was supply. Recently, the prices of these hotel companies have been increasing faster than their values. Now, due to the nature of our portfolio management process, we tend to be trimming or selling some of our best performers and reallocating that capital to sectors that may not have performed very well in the recent past.

So let's use **Boeing** as an example. As one of the best performers in the S&P, we sold that position when we thought it reached our estimate of intrinsic value, and we've been allocating that capital to more discounted names with a greater margin of safety. Some examples of those are in U.S. drug distribution industry, including **McKesson** (NYSE:MCK), **AmerisourceBergen** (NYSE:ABC) and **Cardinal Health** (NYSE:CAH). The stock prices for these companies have not performed well. However, we think they are very good companies and competitively entrenched with stable intrinsic values. So while we've been trimming from some of those good performers I pointed to, we've been allocating to other companies that in the recent past haven't been performing very well.

"If you simply step back, however, and take a long-term view to the investments that you make, it can provide an exceptional opportunity to take advantage of that volatility."

Highlights

McGavock Dunbar says his firm has one guiding strategy, and that is to identify high-quality businesses that have inherently stable values, and then wait for an opportunity to buy them at a discount. He says a significant factor to the firm's performance is its long-term mindset.
Companies include: Oracle Corporation (NYSE:ORCL); Boeing Co (NYSE:BA); Mastercard (NYSE:MA); Ituran Location and Control Ltd. (US) (NASDAQ:ITRN); ACI Worldwide (NASDAQ:ACIW); Hilton Worldwide Holdings (NYSE:HLT); Marriott International (NASDAQ:MAR); InterContinental Hotels Group PLC (ADR) (NYSE:IHG); McKesson Corporation (NYSE:MCK); AmerisourceBergen Corp. (NYSE:ABC); Cardinal Health (NYSE:CAH); Amazon.com (NASDAQ:AMZN); Fossil Group (NASDAQ:FOSL); Michael Kors Holdings Ltd (NYSE:KORS) and Sleep Number Corp (NASDAQ:SNBR).

TWST: What do you see driving performance in the health care distribution industry? Give us a closer look at your investment thesis for some of the stocks you like.

Mr. Dunbar: The large pharmaceutical distributors, **McKesson**, **AmerisourceBergen** and **Cardinal Health**, together have close to 85% market share, creating an oligopoly. The moat surrounding the industry is very strong, and there are high barriers to entry. One such potential entrant, however, may be **Amazon** (NASDAQ:AMZN). We recognize they could enter the industry, but with the razor-thin operating margins, high regulatory scrutiny, and immense scale needed to profitably deliver drugs from all manufacturers to retail locations, we feel they may very well have lower-hanging fruit to pick. We also feel we have valued these companies appropriately if **Amazon** does enter the space.

Over the previous five years, these health care distributors were growing quite quickly in the double-digit range. More recently, because of some headwinds and the pricing of generic drugs, growth has slowed for these companies. We believe, however, that these businesses have very stable values and that they will continue to grow, despite recent challenges. Some of the tailwinds include aging demographics, the growing demand of pharmaceuticals, and that there is probably not going to be a decline in the need to transport these pharmaceuticals from manufacturers to pharmacies. So we feel very good about those positions over the long term.

TWST: On the opposing view, where are you cautious now? Where might you have cut back, and what are your worries?

Mr. Dunbar: We've never owned a commercial bank, utility or airline. We don't like mining stocks and overall try to avoid commodity-oriented companies. Basically we tend to shy away from any company that can't control its own destiny.

TWST: Have any companies in your portfolios disappointed over the recent past? And why did they fall short?

Mr. Dunbar: One company that was a mistake in the portfolio was **Fossil** (NASDAQ:FOSL), the watch company. We believed that **Fossil** had the tools to navigate a transition to technology-enabled watches, and coupled with their portfolio brands, including **Michael Kors** (NYSE:KORS) and **Tory Burch**, it would continue to grow. We thought that with the portfolio brands and the tools they had, that would allow them to make the transition to a world where people are demanding technology and connectivity in their watches.

That may still be the case, but in the meantime, the company made an acquisition and really stretched their balance sheet. After the acquisition, the weakened balance sheet made us concerned that the company would not have a stable value. When a company doesn't present a stable value, it does not qualify for investment by us. So we sold the position this year. It was a mistake, and we have learned from it. But that has been a drag on our performance over the past couple of years.

1-Year Daily Chart of Oracle Corporation

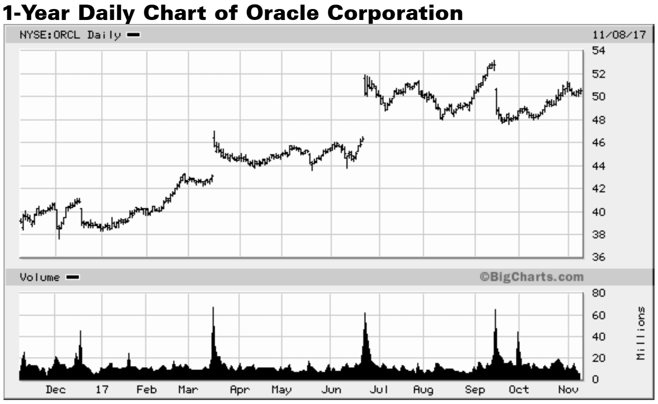

Chart provided by www.BigCharts.com

TWST: What are some of the metrics you focus on in your sell discipline?

Mr. Dunbar: We will sell for three reasons. First, the company is potentially a mistake if its value stagnates or declines. When we make a mistake, our default is to sell regardless of price. Second, if a company reaches fair value, we will sell. We are value investors and don't want to hold anything over fair value. And then lastly, we will either trim or sell in order to redeploy that capital into more discounted names.

We are constantly trying to minimize the weighted average price-to-value ratio of the portfolio. We are often trimming names with higher price to values and redeploying that capital into companies with lower price to values, all while maintaining a very high-quality bar.

TWST: Tell us about your typical investors. Who do you best serve?

Mr. Dunbar: We have a combination of endowments, foundations, corporations and high net worth individuals. It is a diverse mixture. I would say that we're very institutionally focused.

TWST: To conclude, can you share your best advice to investors who would like to participate in the current market? And, is there anything else you would like investors to know about Vulcan?

Mr. Dunbar: My best advice would be to think long term and look for companies that will be strong over the long term. That's what we try to do. It is also worth mentioning that Vulcan is closed to new investors, though current clients can add capital. We do have a wait-list process, and we evaluate it once a year based on net flows, liquidity and general valuation levels in the market.

TWST: Thank you. (VSB)

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Note 1 Source: Vulcan Value Partners Large Cap Composite versus peer group of the eVestment US Large Cap Value Equity Universe. Vulcan Value Partners Small Cap Composite versus peer group of the eVestment US Small Cap Value Equity Universe. Information provided is supplemental information for the Large Cap Composite, Focus Composite, Focus Plus Composite, and Small Cap Composite for period ending September 30, 2017 as of October 18, 2017.

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Vulcan Value Partners buys concentrated positions for our portfolios, averaging 5% in our model portfolios, which may make our performance more volatile than that of our benchmark indices and our performance may diverge from an index, positively or negatively, as a result. Our focus is on long term capital appreciation, so our clients should consider at least a five year time horizon for an investment with Vulcan. **Past performance is no guarantee of future results and we may not achieve our return goal.**

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