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Value Investor INSIGHT

The Leading Authority on Value Investing

Driving a Hard Bargain

Value investors expect to win by doing fine when times are good and better than fine when times are bad. That formula is working for Azvalor Asset Management.

In reflecting on his funds' dramatic outperformance in a rocky 2022 for equity markets, Álvaro Guzmán highlights a simple verity of Azvalor Asset Management's investment approach: "We have a high minimum standard for business and management quality, but I would say the backbone of our philosophy has always rested on buying cheap. That's what really matters."

That has been a sound base principle so far: Since Guzmán and co-CIO Fernando Bernad left famed European value manager Bestinver in 2015 to launch Azvalor, their flagship International portfolio has earned a net annualized 11.2%, vs. 9.3% for the MSCI World Index (in Euro). With many cheap stocks still out there, they see particular upside today in such areas as coal, hardwood pulp, diamonds and plasma-derived medicines. See page 2

INVESTOR INSIGHT

Azvalor Asset Management
Álvaro Guzmán *(l)*, Fernando Bernad *(r)*

Investment Focus: Seek significantly undervalued companies whose current difficulties are expected to be more transitory than the market seems prepared to believe.

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Investor Insight: Azvalor

Álvaro Guzmán and Fernando Bernad of Azvalor Asset Management describe the market tendency they believe regularly creates opportunity, how they gain conviction to go where other investors fear to tread, the industry sectors they consider particularly interesting today, and why they see mispriced value in Suzano, Petra Diamonds, Grifols and Arch Resources.

Álvaro, you've pegged your initial interest in investing to when you were seven years old. Describe how that came about.

Álvaro Guzmán: My father when I was seven gave me an introductory book on thoroughbred handicapping and we almost every Sunday went to the races. It's really quite a good way to learn about probability and risk and reward. I learned early on what went into the odds and noticed that very often it had a lot to do with how the horse did in its last race. But maybe the conditions of that last race with respect to weather or the condition of the course weren't relevant to today and a broader look at the horse's record might lead you to believe the odds were misguided. I naturally gravitated to horses with odds of winning I thought were wrong for reasons I could understand. They were undervalued in much the same way the stocks I came to look for are undervalued. With a stock the consensus "odds" are built into the share price and we think they're too pessimistic for reasons we believe we understand.

Generalize about what some of those reasons tend to be.

AG: Every value investor wants to buy wonderful businesses at bargain prices, but that only happens when there are problems. The market always does the same thing, extrapolating recent events in a linear fashion. Sometimes that makes sense, but how things play out in the real world is mostly non-linear.

So bargains can arise when equity markets overall are out of favor, when a particular geographic area is out of favor, or when a particular industry is out of favor. Then, of course, companies all the time are facing specific problems, many times of their own making. In all of these cases for us to want to take advantage of a bargain price we have to have a view on whatever is clouding the short-term prospects for the company that differs from what the market seems to think.

It's probably helpful here to talk about specific examples. This isn't for all value investors, but we often find opportunity in out-of-favor cyclical companies. Consol Energy [CEIX], the thermal coal producer, is a company we discussed in your pages five years ago [*VII*, September 30, 2018] when the stock traded at just over $40 per share. We thought it was very well managed and that its high-quality coal and ability to offset challenges to U.S. demand with foreign sales made it much more valuable than the market – which hated anything to do with thermal coal – was prepared to believe.

ON BARGAIN PRICES:

Our view on whatever is clouding the short-term prospects has to differ from what the market seems to think.

We appeared to be wrong about that for some time, and ultimately accumulated a 15% stake in the company buying on the way down to a share price that eventually fell below $4. After bottoming in the immediate aftermath of the pandemic, the thesis finally started to play out and the stock since has risen to a current price of almost $86. Consol's market value at the lows was around $100 million, for a company we believed in a normalized environment could earn $250 million in annual free cash flow. We'd obviously prefer to avoid downdrafts like this, but it's a good example of something that interests us and shows how important sticking with your conviction when you still have it can be.

We also find opportunity when there's an industry issue of some kind. You wrote about this not long ago [*VII*, November 30, 2022], but a good example would be Ashmore Group [London: ASHM], which is an investment manager specializing in fixed income in emerging markets. Emerging-market investing has been significantly out of favor for some time, but we don't believe there are fundamental reasons that will be a permanent condition. Given that, here's a company with a CEO, Mark Coombs, who founded Ashmore 25 years ago and has successfully built it into a market leader today. They have a disciplined investment process without star managers and we think there's a positive culture focused on investing excellence and building shareholder value over time. The balance sheet should have something on the order of £700 million in net cash by the end of this year, on a market cap today of £1.3 billion.

That's the company side of things, which highlights the types of things we care most about. In terms of valuation, even in a not-great environment Ashmore earns roughly £100 million in annual net income. After netting out cash, at today's share price [of just under £2] you're buying the company at only around 6x earnings. We think that's far below the 13-14x at which the operating business deserves to trade, and if we're right about emerging markets not always being out of favor, the company is likely to earn a lot more than £100 million per year. It's made almost twice that in the past. Good business, aligned owner, temporarily out of favor and trading at a cheap price – that's what we look for.

Would you say there are any particular geographical tilts to your portfolio today?

AG: There can be, and the general perception on a country can create bargains, but

I wouldn't say today we have any geographic biases of note. Generally we invest in global businesses that sell all over the world. We spend little time thinking about macroeconomics, beyond expecting long-term global growth to be fine, particularly in areas with growing populations and the continued emergence of the middle class. We expect our global businesses over time to benefit from that tailwind.

At the more local level, we will selectively invest when other investors consider a given country uninvestable. That has been the case in the fairly recent past in Argentina, where despite the truly bad political environment for many years we took a stake, though a small one, in Transportadora de Gas del Sur [NYSE ADR: TGS], which owns and operates much of the country's natural gas transportation infrastructure. It's a well-run, market-dominant company that provides a critical service and has a safe, simple business model. With the ADR trading at $4 to $5, we thought the market was extrapolating that the Peronist political disaster of the previous eight years was going to continue forever.

We didn't believe that would be the case, but even if nothing changed we thought the shares at the price then had little to no downside. If the management of the economy did happen to improve – and there were signs that would be the case – we thought we could make multiples on our money. Here fundamental improvement hasn't really happened yet, but just the change in perception that it might sent the stock much higher and we actually ended up selling most of our stake at more than twice what we paid.

A more recent example that is still playing out would be Eletrobras [NYSE ADR: EBR], Brazil's largest electric utility. It has a wonderful collection of assets, many of which are hydroelectric, but when Lula [Luiz Inacio Lula da Silva] recaptured the presidency last October the market fell broadly out of concern that he would mismanage the economy as he had in his previous presidency. Based on our assessment of the real risks facing a company like Eletrobras, as its shares continued to fall after the election we felt earlier this year that they were on sale at 50 cents on the dollar. The stock is up from its lows, but we still think is attractive at today's price [of around $7.50]. It's just a good illustration of how we're able at times to buy a wonderful business at an attractive price.

ON OIL AND GOLD:

We think the market misreads the supply/demand dynamics and therefore underestimates market-clearing prices.

There appear to be some sector tilts to your international portfolio today, namely around oil and gold. What's behind both of those?

AG: It's really very simple in both cases. We don't buy sectors, per se, but it can clearly happen that when we're looking for companies with strong balance sheets, great corporate cultures and great stewards of capital in charge – all at very cheap prices – that can generate a sectorial bias. The cheapness often has a macro basis, of course, which is the case with respect to both oil and gold. We think in each instance that the market is misreading the medium-term to long-term supply/demand dynamics and therefore underestimating the market-clearing prices of each commodity. So much so that even if we assume today's price levels for the underlying commodity, certain stocks in each sector seem remarkably cheap.

Canadian Natural Resources [CNG], the large oil and gas exploration and production company, pays a 4.2% dividend yield, has grown its dividend over the past 23 years at 20% per year, and we can buy the stock today – assuming only $75-per-barrel oil – at an 11% free cash flow yield. Barrick Gold [GOLD], the biggest global gold producer, has dramatically improved its balance sheet and its management – we believe Mark Bristow is the best CEO in the industry – but even assuming flat gold prices we think the stock on normalized earnings trades at a 17-18% free cash flow yield. In an environment where 10-year Treasuries yield 4.2%, we think the risk/reward in companies like Canadian Natural Resources and Barrick is very much in our favor.

One mining stock we spoke about five years ago, Compañía de Minas Buenaventura [NYSE: BVN], hasn't fared very well in the interim, down more than 35%. Wrong or early?

AG: Timing obviously impacts your rate of return, but when investing the way we do if we believe we've valued the assets correctly, we usually stick to our guns and over time that has worked out well more often than not. We may have overestimated the quality of Buenaventura's management team, but our basic thesis for the company is unchanged and we still hold a position. The most valuable asset is a nearly 20% stake in the Cerro Verde mining complex located in Peru, which is one of the top-five copper mines globally. Copper is increasingly in demand in a world that wants to become more green, and we believe Cerro Verde alone is today worth $15 billion. That puts Buenaventura's stake at around $3 billion, for a company that has a current market value of around $2 billion and a number of other operating assets that throw off a healthy amount of free cash flow. We don't know when we'll get paid, but for now we still believe the asset value is there and we're willing to be patient in waiting for it to be realized.

Describe why you think the long-term value is there in Brazilian hardwood pulp producer Suzano [NYSE ADR: SUZ].

Fernando Bernad: To first provide some context, the global market for paper is roughly 415 million tons per annum. Some 60% of that goes to packaging – think boxes used to transport goods – which is growing around 3% per annum. Paper for printing and writing makes up around 20% of the market, and that's been declining at 1.8% per year on average over the last 15 years. Another 10% goes to hygiene products, such as toilet paper, napkins and diapers, a segment that grows steadily at 3-4% per year. There are some additional smaller segments, but these three market areas account for most of the annual tonnage.

If you then look to the fibers used in producing all this paper, roughly 60% of it comes from recycled paper and 40% from virgin fiber. Of the virgin fiber piece, one-third is provided by third-party manufacturers who process wood into what's called market pulp, sold on the global market to paper manufacturers to be made into paper end products. Market pulp is what Suzano provides, specifically made from hardwoods like eucalyptus, which is plentiful in Brazil.

What's unique about Suzano is that we believe it has a naturally endowed competitive advantage due to the nature of eucalyptus trees. These trees are mature for cutting in six to eight years, compared to hardwoods in the Iberian peninsula that take 12 to 14 years to grow, and compared to northern-hemisphere softwoods used to make pulp that have much longer lives to maturity than that. For that reason eucalyptus-derived market pulp is at least 30% cheaper to produce than comparable pulp from different sources. Suzano is the largest and lowest-cost producer globally in this part of the market.

Also working in the company's favor is that the hardwood, short-fiber pulp it produces is better for making end products – particularly in the tissue and hygiene areas – for which there is consistently growing demand. Market penetration for such products in developing markets with the highest population growth is still significantly below the levels in more developed countries. That they provide the lowest-cost raw material to make products where demand is steadily growing puts them in a strong position going forward.

Any commodity market like this is still prone to cyclicality. How would you describe where we are in the cycle here?

FB: Very strong pulp prices coming out of the pandemic did result in material added market-pulp capacity hitting the market in 2022 and into 2023. Inventories have risen, utilization rates are down to 80%, and average market pulp prices are now around $515 per ton versus an average price last year for Suzano of around $770 per ton.

We accept that there may be a period on the horizon where capacity will be ahead of demand in the industry and Suzano won't earn at the record levels it did last year. But with continued solid demand growth going forward, and with a not insignificant amount of high-cost production capacity closing down each year, we think this is an excellent point in the cycle to invest in the cost-leader that benefits from a naturally endowed competitive advantage. It's only when market expectations are low that you can get bargain prices.

How inexpensive do you consider the company's U.S. ADRs, now trading at just under $10.50?

FB: We estimate the market-clearing price for market pulp, required for companies

INVESTMENT SNAPSHOT

Suzano
(NYSE ADR: SUZ)

Negocio: Productor brasileño de celulosa de madera dura utilizada en todo el mundo para fabricar productos como servilletas, papel higiénico, papel de escribir y cartón blanco.

Información sobre la acción (@30/08/23):

Price	**10.45**
52-Week Range	7.46 – 11.09
Dividend Yield	4.2%
Market Cap	$13.77 billion

Financials (TTM):

Revenue	BRL 49.00 billion
Operating Profit Margin	39.5%
Net Profit Margin	47.4%

Valuation Metrics
(@8/30/23):

	SUZ	S&P 500
P/E (TTM)	2.9	20.2
Forward P/E (Est.)	6.4	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
BlackRock	3.4%
Vanguard Group	2.2%
Intrag DTVM	2.0%
T. Rowe Price	1.2%
Norges Bank Inv Mgmt	1.2%

Short Interest (as of 8/15/23):

Shares Short/Float	0.1%

SUZ PRICE HISTORY

THE BOTTOM LINE

The company is the lowest-cost producer in a segment of a global market where it has what Fernando Bernad believes is a naturally endowed competitive advantage. On his estimate of normalized annual free cash flow (after capital spending, interest and taxes), the shares trade at what he considers an extremely attractive 15% free-cash-flow yield.

Sources: Company reports, other publicly available information

to make at least modest returns on capital, at $630 to $650 per ton.

At that price level on the 13 million tons we expect the company to be producing annually by 2025, we estimate it can earn roughly $5 billion in annual EBITDA and $2 billion in free cash flow after capital spending, interest costs and income taxes. On that normalized level of free cash flow, the stock trades today at a 15% free-cash-flow yield. We think that's extremely attractive for a company with this one's track record over time of operating excellence and intelligent stewardship of capital.

With cyclicals, of course, after a period of weak prices there's optionality also that we get back into a peak cycle again. If we assume $750-per-ton pulp – still below the price levels of last year– the stock today trades at closer to a 25% free-cash-flow yield. It's worked well for us in the past to buy the best player in a cyclical market at what we believe is the right moment in the cycle – we think that's exactly what we're doing here.

To a more luxury commodity market, explain why you're high on the prospects for Petra Diamonds [London: PDL].

AG: The diamond industry at a high level is characterized by the concentration of supply with the two industry giants, South Africa's De Beers and Russia's Alrosa. Globally there are only 10 mines that can be described as truly world class, three of which each are owned by De Beers and Alrosa. One of the remaining top mines, called Cullinan and located in South Africa, is owned by Petra, which acquired it from De Beers in 2008.

The company's history has been somewhat rocky. De Beers sold Cullinan because it wasn't willing to spend what was necessary to develop it. Petra invested heavily in the mine and successfully grew production, but ultimately stretched its balance sheet too far and it had to reorganize when Covid hit and diamond prices fell sharply. A big part of that reorganization was a debt-for-equity swap in late 2020. We had invested successfully at an earlier point in the company's development, but with the restructuring we got interested again.

The diamond industry also in general is characterized by a scarcity of new production. The supply of rough diamonds peaked at about 177 million carats per year in 2005, and 18 years later that number is closer to 120 million carats. Irrespective of the short-term volatility, this long-term decline in supply should create strong support for rough-diamond prices going forward.

Petra has an estimated 230 million carats of diamond resources and is one of the few producers of large rough-cut stones worth at least $5 million each. This is impossible to forecast, but in the latest fiscal year it recovered stones of this size with a value of almost $90 million. Finding the biggest stones adds almost zero incremental cost to the normal operation of a mine, so discovering more of them is highly accretive to margins.

How would you characterize Petra's corporate governance?

AG: The quality of management and the board of directors is something on which

INVESTMENT SNAPSHOT

Petra Diamonds
(London: PDL)

Business: Mining, processing, sorting and sale of rough diamonds; operating properties consist of three underground mines in South Africa and one open pit mine in Tanzania.

Share Information
(@8/30/23, Exchange Rate: $1 = £0.79):

Price	**£0.70**
52-Week Range	£0.63 – £1.23
Dividend Yield	0.0%
Market Cap	£136.5 million

Financials (TTM):

Revenue	£532.6 million
Operating Profit Margin	22.1%
Net Profit Margin	0.4%

Valuation Metrics
(@8/30/23):

	PDL	S&P 500
P/E (TTM)	83.9	20.2
Forward P/E (Est.)	18.3	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Vontobel Asset Mgmt	15.3%
Azvalor Asset Mgmt	10.1%
Franklin Resources	5.0%
Invesco	4.7%
Massachusetts Fin Serv	2.2%

Short Interest (as of 8/15/23):

Shares Short/Float	n/a

PDL PRICE HISTORY

THE BOTTOM LINE

In a largely duopolistic market for rough diamonds, the company is a small player but with a world-class South African mine that Álvaro Guzmán believes positions it well to benefit as ongoing industry supply constraints put upward pressure on rough-diamond prices. At 10x his estimate of normalized free cash flow, its shares would trade at closer to £2.80.

Sources: Company reports, other publicly available information

we don't ever want to compromise. Richard Duffy is Petra's CEO, taking over in 2019 when it was already clear the company needed to be restructured and we think he's done an excellent job in improving operating efficiency and in working through the recapitalization of the balance sheet. On the latest fiscal-year numbers, net debt to EBITDA is now a very manageable 1.3x. At the board level the chairman is Peter Hill, who arrived in 2020 with a very impressive track record in both mining and technology companies, and we believe he has been and will be a good steward of capital. We like that they've been responsive in working with us on better aligning the management team's incentive compensation with the creation of shareholder value.

The shares are down 45% from their 2022 high. How are you looking at upside from today's price of 70 pence?

AG: To give you a sense of the valuation here, Petra on a trailing-12-month basis earned just over £200 million in operating cash flow. That's against a market cap today of less than £140 million.

Making what we believe are conservative assumptions for production levels and the diamond price – $140 per carat versus today's market price of around $112 per carat – we estimate the company's normalized annual free cash flow to be at least £60 million per year. On today's market cap that's a better than 40% free-cash-flow yield. If we assume a reasonable 10x multiple of free cash flow, the share price would be closer to £2.80.

Upside from there would come from diamond prices going much higher than what we're modeling, which we believe is possible given the supply constraints in the market and the potential that inflation becomes a longer-term problem than many investors seem to expect. We also think we're protected on the downside by the attractiveness of Petra's assets to both strategic and financial buyers, each of which could significantly reduce costs in what is now a small, standalone public company.

Turning to an idea from your home country of Spain, walk through your investment case for medical-products company Grifols [Madrid: GRF].

FB: The company's history of innovation goes back to the founder developing some of the early instruments for extracting blood and for carrying out indirect blood transfusions rather than the arm-to-arm process used initially. In the 1950s it invented plasmapheresis, a new method of obtaining plasma from blood. Today Grifols has roughly 20% of the global market for plasma-derived therapies, similar to Japan's Takeda Pharmaceutical [Tokyo: 4502] and behind the 30% share of market leader CSL Ltd. [Sydney: CSL], which is based in Australia.

This isn't the most well-known part of the pharmaceutical industry, but blood plasma has proved to be a valuable building block in developing a wide range of medical treatments, diagnostics and supplies. Grifols' therapeutic areas of focus include immunology, hepatology, pulmonology, hematology, neurology and more. It's vertically integrated, with 400 plasma collection centers globally as well as a significant number of fractionation and puri-

INVESTMENT SNAPSHOT

Grifols
(Madrid: GRF.P)

Business: Global collection of blood plasma and the development and production of plasma-derived therapies used in a wide variety of medical treatment protocols.

Share Information
(@8/30/23, Exchange Rate: $1 = €0.91):

Price	**€8.67**
52-Week Range	€5.75 – €10.19
Dividend Yield	0.0%
Market Cap	€7.67 billion

Financials (TTM):

Revenue	€6.48 billion
Operating Profit Margin	9.5%
Net Profit Margin	0.1%

Valuation Metrics
(@8/30/23):

	GRF	S&P 500
P/E (TTM)	n/a	20.2
Forward P/E (Est.)	14.8	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Capital Research & Mgmt	10.8%
Vanguard Group	3.1%
BlackRock	2.1%
Norges Bank Inv Mgmt	1.6%
Santander Asset Mgmt	1.4%

Short Interest (as of 8/15/23):

Shares Short/Float	n/a

GRF.P PRICE HISTORY

THE BOTTOM LINE

The company has endured both market-related and self-inflicted challenges that Fernando Bernad believes are beginning to turn for the better, in part due to the naming earlier this year of its first non-founding family member CEO. At a more typical historical EV/EBITDA multiple of 11x, on his estimates for next year the shares would trade at around €16.

Sources: Company reports, other publicly available information

fication facilities. We consider this a complicated business and think Grifols and its two major competitors benefit from significant barriers to entry – it's almost impossible to imagine replicating what they do, even if you had all the money in the world. We also like that they appear to compete rationally, capitalizing on those barriers to entry and on scale advantages.

The plasma-derivatives market has been steadily growing at 7-8% per annum, driven by innovation, population growth, population aging, and increased penetration in developing markets. On this last point, immunoglobulins used to treat immunodeficiencies – a key product area for Grifols – are used at a rate of 270 grams per inhabitant in the U.S., 100-150 grams in Europe, and at only 25 grams per inhabitant in China. There are always new potential competitive threats, but the industry growth has been very resilient and we believe remains highly attractive.

What's going on that makes the stock – the preferred version of which currently trades at around €8.70 per share – cheap enough for you to be interested?

FB: There are a few things going on. The business has been slow to fully recover from the general hit inflicted by the pandemic. On top of that have been self-inflicted issues mostly from acquisitions and incremental R&D spending that resulted in debt piling up on the balance sheet without delivering the expected benefits. Net debt of close to €10 billion is over 7x this year's expected EBITDA. The market has not looked kindly on any of that.

Our view is that general business conditions continue to turn for the better, some of the new products acquired and developed in recent years will soon start contributing, and that the company under new CEO Thomas Glanzmann – the first non-Grifols family member to serve as CEO – is taking the right steps to streamline the company's business mix, reduce debt and improve operating efficiency. Over the next couple of years we conservatively estimate that annual EBITDA will be over €2 billion, with free cash flow of around €750 million. At today's market value that results in a 10% or so free cash flow yield, which is very high for a company of this quality. If the stock traded at its typical historical 11x EV/EBITDA multiple, on our next year's estimates that would result in a share price of €16.

Coming back to commodities, describe your interest in U.S. coal producer Arch Resources [NYSE: ARCH].

AG: The company produces both metallurgical coal used in blast-furnace steel production and thermal coal used to generate electricity. The mix has continued to shift over time and now 60% of total revenues and 75% of EBITDA are generated by the met coal business. The mines for it are in West Virginia and account for about 15% of total annual U.S. met coal production.

The met coal assets are of high quality. The reserves mostly consist of what's called "high vol A" coal, and the total reserve life is around 20 years. The mines are non-unionized and have low costs, in the lowest quartile of the U.S. cost curve. They're also well located to rail transportation networks to move the coal out

INVESTMENT SNAPSHOT

Arch Resources
(NYSE: ARCH)

Business: Owner and operator of coal mines in the U.S. that produce both metallurgical coal used to manufacture steel and thermal coal used in the production of electricity.

Share Information (@8/30/23):

Price	**128.39**
52-Week Range	102.42 – 167.68
Dividend Yield	15.1%
Market Cap	$2.33 billion

Financials (TTM):

Revenue	$3.33 billion
Operating Profit Margin	22.1%
Net Profit Margin	27.8%

Valuation Metrics
(@8/30/23):

	ARCH	S&P 500
P/E (TTM)	2.8	20.2
Forward P/E (Est.)	5.7	20.0

Largest Institutional Owners
(@6/30/23 or latest filing):

Company	% Owned
Vanguard Group	10.5%
BlackRock	7.0%
State Street	5.6%
Azvalor Asset Mgmt	5.0%
Dimensional Fund Adv	4.3%

Short Interest (as of 8/15/23):

Shares Short/Float	9.4%

ARCH PRICE HISTORY

THE BOTTOM LINE

Álvaro Guzmán believes the supply/demand dynamics for metallurgical coal will prove more positive for the company's prospects than the market seems to expect. Valuing its met coal and thermal coal businesses separately on his normalized estimates and adding back balance sheet cash, he believes the stock can at least double from today's price.

Sources: Company reports, other publicly available information

– 40% of which is sold domestically and another 40% ultimately going to Asia.

Do you have to have an opinion here on the longer-term outlook on the demand for met coal?

AG: The pushback you'll hear is that steel made in blast furnaces is losing share to that made by electric-arc furnaces, which use scrap steel and are more environmentally friendly. Blast-furnace steel production has grown 2% per year over the last ten years and estimates for the next ten are maybe 1% annually at best going forward. That's not exciting, but the reality is that given the age and scope of the installed base of blast furnaces, which have 50-year useful lives, there's pretty good visibility into demand for met coal to produce steel relatively far into the future.

The bigger story, however, is on the supply side, which has been characterized by historic levels of underinvestment over the past seven or eight years. Regulations in certain regions have tightened and companies – Arch being a good example – have gotten religion, so to speak, and are choosing to return capital to shareholders rather than pour money back into new capacity. That shows little sign of changing, particularly with higher costs today for both equity and debt. We think that will result in higher average prices for met coal through the cycle.

Given that the shares at the current price of around $128.50 go for less than 3x trailing-12-month earnings, the market would seem to disagree.

AG: That's true – for the market to be right we would need to see a complete collapse of met coal prices. In our valuation for the quality grade of Arch's reserves we're using a coal price of $175 per ton, which is the level at which companies to the right of that on the cost curve don't make any money. That compares to the price today of around $250 per ton.

At that $175 price for the commodity we estimate that Arch – which should earn close to $700 million in free cash flow this year – will generate at least $400 million in normalized cash flow in 2025 and should also at that point have close to $1.5 billion in net cash on the balance sheet. This for a company whose current market cap is less than $2.4 billion.

If we value the $320 million of 2025 normalized cash flow we expect to come from met coal at 10x, the $80 million in cash flow we estimate for the thermal coal business at 3x, and add back the cash, our sum-of-the-parts company value would be close to $5 billion, more than twice today's level. The wild card is what happens to met coal prices and here we think the upside is materially higher than the downside. We're using $175 per ton, but just a couple years ago that number was over $600. It's not inconceivable if prices again rise sharply that Arch could generate in free cash flow roughly half its current market cap in one year.

ON INVESTING FASHIONS:

We don't think requiring bargain prices as a central element of your investing strategy will ever go out of fashion.

Describe something in your portfolio that hasn't worked and what you appear to have gotten wrong, at least so far.

AG: It's a small position, but we own roughly 10% of a company in Australia called AMA Group [Sydney: AMA]. It provides automotive collision repair services primarily to insurance companies, the best North American analog for which would be Boyd Group Services in Canada. AMA is by far the market leader in Australia and we bought the shares at what we thought was a significant discount when the business turned down sharply after Covid hit. The founder was stepping down and we believed the company was so well positioned that under a new CEO the business would quickly get back to normal – or better than that – as the negative pandemic effects went away.

Instead of that, there's been consolidation among the insurance-company customer base and they've increasingly decided to play hardball with AMA on pricing. There has also been a lot of negative drama around the integration of a 2019 acquisition made at the top of the market by the founder who has since left, including a lot of public name-calling and dissension at the board level.

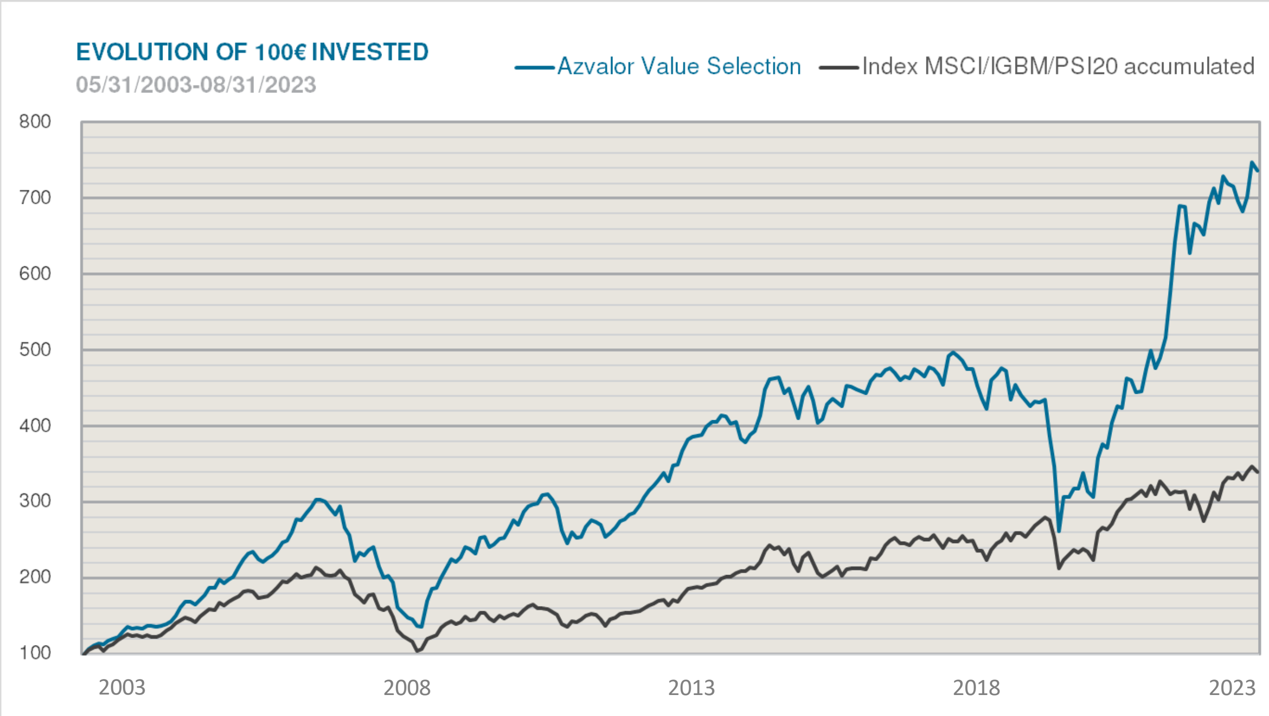
Our average cost is around 30 Australian cents per share and the stock currently trades at 12 cents. I would consider this an analysis mistake. We assumed the company's market position would allow it to make better-than-normal returns, that the debt taken on for the acquisition would be manageable, and that the transition in management would go smoothly. Australia is a small country and it may be that when we look around the poker table here and ask who the patsy is, that it's us. We still think in a normalized environment that AMA can make A$100 million per year in EBITDA, which at 10x EV/EBITDA would result in a share price of 50 cents. We'll see – to our credit, this type of bet would never be a big position in the fund.

As value investing itself seemed out of favor for a number of years prior to 2022, did you ever find it hard to keep the faith?

AG: Never. Like any investor you have to be right in judging earnings power and asset value and management quality, but we don't think requiring bargain prices as a central element of your investing strategy will ever go out of fashion.

Warren Buffett has often talked about how you can only see who's swimming naked when the tide goes out. A truly conservative portfolio should perform exceptionally well when the market purges past excesses with sharp declines. That was very much our experience in 2022. Given our natures we couldn't invest any other way, but that again reinforced for us the superiority of a value approach over the fullness of time. VII

AZVALOR VALUE SELECTION SICAV



	Azvalor Value Selection	Index MSCI/IGBM/PSI20	Alpha
Cummulative Return	635.9%	239.4%	396.5%
Annualized Return	10.4%	6.4%	4.0%