

Select Opportunity

Top investors like Fiduciary Management's Pat English often make what they do sound easier than it is. "You don't get extra points for complexity," he says.

INVESTOR INSIGHT



Fiduciary Management

Pat English (l), Jonathan Bloom (r)

Investment Focus: Seek companies with strong market positions, attractive returns on capital, and talented, shareholder-focused leaders keen on improving both.

You wouldn't guess from Pat English's less-than-upbeat investor letters that his Fiduciary Management, Inc. recently reopened its \$7.4 billion (assets) international strategy to new investors. The rationale? "Tough times can happen quickly," he says. "We want to make sure we're available for those who will want a cautious product."

English's foresight – and caution – have generated excellent results for FMI investors. The firm manages \$24 billion, its domestic funds have handily beaten the market, and its international fund since 2010 has bested its MSCI developed-market benchmark (in US\$ and after fees) by 410 basis points per year.

Today, English and FMI Research Director Jonathan Bloom are finding select opportunity in a variety of areas, including hotels, theme parks, aerospace and cosmetics.

You put a lot of emphasis on what might be called a "pre-approval process" for potential ideas. Explain that.

Pat English: We aren't a firm where an analyst plops a 30-page report on my desk and says, "Look what I found." We try to do a lot of the portfolio management upfront, which means before we get to the exhaustive research on whether it's a good business with good management and a good valuation, we're making sure certain conditions are met. Is there minimal financial risk on the balance sheet? Is the company's full-cycle return on invested capital well in excess of its weighted average cost of capital? Is management reputable and honest, with compensation plans aligned with our interests? It sounds basic, but is it a business we understand? You'd be surprised how often something belongs in the too-hard bucket. In general, we care about the research quotient in an idea – we don't want to spend 30 hours on an idea before we come across something we should have found in the first two or three hours.

We have two working lists. The first is a wish list of stocks where we understand and like the company, industry and business model, but where we think the shares are at least 20% overvalued. The second is a monitor list, usually with 15 to 20 names we're working on in depth because the valuation is within 20% of being interesting. We want to be prepared to take advantage if disappointment of some kind hits and their shares become attractive.

Give a recent example of something making the journey from wish list, to monitor list, to the portfolio.

Jonathan Bloom: We know the medical-equipment industry well, and one area we find attractive are companies focused on orthopedics like Smith & Nephew [SN:LN], which is a global provider of implants, advanced wound-care solutions and surgery tools used in sports medicine. It's a business we view as pretty defensive, with a recurring usage pattern and relatively inelastic demand.

The company has fundamentally changed its manufacturing, operating and commercial structure, but overall margins have remained effectively flat given the complexity of the changes and decisions made to reinvest savings. We believe these changes and reinvestment efforts will pay off over the next several years, narrowing the approximately 600-basis-point gap between Smith & Nephew's operating margins and those of comparable companies. That margin opportunity, combined with a reasonably attractive valuation, caused us to move the stock off the monitor list and into the portfolio earlier this year.

PE: Smith & Nephew is a fairly typical example in that we're tearing apart the business to determine what the eventual margin structure should be. If we're right that an underearning company can improve its margins, we'll benefit both from the catch-up in earnings and from a likely revaluation of the business by the market.

You've always focused on high-quality, compounder-type businesses. Is that more and more a crowded trade?

PE: In the current market, it is very difficult for a value investor to find the kinds of businesses run by the types of managers we want at a cheap price. But I'd ar-

gue that investors today need to be very careful in assessing quality. It's maybe less of an issue in international markets, but I think this whole movement in the U.S. toward adjusted earnings of various stripes is in most cases complete nonsense. Management teams, for example, say you should ignore the amortization from an acquisition because it's a non-cash charge, and then three years later there's a big write-off related to the deal.

We're very focused on ROIC, but there is still plenty of value to be added in understanding not only the true returns of the business historically – adding back some or all of any write-offs to the capital base, for example – but also what the incremental ROIC's can be going forward. That's very difficult when the quality of reported earnings is so poor.

I'd also say memories seem short when it comes to debt. Public companies want to be like private-equity firms and lever up to do deals, in many cases to what we consider an unhealthy level. There's a lot of opportunity for investors to compromise on the quality and strength of the balance sheet, which we're not willing to do.

Describe your type of management team.

PE: We want management to have actual skin in the game – dollars invested in the business, not just stock options. We also look in a detailed way at their track record over time in allocating resources, whether to capital spending or to M&A. We want them to be as focused as we are on incremental ROIC, which we track every quarter and year to year. The compensation policy is also critical and it should be built on returns, not growth in things like earnings per share. That's how companies get into trouble, when they'll do almost anything to grow.

JB: One of our favorite CEOs has been Kasper Rorsted, who prior to going to Adidas in 2016 ran one of our long-standing investments, German adhesives and consumer-products company Henkel [HEN:GR]. He was internally focused and did an excellent job over time in driving

margin improvement while balancing that with solid and profitable organic growth in the company's key business lines. With minimal focus on M&A he was able to drive growth that was well above peers, and the stock price followed accordingly.

Henkel is a stock Pat discussed when we first spoke six years ago [VII, March 30, 2012]. The valuation there has never gotten ahead of itself?

JB: This is a case where years ago all the key businesses were underearning, with margins well below potential and peer levels. As they drove an improvement in earn-

ON ASSESSING QUALITY:

Investors need to be careful. This whole movement to adjusted earnings is in most cases complete nonsense.

ings, the multiple has never really run too far ahead. Even today compared to either industrials or consumer-products peers, the company still has an attractive growth profile and a very reasonable 15x P/E on the ordinary shares. And in keeping with how long these types of things can take, there's still some margin opportunity to wring out in the core businesses.

What do you think of the current CEO?

JB: After any change in management there's a probationary time period where you're getting to know them and how they do things. In this case, the new CEO, Hans Van Bylen, has been a bit more externally focused on deals, but not alarmingly so. His operational track record is strong, having driven significant margin improvement in the firm's beauty-care division before becoming CEO.

On the subject of change, how have you responded to the departure of Martin Sorrell at portfolio holding WPP [WPP:LN]?

PE: This is a typically contrarian idea of ours. WPP is a global leader in advertising, direct marketing, media buying and public relations, but the market is treating it as if it's a relic of a bygone era. We think that's wrong, that the company is still highly relevant, and that many issues it faces are more cyclical than secular in nature. It's not getting credit for a sustainable, high-margin business model and the strong positions it has in areas of more-rapid industry growth, including emerging markets, marketing services and digital advertising.

Nothing has changed in that basic view since Sorrell left. The early scouting report on Roberto Quarta [WPP's Chairman, who is running the company on an interim basis] is that he's a hard-nosed businessman who's not wed to doing anything just because that's the way it's always been done. We'll watch for a few quarters and see how he does. With a 5% dividend yield and the shares trading at only 10x forward earnings, there is a pretty significant margin for error.

Is cyclicity a common reason you find ideas inexpensive enough to buy?

PE: We are interested in the full-cycle dynamics of the business, which can give us opportunity when the market is anticipating a nearer-term downturn. Take something like Samsung [005935:KS]. How can a company with good margins that are getting better and an incredible balance sheet trade in a market like today's at 6x earnings? Clearly the conventional wisdom expects a retracement in some of their semiconductor earnings. We're willing to look beyond that and think Samsung has a fantastic semiconductor franchise. This is not a company that deserves almost a throw-away multiple.

Another example would be Adecco [ADEN:SW], the temporary staffing company. At 10-11x earnings, the market clearly anticipates weakness, but if we look at it through the cycle we see a company that can grow at least as fast as nominal GDP, and that for company-specific and secular industry reasons has an improving margin structure. If we're right, the stock today is

significantly undervalued.

You seem to shy away from commodity cycles, although you have a good-sized stake in fertilizer giant Nutrien [NTR]. Why does it make the cut?

PE: This is the product of the Potash Corp./Agrium merger and let me just start with the statement of fact that this is the worst investment we've ever made. Potash prices had gotten too high, too much capacity came on, and then prices collapsed. The industry, which we thought was a rational global oligopoly, totally lost its way for a couple of years and we got caught in the middle of that.

But we try to approach each day with a clean sheet of paper. The balance sheet is strong. The business generates free cash flow even in the worst of times. Pricing has firmed and we think there are early signs the major players have regained their discipline. We completely blew the timing – which is why investing in these types of commodity businesses is so hard – but looking out three to five years we think the outlook is quite positive.

You have very successfully translated your strategy built in the U.S. to one investing internationally. What about your approach do you think fostered that?

JB: We had plenty of experience looking at non-U.S. businesses before we launched the international product in 2010, but we said in opening the new fund that we were not going to go anywhere or do anything in markets where we couldn't do our customary due diligence. What we look for is the same. The process is the same. The team is the same. If for any reason we don't feel we have the amount or quality of information we need, we just pass. As a result, we stick predominantly to developed markets, to companies with market caps of at least \$4 billion, and to markets where financials are done using U.S. Generally Accepted Accounting Principles or International Financial Reporting Standards. That doesn't mean we'll never invest in China or Russia or in emerging

markets, but for the time being we don't want or need to.

Last time we spoke you said you always wanted to keep your investment team small, saying things were more likely to “break down” when the team numbered more than 10. Managing roughly twice the level of assets you did six years ago, do you still believe that?

PE: The investment team is still nine, including me. Given the products we man-

ON GOING INTERNATIONAL:

What we look for, the process and the team are the same. If we can't do customary due diligence, we pass.

age, the concentration of our portfolios and our typical turnover, we really only need to generate one or two good ideas a month firm-wide. With that and keeping track of what we own, we think that's a very manageable task for nine people.

Any wavering on your unwritten rule that all of your investment team's equity investments be in FMI products?

PE: No. You only have one brain. If you're going to think about something else that can't benefit our clients, that's not a good idea. It should be very important to us that what we're doing works – there's no better way to ensure that than to have our own money invested directly alongside the money of our clients.

You've tended over time in your portfolios to be light on technology stocks and financials. Is that changing at all?

PE: I would say that's still generally true. With technology that means particularly avoiding businesses where product cycles and innovation move rapidly. I've just found that the obsolescence risk and the

research intensity required in those types of names is too high.

With financials, especially banking, we generally view it as a commodity business and we're not keen on opaque and highly levered balance sheets. We have added concerns for international banks. Capital standards vary a lot across regions, as do the underlying rules concerning assets used to secure debt financing. For these and a number of other reasons, while many of our peers are piling into “inexpensive” banks – particularly in Europe – we've chosen to err on the side of caution and watch that game from the sidelines.

Are there particular geographies you're finding more or less interesting today?

JB: Starting out with less interesting, we've sold out of a number of positions in Japan, including Makita [6586:JP], SMC [6273:JP] and Shimano [7309:JP]. These are great businesses, but the stocks in our opinion have run away from a valuation perspective, particularly given the macroeconomic backdrop. Government debt levels in Japan are excessive, interest rates are unsustainably low, the population is aging and shrinking, and even though there's been an uptick in recent years, overall economic growth prospects are relatively weak.

Meanwhile, the Japanese stock market has been on a tear since November of 2012, increasing at close to double the rate of the MSCI developed-markets index. When we sold our position late last year in Makita, which makes power tools, its stock was on its way to trading at more than two standard deviations above its historical average. That's not uncommon in Japan for the best businesses. While many investors are flocking to Japan, we're becoming more reticent.

PE: On the more-interesting front, the equity market in the U.K. has been underperforming for years and now is obsessed with concerns around Brexit, slowing growth and rising inflation. We realize there's significant uncertainty in the near term regarding economic growth, trade-

deal negotiations and currency fluctuations, but we actually support the country's desire to take back its independence and free itself of the regulatory burden, financial obligations and bureaucracy of being part of Europe. The U.K. is the world's 5th-largest economy and we think ultimately it will fare better on its own.

As stock prices have come under pressure, we're finding some companies with strong, durable business models offered up at value prices. We're just trying to capitalize on people throwing the babies out with the bath water.

You mentioned Smith & Nephew earlier, but walk through the thesis for another company on your U.K. shopping list, hospitality group Whitbread [WTB:LN].

JB: Whitbread has two dominant businesses: Premier Inn is the largest budget hotel chain in the country with over 785 hotels, and Costa is the U.K.'s largest coffee chain, with approximately 2,500 stores and 40% market share. The company also operates 400 restaurants, mostly co-located with the hotels. The majority of the hotels are owned and operated, while the Costa operations have a mix of owned, franchised, wholesale and other locations. Lease-adjusted returns on invested capital in recent years have been around 11%, well in excess of the cost of capital, and the balance sheet is strong with net debt to EBITDA of just 1x.

The Premier Inn business is particularly well positioned. These are ubiquitous business-focused hotels in prime locations that offer consistent customer experiences and excellent value. With a single brand network across the U.K., they cultivate repeat customers that book directly with Premier online. The largest branded hotel groups such as Accor, InterContinental and Marriott typically generate 15-20% of bookings through online travel agencies (OTAs), and smaller independent European hotels often book over 50% of their rooms that way. OTAs charge 10-30% commissions, which Premier avoids almost entirely given its 97% direct bookings. That yields significant savings that

are used to reinvest into the hotels and maintain a superior product. That's an added advantage in a U.K. hotel market where 50% of the competition is independently owned and doesn't have the same financial wherewithal to reinvest.

Whitbread's stock has been under pressure both from the general economic malaise around Brexit and the fact that an internal reinvestment program, focused on upgrading infrastructure and digital capabilities, has shaved 200 basis points off near-term operating margins at Costa. The CEO, Alison Brittain, emphasizes return on invested capital – which is linked

to her long-term incentive plan – and we see it as a big positive that management is willing to invest in order to drive long-term like-for-like sales growth and higher margins. This is a classic set-up for us: it's a good, understandable business with a strong balance sheet and management team, with clouds hanging over it that we think are temporary.

How attractive do you consider the growth potential here?

JB: Management believes it can expand the footprints of both businesses by

INVESTMENT SNAPSHOT

Whitbread
(London: WTB)

Business: United Kingdom-based operator of the country's largest budget hotel chain, Premier Inn, as well as its largest chain of coffee shops, under the brand name Costa.

Share Information
(@6/29/18, Exchange Rate: \$1 = £0.76):

Price	£39.59
52-Week Range	£35.00 – £45.73
Dividend Yield	2.4%
Market Cap	£7.24 billion

Financials (TTM):

Revenue	£3.30 billion
Operating Profit Margin	18.4%
Net Profit Margin	13.3%

Valuation Metrics

(@6/29/18):

	WTB	S&P 500
P/E (TTM)	16.6	24.0
Forward P/E (Est.)	13.9	17.2

Largest Institutional Owners

(@3/31/18 or latest filing):

Company	% Owned
Longview Partners	5.0%
Vanguard Group	3.3%
Walter Scott & Partners	3.3%
Massachusetts Fin Serv	3.0%
Fiduciary Mgmt	2.9%

Short Interest (as of 6/15/18):

Shares Short/Float n/a

WTB PRICE HISTORY



THE BOTTOM LINE

Likely due to the general economic malaise around Brexit and a near-term margin hit from a reinvestment program, Jonathan Bloom believes the market isn't adequately recognizing the company's prospective earnings power and asset base. On a sum-of-the-parts basis he values the shares in the mid-£50s, a nearly 40% premium to the current price.

Sources: Company reports, other publicly available information

25-30% in the U.K., which we think is achievable. In hotels, Premier has a long runway of growth. It has increased market share from 6% in 2010, to 9% in 2016, and is on track to be over 11% by 2020, primarily at the expense of the country's still-large contingent of independent hotels. Outside the U.K., Premier has shown excellent early results in Germany, a significantly larger hotel market that has value-focused customers and, so far, low penetration of branded hotels. Costa's main growth opportunity is China, where it already has about 500 stores. Management expects that to grow to 1,200 in the next few years.

What's the supply-demand situation for hotels in the U.K., including the emergence of rental platforms like Airbnb?

PE: Outside of London the market is in balance, with both supply and demand growing 2-3% per year. In London, supply growth is slowing to 2-3% this year. Overall revenue per available room is growing at 1-2%. In general, we're comfortable with the supply/demand dynamics at least for the next few years.

As for Airbnb, we thoroughly researched that threat and found that the budget segment doesn't really compete directly with the rental platforms. Airbnb typically is used for longer stays, generally for leisure and often where space for more people is needed. Premier Inn caters to domestic customers, often the single business customer who wants very competitive pricing, and over 80% of its rooms are located in regional markets where we consider Airbnb to be less of a threat.

How are you looking at valuation with the stock recently at just under £40?

JB: The shares are still down 25% from three years ago and trade on 2018 consensus earnings estimates at a 15x P/E, 15% below the average of the past five years.

On a sum-of-the-parts basis, we value Costa at around 12x EV/EBITDA, a discount to where something like Starbucks trades and to the roughly 15x EBITDA

JAB Holdings recently paid to buy a controlling stake in Pret A Manger.

For Premier, the valuation has two components, based on hotel cash flow and on the value of the property it owns. (Premier owns 64% of its rooms outright, compared to less than 3% for a Marriott or a Hilton.) For this freehold property, we apply a 35% discount to the £4-5 billion third-party valuation range the company shared at its November 2016 investor day. For the hotel operations, we use 11x EBITDA – adjusted for estimated rental expenses if Premier did a sale/leaseback on its property – well below the roughly

15x multiple on a public comp like Hilton. All in, we value the shares in the mid-£50s, 40% above the current price.

One interesting wrinkle is that Whitbread, responding to pressure from activist investors Elliott Management and Sagem Head Capital, announced plans to separate its two businesses within the next two years. We like the business as it is, but if value can be realized in a shorter window we won't complain.

Explain the investment appeal of U.K. theme-park operator Merlin Entertainments [MERL:LN].

INVESTMENT SNAPSHOT

Merlin Entertainments

(London: MERL)

Business: Global operator of family-focused theme parks and attractions, under such brands as Legoland, Madame Tussauds, Sea Life, The Dungeons and Warwick Castle.

Share Information

(@6/29/18, Exchange Rate: \$1 = £0.76):

Price	£3.86
52-Week Range	£3.17 – £4.92
Dividend Yield	1.9%
Market Cap	£3.95 billion

Financials (TTM):

Revenue	£1.59 billion
Operating Profit Margin	20.3%
Net Profit Margin	13.1%

Valuation Metrics

(@6/29/18):

	MERL	S&P 500
P/E (TTM)	18.9	24.0
Forward P/E (Est.)	17.2	17.2

Largest Institutional Owners

(@3/31/18 or latest filing):

Company	% Owned
Kirkbi A/S	29.6%
ValueAct Capital	5.3%
Marathon Asset Mgmt	5.0%
Fiduciary Mgmt	2.9%
Capital Research & Mgmt	2.7%

Short Interest (as of 6/15/18):

Shares Short/Float n/a

MERL PRICE HISTORY



THE BOTTOM LINE

Just by continuing to build out its existing theme-park and other entertainment-attraction platforms, Pat English believes the company can deliver high-single-digit earnings growth for several years. Combined with a 2% dividend yield and a mean-reverting valuation multiple, he thinks the shares from today's price can deliver a mid-teens annual return.

Sources: Company reports, other publicly available information

PE: Merlin operates theme parks and other entertainment attractions in 25 countries, with average ticket prices of about £20. The company is organized into three segments. Midway Attractions are things like Madame Tussauds wax museums and the famous London Eye observation Ferris wheel. Resort Theme Parks include leading regional theme parks in the United Kingdom, Italy and Northern Germany. The most important segment, accounting for 45% of operating profit, consists of eight Legoland theme parks. Merlin has the exclusive rights to operate the existing parks in perpetuity, and has global exclusivity to open more Legoland parks through 2047.

The company has grown revenues at an average 8% per year over the last five years and we think it has a strong pipeline for continued growth. Management thinks it can triple the number of Legoland parks over time, and there's also an underappreciated opportunity to build out hotel properties adjacent to the bigger parks. We think new hotels alone can add £10-£20 million in annual EBITDA over the next five years.

Since the company went public in 2013, the stock has lagged the FTSE All-Share Index by about 30%, with nearly all of the underperformance having occurred since last summer. Most of that resulted from margin and revenue-growth weakness in 2017 attributed to the slowing U.K. economy and a falloff in tourist activity after the London and Manchester terrorist attacks.

How are you thinking about any near-term economic headwinds?

JB: We're looking through the economic cycle, but Merlin's business has actually proven over time to be nicely defensive. Domestic U.K. visitors account for two-thirds of the company's overall attendance, and it actually benefits in tougher economic environments as people trade down in search of cheaper family entertainment. During the 2008 global financial crisis, like-for-like revenues and EBITDA grew more than 5%.

How inexpensive do you consider the shares at a recent £3.85?

PE: The stock currently trades at 17x consensus 2019 earnings estimates, or roughly one standard deviation below the average 19x multiple since the company came public. Without assuming any significant recovery in the U.K., we're expecting high-single-digit earnings growth, which combined with the 2% dividend yield and some eventual mean reversion in the earnings multiple can result in mid-teens shareholder returns over the next several years.

You've spoken about finding opportunity over time in South Korean preferred shares. Describe a current representative example of that, in beauty company Amorepacific [090435:KS].

PE: This is a theme we've taken advantage of since the early days of the international fund. These preferred shares have essentially the same economic interests as the common, but typically don't have voting rights. In Europe you'll see 10-15% discounts to the common for similar types of preferred shares, but in Korea that can be up to 60-70%, which just doesn't make

INVESTMENT SNAPSHOT

Amorepacific Corp.
(Seoul: 090435)

Business: South Korea-based seller of mid-to high-end cosmetics and beauty products, with a large and growing business elsewhere in Southeast Asia, particularly in China.

Share Information

(@6/29/18, Exchange Rate: \$1 = ₩1,115):

Price ₩155,000
52-Week Range ₩143,000 - ₩189,000
Dividend Yield 0.9%
Market Cap ₩20.70 trillion

Financials (TTM):

Revenue ₩4.99 trillion
Operating Profit Margin 10.3%
Net Profit Margin 7.0%

Valuation Metrics

(@6/29/18):

	090435	S&P 500
P/E (TTM)	30.8	24.0
Forward P/E (Est.)	13.9	17.2

Largest Institutional Owners

(@3/31/18 or latest filing):

Company	% Owned
Aberdeen Asset Mgrs	10.5%
Fiduciary Mgmt	6.5%
BlackRock	2.7%
Vanguard Group	2.5%
BC Inv Mgmt	0.9%

Short Interest (as of 6/15/18):

Shares Short/Float n/a

AMOREPACIFIC PRICE HISTORY



THE BOTTOM LINE

Jonathan Bloom expects the company's expansion of its well-regarded brands beyond their home South Korean base to drive 10-15% annual earnings growth over the next few years. That alone would provide a nice shareholder return, but he expects additional upside from a narrowing of the unwarranted discount at which the preferred shares trade.

Sources: Company reports, other publicly available information

any sense. Fortunately we've been able to take advantage of that over the years.

JB: Amorepacific is South Korea's leading cosmetics company with roughly 27% market share. It's focused on the middle and high-end segments of the market and its brands are highly regarded and tend to foster significant customer loyalty. Years ago the company relied on door-to-door sales in South Korea, but it has since successfully built sales volume through other channels and by expanding internationally. Sales in Southeast Asia, excluding China, have grown by more than five-fold since 2013 and now account for 10% of total revenues. China has been even more important: counting direct sales there and estimates of sales to Chinese consumers through the company's duty-free channel, overall revenues tied to China are now over 40% of the total.

The increased reliance on China hurt the company last year when South Korea's implementation of a missile-defense system led China to enforce a blockade on Korean products and to limit travel to South Korea. That tension has since begun to thaw and the number of Chinese travelers going to South Korea is expected to increase significantly for the remainder of this year.

You've been a pessimist on China's economic outlook. Doesn't that concern you in this case?

JB: Our concerns relate primarily to the production side of China's economy, not the consumer side. The two are obviously related, but we believe the huge waves of Chinese moving into the middle class and beyond over coming decades is more of a positive for a company like Amorepacific than the excess production capacity in infrastructure or real estate is a negative. Korean and western cosmetic brands have considerable cachet with higher-end consumers in China. With Amorepacific's penetration in the Chinese market still quite low, we think there's a long growth runway.

With the preferred shares trading at 155,000 Korean won, how are you looking at fair value?

JB: The shares trade for 14x 2019 consensus earnings estimates, which is a roughly 50% discount to both the company's own common and to global peers such as L'Oréal, Estée Lauder and Shiseido.

If we assume no improvement in the multiple, we're expecting a return that approximates the 10-15% annual earnings growth we expect the company to generate over the next few years. But we also don't think the 50% discount relative to the common is a permanent state of affairs. The discount has already closed from 67% when we initially invested in 2013, and it's not unreasonable to expect further progress. Samsung has set a good example by allocating large share repurchases to its preferred class, which has narrowed its preferred-share discount to 20%. We're hopeful that more Korean companies follow that playbook.

In Amorepacific's case, it's worth pointing out that a big discount based on voting rights doesn't make a lot of sense at a company that is essentially family controlled. Suh Kyung-bae, the chairman and son of the founder, has nearly \$2 billion in net worth in the company's shares, controlling 48% of the vote. Significant skin in the game to us is a big positive and the stewardship here we believe has been quite good.

From beauty products to aerospace, explain the upside you see in France-based Safran [SAF:FP].

JB: Safran is a leading manufacturer of commercial-aircraft components, including jet engines, landing gear and wiring systems. It's also a top maker of military-aircraft, helicopter and rocket engines.

The crown jewel of the portfolio is its narrow-body jet-engine business called CFM International, which is a 50/50 joint venture with General Electric. CFM has produced 78% of all narrow-body jet engines over the last 20 years, and it com-

petes in what is essentially a duopoly with United Technologies' Pratt & Whitney division. This is a business with a tremendous tailwind, as the company estimates that to replace scrapped aircraft and to satisfy increasing passenger demand, nearly 40,000 new commercial aircraft will be put into service over the next 20 years. To put that in perspective, the number of commercial aircraft in service today is roughly 26,000.

To maintain its competitive position, Safran overall spends 11% of revenues on research and development. Returns on invested capital have been better than 17% over the past decade, far ahead of the cost of capital.

There are two primary investor concerns about the company today. One is around the transition to the next-generation Leading-Edge Aviation Propulsion (LEAP) jet engine, which compared to its predecessor delivers 15% lower fuel consumption and carbon-dioxide emissions, as well as dramatic reductions in noise. Orders to date have been excellent, representing more than eight years of production, but the economics don't look great early on. The product is sold at a loss until production reaches scale, and even at scale most commercial aircraft engines are sold near breakeven. That said, the LEAP's predecessor, the CFM 56, was quite profitable at maturity and management expects LEAP engines to be more profitable in the early years than the CFM 56. The real money, however, is made on the roughly 25 years of high-margin replacement parts and service business that follows the sale. We've been through disruptions like this around big-ticket aerospace items before. While the market may get hung up on things like the timing of the production ramp, we expect that with patience the LEAP product line will generate a tremendous amount of value over time.

PE: The second concern is the acquisition earlier this year of Zodiac Aerospace, an underperforming manufacturer of aircraft interiors and other equipment. Primarily due to problems with a supply contract for

INVESTMENT SNAPSHOT

Safran

(Paris: SAF)

Business: Global manufacturer of engines, landing gear, seating systems and other components used in the original-equipment production of commercial and military aircraft.

Share Information

(@6/29/18, Exchange Rate: \$1 = €0.85):

Price	€104.05
52-Week Range	€78.94 – €105.35
Dividend Yield	1.6%
Market Cap	€45.36 billion

Financials (TTM):

Revenue	€17.08 billion
Operating Profit Margin	15.9%
Net Profit Margin	28.0%

Valuation Metrics

(@6/29/18):

	SAF	S&P 500
P/E (TTM)	9.1	24.0
Forward P/E (Est.)	19.2	17.2

Largest Institutional Owners

(@3/31/18 or latest filing):

Company	% Owned
Ostrum Asset Mgmt	5.0%
BlackRock	2.8%
Vanguard Group	1.8%
Harris Assoc	1.6%
Tweedy, Browne	1.1%

Short Interest (as of 6/15/18):

Shares Short/Float n/a

SAF PRICE HISTORY



THE BOTTOM LINE

The transition to a new jet-engine platform and a troubled recent acquisition should prove to be only passing earnings depressants for the company, says Pat English. If that turns out to be true, he believes it over the next three to four years can generate mid- to high-teens annual earnings growth, which will translate into comparable shareholder returns.

Sources: Company reports, other publicly available information

the Airbus A350, Zodiac's interiors business is losing money today, in an industry where top competitor B/E Aerospace earns operating margins approaching 20%. We don't think there's any structural reason why Zodiac can't one day earn 10-15% margins, and Safran has promised €200 million in cost synergies from the acquisition over four years. So while the market currently views this as a troubled acquisition, if they can get Zodiac to even 10% margins, this would turn out to be an attractive deal. If they can get it to 15% margins, that would add €1 per share to

earnings, which is more than 20% of this year's expected EPS.

What sort of return do you expect on the shares from today's price of €104?

PE: We originally invested at 17x earnings, but the shares now go for closer to 19x consensus 2019 EPS estimates, which is a modest premium to the historical range.

Assuming over the next three or four years an improvement in Zodiac margins toward a normal level and the reversal of the 200-basis-point erosion in operating-

profit margins from the LEAP transition, we believe earnings here can grow at a mid- to high-teens rate for a few years before moderating somewhat to a more normalized 10% annual level. If that happens, today's multiple would be more than reasonable and we'd expect our return on the shares to approximate the rate of earnings growth.

Describe the typical reasons you sell out of a position, as well as an example or two of recently doing so.

PE: I'd say 80% of our selling is due to valuation going beyond what we think is reasonable. We're looking at historical valuation relationships and when a stock gets to one to one-and-a-half standard deviations above what we think is normal for the business, we're usually moving it out of the portfolio. We own Accenture [ACN], a business we like very much, but the P/E multiple from when we bought it has gone up more than 50%. Is the business better than when we bought it? We think so. Is there still continued margin-expansion opportunity there? Probably. But everything comes at a price and this is a name where we're much closer to taking profits than adding to.

The rest of the time we're selling it's typically because we just got the thesis wrong or something important has changed. One example of the latter is Brookfield Asset Management [BAM], where we concluded the story had gotten too hard to analyze. It had been a decent investment for us, but we think the pace of change – going into new investment areas, doing more complicated deals – is too rapid and challenges their ability to manage it all well. I always say you don't get extra points for complexity, so we decided to take profits and move on.

Can you generalize at all about the types of mistakes you've made over time?

PE: We analyze every stock we own and try to categorize why this one or that one turned out to be a dog. I'm sure we've

made just about every mistake in the book, but it turns out our biggest losers have tended to be in stocks that went the wrong way, we bought more, they continued to go the wrong way, and maybe we bought more again. It's perfectly natural: we think we know what we're doing and have had some success, so why not go out and buy more when something we like goes against us? Be that as it may, we've learned to be much more careful than we used to be in adding to names. We'll now more often than not let the dust settle and have more patience before adding to the

position. I think we're better off because of that.

Like most value investors, you tend to shine much more in troubled rather than blessed markets. Are you well prepared for trouble today?

PE: We've added value both through bad markets and by reloading in those bad markets in preparation for when markets start to recover. Where we tend to lag is when a bull market goes on and on and on, like we have today.

In the FMI International Fund we have around 15% in cash and a fair amount in what we consider very defensive consumer-products names, like Nestle [NESN:SW] and Unilever [ULVR:LN]. As other investors gravitate to those types of names in a downturn, we'll likely be selling them to raise cash, giving us somewhere between 20% and 30% of the portfolio in dry powder to really pounce when values present themselves. Rest assured that will happen again. VII

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For more information about the FMI Funds, call 1-800-811-5311 for a free Prospectus or Summary Prospectus. Please read these Prospectuses carefully to consider the investment objectives, risks, charges and expenses, before investing or sending money. These Prospectuses contain this and more information about the FMI Funds. Please read the Prospectuses or Summary Prospectuses carefully before investing.

Risks associated with investing in the FMI International Fund are: Stock Market Risk, Non-Diversification Risk (Non-Diversified funds are subject to higher volatility than funds that are invested more broadly), Value Investing Risk, Foreign Securities Risk (fluctuation of currency, different financial standards, and political instability), Geographic Concentration Risk, Currency Hedging Risk, Large Capitalization Companies Risk and Liquidity Risk.

For details regarding these risks, please refer to the Fund's Summary Prospectus dated January 31, 2018 and supplemented on March 19, 2018 or the Statutory Prospectus dated January 31, 2018 and supplemented on March 19, 2018 and December 28, 2018.

As of the Fund's Prospectus dated January 31, 2018 and supplemented on March 19, 2018 and December 28, 2018, the FMI International Funds' Investor Class annual operating expense ratio is 0.91% and the Institutional Class annual operating expense ratio is 0.77%.

The Standard and Poor's 500 Index consists of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The Standard & Poor's Ratings Group designates the stock to be included in the Index on a statistical basis. A particular stock's weighting in the Index is based on its relative total market value (i.e., its market price per share times the number of shares outstanding). Stocks may be added or deleted from the Index from time to time.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI EAFE Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. The MSCI EAFE Index is unmanaged and investors cannot invest directly in the Index. Index results are inclusive of dividends and net of foreign withholding taxes. The reported figures include reinvestment of dividends and capital gains distributions and do not reflect any fees or expenses.

The MSCI EAFE Index is calculated in local currency (LOC) as well as in U.S. Dollars (USD). The concept of a LOC calculation excludes the impact of currency fluctuations. All currencies of listing are considered in the Index calculation in LOC where current prices (t) and previous day prices (t-1) are converted into USD using the same exchange rate (exchange rate t-1) in the numerator and denominator. As a consequence, the FX factor drops out of the equation. The USD calculation includes exchange rates at t and t-1. Therefore, the LOC calculation only represents the price appreciation or depreciation of the securities, whereas the USD calculation also accounts for the performance of the currency (or currencies) relative to the USD.

MSCI EAFE is a service mark of MSCI Barra.

All indices are unmanaged. It is not possible to invest directly into an index.

As of December 31, 2018, the holdings mentioned in the article represent the below stated percentage of the FMI International Fund:

Security Name	Percentage of Total Net Assets
Accenture PLC	3.3
Adecco Group AG	2.3
Amorepacific Corp. Preferred	1.7
Henkel AG & Co. KGaA	3.7
Merlin Entertainments PLC	1.9
Nestle` S.A.	3.2
Nutrien Ltd.	2.9
Safran S.A.	2.6
Samsung Electronics Co. Ltd. Preferred	3.4
Smith & Nephew PLC	2.5
Unilever PLC	2.4
Whitbread PLC	4.8
WPP PLC	1.6

GLOSSARY

EBITDA - Earnings Before Interest Taxes Depreciation and Amortization is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

EV/EBITDA - Enterprise Value to Earnings Before Interest Taxes Depreciation and Amortization is a measure of the value of a stock that compares a company's enterprise value (market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents) to its earnings before interest taxes depreciation and amortization. EV/EBITDA is one of several fundamental indicators that investors use to determine whether a stock is priced well. The EV/EBITDA multiple is also often used to determine a company's valuation in the case of a potential acquisition.

Price-to-earnings ratio - The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

ROIC - Return on Invested Capital - a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns.

Reference definitions found at Investopedia.com

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