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Missive

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Looking for the Outsiders

William Thorndike's book *The Outsiders* has been considered a classic for some time now. His story teaches readers about the business performance of Henry Singleton, Katherine Graham, John Malone and Daniel Burke. These are people who weren't household names like Jack Welch, but produced results that would make any investors feel jealous of the success they had. At a moment like today where the world seems vastly different than where we have been for much of the last decade, we would like to use this piece as a way to remind ourselves where *The Outsiders* may sit and provide an example of ones that we've witnessed, but others don't recognize.

In the appendix of the book, Thorndike lays out a way of thinking about value creation of a successful executive. For each $1 dollar of retained earnings, does it generate at least $1 in shareholder value? This creates two outcomes for the capital allocator of a business. Don't overpay to create value and find investments that drive higher returns. It's harder than you think, especially in a world where many things are so expensive. To further play on the past of Warren Buffett, I'd like to go to last year's Berkshire Hathaway Annual Shareholder Meeting, "Woodstock for Capitalists" as they call it.

> *WARREN BUFFETT: Yeah. Well, I can say this. If you follow sound banking methods, which means not doing some things that other people do, a bank can be a perfectly decent investment. And in fact, Charlie and I, well, me originally in 1969, we bought a bank at Berkshire. And we had $19 million invested in that bank. And we had $17 million I think invested in our insurance companies. And if the Banking Holding Company Act of 1970 hadn't been passed, we might've ended up owning a lot of banks instead of a lot of insurance companies. We were looking at more banks, and Harry Keefe was taking us around Chicago. And there were other things we could do. And then, bingo, they passed the 1970 Bank Holding Company Act, and we had to divest ourselves of that bank in ten years, which we did —*
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> *(a few moments later)*
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> *WARREN BUFFETT: Yeah, and we were going to buy more banks.*
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> *CHARLIE MUNGER: And we were forced out of it.*
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> *WARREN BUFFETT: We were going to buy more banks. And if we bought more banks, we probably wouldn't have expanded the insurance business. But, you know, the law changed and so we divested, and we've done OK in insurance. But banking was more attractive to us. It was bigger and there were more targets to buy. And you could run a perfectly sound bank then, and no negotiable certificates of deposit. All these things, all the inventions that came later, and you could still run them today and you could earn good money. Very good money. And we would've found more banks. But we're precluded from doing that.*

Warren and Charlie were arguing that they don't have the ability to have a large ownership of a bank because they don't want to be subject to bank holding rules. What a blessing! Some of the smartest investors in the world can't own banks in a meaningful way. The secret to life is weak competition. Having them excluded is a great start when looking for *The Outsiders*.

Warren and Charlie's stewardship of Berkshire Hathaway is just one example that sits in *The Outsiders* by Thorndike. The problem is that everyone knows this. Can we find an Outsider, can they generate more than $1 of value per $1 of retained earnings and, by chance, can we find this in an arena like banks?

Enter Andrea Orcel stage left. Mr. Orcel took over UniCredit (UCG IM) in the Spring of 2021. He came in with some hair as he was slated to run Santander, but was abruptly not hired. He eventually was hired at UniCredit with a pending lawsuit against Santander. Orcel came in and communicated two simple things. Yes, he was a banker, but he would only do deals if it was accretive to shareholders.

At the time, the ECB had been performing its first approvals of stock buybacks for European banks. Second, Mr. Orcel communicated that a large portion of their excess capital would go towards share buy backs. He was doing this at a book multiple of 0.40 or 40% of the book value. We have calculated that UniCredit has retained roughly $11.8 billion of capital from net income (in USD) since 6/30/2021. The share count has gone from 2.226 billion shares to 1.702 billion shares during that time. The market cap has gone from $26.2 billion (in USD) on 6/30/2021 to $46.3 billion (in USD) as of 12/31/2023.

In US Dollar terms, Andrea has retained $11.8 billion of the earnings and created $20.41 billion of value for shareholders. The Buffett Test in Thorndike's Appendix says it's a ratio of 1.73 of value per $1 of retained earnings. Are we surprised that there is talk in Switzerland for him to go to Paradeplatz to run UBS if their current CEO retires? No. Orcel is one of *The Outsiders* and knows how to allocate capital to create wealth for shareholders.

Today, UniCredit trades at .88 times book value or 88% of the stated book value. Remember, it started at below half of that. The power of capital allocation can greatly change how the outside views a

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business when the right person is making decisions. At the current book multiple, we expect UniCredit to continue to buy back their own shares, particularly now that they are generating return-on-equity (ROE) of greater than 10%. They didn't have returns this high when Andrea first joined.

His next act as one of *The Outsiders* will be to fully acquire other banks, once UniCredit trades at a premium to book value. He can do stock or cash plus stock deals to create value at that point. He has been very public in his comments to say that he won't acquire until the stock price reflects the value of the assets. Do we know he is sensitive to price? Yeah, he bought 9% of Alpha Bank, a Greek bank, at a price to book multiple of 0.50. That bank now trades at a book multiple of 0.55, producing roughly 9% ROE. Begins to remind us where UniCredit has been. The only thing missing is an executive buying back stock at Alpha Bank. Maybe a bigger company would want to do that? Andrea may know of one.

Is Andrea Orcel the only company that looks like they have one of *The Outsiders* running their business? No. What the Schoen's are doing at U-Haul (UHAL US) looks misunderstood. What Anas is doing at the Austrian bank Bawag (BG AV) looks like no one cares. What Ken Booth has done and is doing at Credit Acceptance Corp. (CACC US) makes you very interested to look past whatever politician wants to use their business model as a tool of class warfare. Do we count ourselves alongside Buffett in seeing the attractiveness of US banks? Yes, our best guess is that another set of *The Outsiders* are sitting at Western Alliance Bank under Ken Vecchione's leadership.

While we do not expect investors to fall in love with these companies and capital allocators soon, we believe it will be like Mick Jagger said, "Time is on our side." The industries of US banking, European banking, self-storage and sub-prime auto credit don't exactly scream sexy. It reminds us more of the spread businesses of the mob. Our job isn't to decide where the opportunity is. Our eight criteria for common stock selection allows our investors to take advantage of what Mr. Market gives us. It is our guide as we are looking for *The Outsiders*.

Fear stock market failure,

Cole Smead, CFA
CEO & Portfolio Manager

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