SMEAD capital management

Newsletter

SMEAD INTERNATIONAL VALUE — 4TH QUARTER 2024 (12/31/2024)

Paku Paku: Swallowing Like Pac-Man

Pac-Man was released in the second half of 1980. Out of the gate, it became an obvious commercial success that has endured decades of change in society and technology. Pac-Man derives from the Japanese phrase "paku paku (パクパク)" which translates to "gobbling something up." This is intriguing to the investors of Smead Capital Management because we have always talked about share buybacks as companies swallowing themselves. When we see companies buying a lot of shares over time, we comment on this buying saying that it's like they are playing Pac-Man.

Investors and management teams often forget that the stock market isn't a game of you versus them. It's a game of you versus you. Mr. Market comes to you every day with a price for each company. Sometimes he's depressed and scared. Sometimes he's excited and euphoric, as we see among big US stocks. Mr. Market is not there to instruct you. His manic performance is something you can take advantage of or not. It really depends on how you seek to exploit him.

We have seen a very recent example of this in the Smead International Value Fund. We began purchasing shares in Unicredit (UCG IM) in the third quarter of 2022. The CEO, Andrea Orcel, was communicating that he disagreed with the valuation of the business and believed the best allocation of capital was large stock buybacks on behalf of shareholders. Large buybacks in European banks were unprecedented at that time. It was viewed to be what the American banks did.

Fast forward, Unicredit has reduced their shares outstanding by 19.4% from the end of the third quarter of 2022 to the third quarter of 2024. Since these were at depressed prices and the return on equity (ROE) of the underlying business has improved, it has provided financial leverage to the shareholders who were patient for this reward. Some chose to sell and those shares were deleted. The stock has gone from a high single-digit price, up to the high 30s, and is in the low 40s today (in Euros). It doesn't seem that Mr. Market understood what the opportunity was. He was selling the company shares at far too cheap and he was scared.

The takeaways for this would be to find a business with high current excess capital (unencumbered cash) and/or a business that is generating higher returns than their more recent past. You'd want to find a business that Mr. Market has become more depressed about, for whatever reason. You'd also want to find a management team that has begun to show that they like to play Pac-Man with the shares in the open market and it hasn't become obvious to Mr. Market that they could gobble themselves up.

This brings us to an opportunity in Japan. There has been much talk about the change that would come in Japan over the last five years. Much of this arose from the late Shinzo Abe's three arrows of Abenomics. A key pillar of this has been driving Japanese companies to change the practices of the past. The Tokyo Stock Exchange adopted a rule of focusing on ROE as a metric for Japanese companies. While ROE may not be the best metric for levered businesses, we do like the focus on returns by the powers that be in the Japanese stock market. Lastly, many Japanese companies have begun to perform their first buybacks ever!!! We know that sounds crazy to say, so will reiterate it. Japanese companies are testing their first-ever buyback announcements right now in the year 2025 in many cases.

Over the last year, the current views of the auto business have become very dark. We've seen everything from Volkswagen (VOW3 GR), which we own, seeking drastic changes to its German labor to Nissan possibly disappearing in a merger. Mr. Market is very scared of the space. If we could find a business in this cyclical industry that produces attractive returns and has no capital risk, we'd be interested. If we could get good capital allocation on top of that, we'd be elated. Mr. Market again is very depressed.

Enter Subaru (7270 JT) stage left. We will be the first to say that we have not been customers of the brand in the past. However, we're from Seattle where there is a customer base of outdoor enthusiasts and fans of crossover wagons that could be confused with a cult. They created the category of crossover SUVs, in our opinion, and have been a dominant brand that fetches higher valuation whenever dealerships choose to sell amongst each other.

Subaru currently trades for roughly the net cash on their balance sheet. Like we said earlier, there is an abundance of excess capital. The current long-term debt could be paid off with a little more than one year of free cash flow. This would be true even if the all the current cash was sent back to the shareholders. Excess capital on the balance sheet and a plausible excess amount in the future is what we'd hope for.

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Lastly, like other Japanese entities, Subaru has begun to purchase shares back. We would argue that they are making a splash with this tool. In the third quarter of 2024, Subaru repurchased 13.6 million shares back, which is 1.82% of the shares they started the quarter with. If this was a regular practice for them, we could see large gains by taking advantage of Mr. Market not seeing how powerful this tax-free transfer of ownership from him to us as shareholders may be. Remember, the governments of the world make money on dividends and we get the remainder. On buybacks, we get it all.

As investors we should feel elated that we are coming full circle on the story of Pac-Man. A game that was invented in Japan based on paku paku, gobbling something up, has become the principle for understanding a great Japanese brand and addicted consumer base. Even if Subaru isn't adamant about their buyback, we could still get most of our capital back in a dividend. Even after that less effective return of capital, we'd still wake up with a business producing over 30% returns on book value from free cash flow. The difference with the arcade version of Pac-Man is the investing game never has to end and we don't have to give up 25 cents as we watch these companies attempt to exact the Smead investors' version of paku paku.

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The recent growth in the stock market has helped to produce short-term returns for some asset classes that are not typical and may not continue in the future. Margin of safety is the difference between the intrinsic value of a stock and its market price. The price-earnings ratio (P/E Ratio or P/E Multiple) measures a company's current share price relative to its per-share earnings. Alpha is a measure of performance on a risk-adjusted basis. Beta is a measure of the volatility of a security or a portfolio in comparison to the market. Growth investing is focused on the growth of an investor's capital. Leverage is using borrowed money to increase the potential return of an investment. Momentum is the rate of acceleration of a security's price or volume. The earnings yield refers to the earnings per share for the most recent 12-month period divided by the current market price per share. Profit margin is calculated by dividing net profits by net sales. Quality is assessed based on soft (e.g. management credibility) and hard criteria (e.g. balance sheet stability). Value is an investment tactic where stocks are selected which appear to trade for less than their intrinsic values. The dividend yield is the ratio of a company's annual dividend compared to its share price.

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