



# Newsletter

SMEAD INTERNATIONAL VALUE — 3RD QUARTER 2025 (9/30/2025)

## Scaling Old Industries

It is not uncommon for investors to want to scale new businesses. We are currently seeing it in the AI story, where businesses are trying to find new customers and gain scale in what is believed to be a burgeoning industry. While there may be a winner, there tend to be many losers when it comes to scaling new industries. We like far more predictability in analyzing companies, which time and time again draws us to old industries. Banking is a roughly 600-year-old industry. The energy industry has been around since the first fire, but the oil business has been around since the 19th century. We will use this letter to explain to the investors of the strategy why these industries currently have so much in common.

Banca Monte dei Paschi di Siena S.p.A. (BMPS) is the world's oldest existing bank since it took its present form in 1624. Italy is the bedrock of banking because Venice is where double-entry accounting was first used in the 15th century. If Italy is the home of modern accounting and banking, you'd probably assume it has been a great performer in the long run. No, it's been mostly a basket case, including BMPS being subject to numerous bailouts by the Italian government.

This example teaches us that industries don't change on their own. History argues that someone steps up to the microphone, does something unique in banking and everyone plays copycat. Unicredit (UCG IM) has been a model of this copycat game. Banks take in deposits and lend them out to collect the spread. This is referred to as net interest margins. This is a key income-generating part of most banks. Beyond this, you'd want to understand how efficiently they produce this income.

In the past, big costs to a bank included their branch employees, the lease for the branch, the cost to move cash deposits and the company overhead for running the branches across the bank. Now, locations and people in the branches are less important to today's bank customer, a nice cost reduction benefit for banks. However, banks have digitized their accounting ledger and the hosting of customer data has become a much bigger investment. Those that have scale can make this an annual operating expense. Smaller banks will struggle with these costs in comparison.

In discussions our firm has had with Andrea Orcel, CEO of Unicredit, he has explained how important his bank's operating platform is and the investments they've made. We have seen how their partial ownership of Alpha Bank in Greece has improved the technology spending of that bank as they have been able to leverage Unicredit's agreements to save cost in hosting and software. This cost savings is where the industry is headed. Scaled players become part or whole owners of another bank. They are able to reduce the cost of operating the acquired bank and the combined businesses run a higher return on equity. This is the simple math that Orcel has been seeking to enact in European banks, including his investment in Commerzbank, while the Germans drag their feet.

The oil business is seeing the same thing. Our ownership of MEG Energy (MEG CN) has been the talk of the town in Calgary and parts of New York's merger arbitrage desks over the last 90 days. MEG was put in play by another company we own, Strathcona Resources (SCR CN) in May. Another holding of ours, Cenovus Energy (CVE CN), has made a rival offer that taught us all what we need to know about the financial attractiveness to scale a couple of oil companies in a merger.

In their presentation to investors in August, Cenovus communicated that they expected \$400 million in annual savings when you combine the two businesses. This is a massive number as MEG only does \$3 billion in revenues. It would roughly double the returns on capital for MEG over the last 12 months.

For pre-tax cost savings like this, an investor may give this a multiple of about eight times the cost savings to understand the long-term value obtained. This would be \$3.2 billion CAD as of MEG's price on September 30, 2025. This represents about 45% of MEG's market cap while they are in an open auction taking their price higher. This \$3.2 billion CAD doesn't include the \$600 million CAD tax benefit that Cenovus would recognize in the next 12 months from existing net operating losses that MEG also has.

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Adam Waterous, Chairman of SCR, has been very aware of this value and has done an excellent job of communicating the value creation in the oil and gas business like Orcel has in banking. While Cenovus's two offers (as of this writing) have landed below \$30 per share, Adam has talked about \$42 per share in statements he has made publicly. Why would he talk of such large numbers? He is directly communicating how much value creation there is in a transaction for MEG. SCR's last offer for MEG sits close to \$30, but the value of MEG is only going up as this auction works itself out. Our interest for our investors is an all-stock offer that defers capital gains from the highest price bidder. At this point, that continues to look like it will be SCR. Adam is willing to share more of the value unlocked from that \$3.2 billion in the merger, which ultimately benefits current SCR and MEG holders if he is successful.

We were reminded of these small savings that compound each other over time. In John Malone's biography *Born to be Wired*, he explains what the edges of scale brought to the cable industry. Malone's cable operator initially had a lower cost of buying the equipment to roll out to their customers. You then added geography to extend these savings to more customers, which allowed you to pay a higher price to

sellers in geographies you wanted to acquire. Later, this allowed them to leverage their cable business, TCI, into the lowest cost content agreements, or in many cases, equity stakes in content they agreed to provide first. TCI was 20% of the cable customers in the US by then. Scale provided different benefits at different moments.

As we watch Orcel at Unicredit or Waterous at Strathcona, we see what scale does for their companies as they seek to be acquisitive in recognizing value. The patterns that we discussed in this letter are not new in business. It's just fairly new for industries like European banking and the oil business. We see leaders like Orcel and Waterous as unique capital allocators and have others among our holdings like Anas Abuzaakouk at Bawag (BG AV) or John Fredriksen at Frontline (FRO NO). These individuals should make us all, as fellow investors, excited to be scaling old industries.

Play The Long Game,



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Lead Portfolio Manager



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# Invest With Us Today!

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