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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Midcaps Using a Long-Term Intrinsic Value Philosophy

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SECTOR — GENERAL INVESTING

TWST: Could you please identify yourself?

Mr. Welch: This is Chris Welch. I am the Lead Manager on the Mid Cap strategy at Diamond Hill Capital Management, and also Co-Chief Investment Officer at the firm.

TWST: And could you tell me a little bit about the firm and its history?

Mr. Welch: Sure. Diamond Hill was founded in 2000, and it's grown to over $21 billion in assets under management in both equities and fixed income. And all of our strategies are based on a long-term intrinsic value investment philosophy. I joined the firm in 2005 and had worked with a number of our portfolio managers at a prior employer in the 1990s.

TWST: And does the firm have a unique investment philosophy, or is there a unique philosophy on the funds you work on?

Mr. Welch: We do. We have a long-term intrinsic value investment philosophy. So in carrying out that philosophy, we estimate the intrinsic value of companies based on the future cash flows that they generate and adjusting those cash flows for the risk involved in producing them. We always take a long-term time horizon when we do that. We always model companies over a five-year time horizon. We apply a terminal valuation and then we discount back at an appropriate rate. And our estimates are based on the independent research of our analyst team. We have 30 industry research analysts and associates that use a variety of sources of independent research to form their estimates. And importantly, the long-term time horizon is really a crucial part of what we do.

TWST: Do you want to highlight a stock you find interesting now?

Mr. Welch: Yes. Generally speaking, it's been a little more difficult to find a lot of attractive stocks in the current marketplace due to high valuations, but we have found some individual opportunities. We use a bottom-up stock selection process. And one company that we bought for the Diamond Hill Mid Cap portfolio about a year ago is Red Rock Resorts (NASDAQ:RRR). And they're the leading local gaming company in Las Vegas, and they have a loyalty program that nearly half of local residents have joined, and those members go to a Red Rock property multiple times per month. The stock has been held back by some capital spending that they're putting into place to improve both some of their existing properties as well as the Palms Casino Resort which they acquired about a year ago. And with the five-year time horizon, the company has the potential to generate a significant increase in profits, and we believe the stock deserves a higher valuation.

TWST: And is there something on the horizon for them that might be interesting to investors?

Mr. Welch: I think it's really — and this is often the case for a lot of our investments — it's just a matter of time. We know that they have a very strong position in the local market. They have more than a 40% share of local Las Vegas residents in terms of the gaming market, people who aren't going to typically go to the Strip for their gaming and entertainment, but are going to go to local properties. So they have a very strong market share.

Their earnings are being held back because of some near-term capital investments. If your time horizon is beyond 12 months, then you can see a significant increase in earnings; but if your time horizon is three or six or 12 months, then you don't see that increase, so it may look less interesting. So that's quite often a characteristic of the type of investments that Diamond Hill invests in, something that may take more than a year to actually see the benefits for investors, but with our long-term time horizon we're able to add value for clients by taking that longer view.

TWST: And most of their focus is on the Las Vegas operations as opposed to different parts of the country?

Mr. Welch: That's right. They have a couple of management agreements with Native American casinos where they don't actually own the property, they just manage them. But those are smaller contracts. It's a much smaller portion of their business. So yes, the overwhelming majority of their business is managing Las Vegas casinos that are primarily patronized by local residents.

TWST: And the outlook for the casino industry in Las Vegas is pretty solid for the next few years?

Mr. Welch: It is. Las Vegas had, during the housing bubble 10 years ago, there were a lot of construction workers because the housing market was growing so quickly. That caused there to be a sharp upward trend followed by a sharp downward trend, but the economic expansion in Las Vegas is much more balanced now. The housing market has recovered, but it's not, in our opinion, in a bubble situation. You just had a new hockey team go there to Las Vegas that just started playing. You've had a NFL football team that's looking to relocate there. So there is a lot of activity going on in that Las Vegas market that should bring more people to that local market which should be a benefit for Red Rock.

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TWST: Did you want to mention a second company?

Mr. Welch: Sure. A stock in the financial industry that we bought about a year and a half ago is Discover Financial Services (NYSE:DFS). And they're focused on lending to prime customers in their credit card business, so that reduces the risk that would come with subprime lending. They've done a nice job of lowering their funding costs by growing their direct banking business over the years, and they also have a growing student loan business that they acquired from Citigroup (NYSE:C) during the financial crisis period that's been doing quite well for them. And also, their Discover Network has some potential optionality if a larger financial institution would ever look to acquire the company. So financials has been an area where we've tended to find more opportunities in the past few years, and Discover is one that stands out as being attractively valued.

Highlights

Chris Welch talks about his firm's Mid Cap strategy. He says this strategy, like all others at the firm, is based on a long-term intrinsic value investment philosophy. Mr. Welch focuses on bottom-up stock selection and always takes a long-term time horizon. He talks about a few individual opportunities in the marketplace which occur in sectors such as gaming, finance and semiconductors..
Companies include: Red Rock Resorts (NASDAQ:RRR); Discover Financial Services (NYSE:DFS); Citigroup (NYSE:C); CubeSmart (NYSE:CUBE); Avnet (NYSE:AVT); Analog Devices (NASDAQ:ADI); General Motors Company (NYSE:GM); Arrow Electronics (NYSE:ARW); SYSCO Corporation (NYSE:SYY) and US Foods Holding Corp (NYSE:USFD).

TWST: And it sounds like it's sort of tried to create a niche for itself among the different larger players. Does that sound right?

Mr. Welch: Yes, there are a number of large credit card companies that have different focuses. Discover has been very disciplined, in our opinion, in terms of their lending; in terms of being responsible, extending credit in a responsible way so that if there is any kind of downturn in the economy that they will be more protected and have less severe losses perhaps than some competitors who have been more aggressive in their lending.

TWST: And does it look promising too, if there isn't a downturn, that Millennials are starting to get jobs and starting to pay off their student loans, so they might have more money to spend, and is that potentially a target group for them?

Mr. Welch: Yes, they've actually had good results with Millennials through their student loan efforts. That's been a growing area for them, and as there has been some disruption in that market, they've had good opportunities to lend to students, get attractive returns, and then whether it's their student loan business or their credit card business, the continued steady — modest but steady economic growth — the decreasing unemployment has been very favorable for consumer credit status. So losses have been very low, and a continuation of that trend of low losses would certainly be the best scenario for Discover. But they manage their business hoping for strong economic conditions and low losses, but also ensuring that if there is a downturn that they won't get hit too hard, and we think they've done that effectively.

TWST: And from what I understand, a lot of the credit card companies have been implementing new technology to make operations more efficient; have they done it too at Discover?

Mr. Welch: They have. Actually, an area where they've expanded their technology a lot is in their direct banking business. They are getting deposits from people, and they've been kind of approaching Millennials in some ways just by giving them the chance to do all their banking over the internet. So they don't have branches that people go to in their neighborhood to make deposits or get services because they are doing everything over the internet. And because they don't have the branches they're able to have lower costs, and so they can offer more favorable rates, and they've had a good amount of growth in their deposits. These deposits have been cheaper than getting deposits at bank branches, and that's allowed them to expand their profit margins, and that's improved their total returns.

TWST: And did you want to mention another company?

Mr. Welch: Sure. CubeSmart is a storage REIT (NYSE:CUBE). We bought it for the Mid Cap portfolio about a year ago. The company got a new management team a few years back, and they upgraded the quality of their portfolio and their customer service, and they also reduced the leverage on the balance sheet. They have a strong position in the greater New York City market, and that market is somewhat more supply constrained than some other geographies which helps their pricing. So the stock will vary due to interest rates in the short term, but valuation and business fundamentals will be the main drivers over our five-year time horizon.

TWST: And it's a more specific way to invest in a REIT? It's a specific sector within a REIT?

Mr. Welch: Right, they're just offering storage facilities. So when people have disruptions in their life — whether it's divorce, disaster like the recent hurricanes, downsizing for various reasons, or death of a family member — they may need a storage facility. And it generally has been a good business because oftentimes people get these storage facilities, they just continue to pay on a monthly basis, and the collections are not all that difficult in many cases. It's a steady cash flow business.

And then the question is, how do you differentiate yourself from other providers of this service? One aspect is being in areas where it's difficult for other competitors to build new supply, and the New York City market is one of those areas. Another aspect is by providing better services to your customers — having internet availability, having strong customer service if people call with questions, having other services that they can add on, and then there are some advertising economies of scale when you have a certain size within a market.

1-Year Daily Chart of Red Rock Resorts Inc

Chart provided by www.BigCharts.com

"It generally has been a good business because oftentimes people get these storage facilities, they just continue to pay on a monthly basis, and the collections are not all that difficult in many cases."

TWST: And did you want to mention another company?

Mr. Welch: Sure. Avnet (NYSE:AVT) is a company that we bought in the second quarter of this year, and it's a semiconductor distributor that had dropped sharply due to a couple pieces of disappointing news. They struggled with an ERP, enterprise resource planning, software implementation in the U.S. that was hurting their profits and cash flows in the short term. Then also consolidation in the industry caused a loss of a couple of higher-profit customers, and that caused the company to reduce their earnings guidance.

While the customer loss was disappointing, we believe the company still offers a good valuation proposition to its customers, and we think the stock overcorrected. It will take them a number of quarters to fix the ERP issue, but with our long-term investment horizon, we think we'll be more than compensated for sticking with the stock during this period. So it's similar to what I mentioned about Red Rock Resorts. There is some near-term bad news, but we think in the longer term, the outlook is pretty bright.

TWST: And what are some of the target groups that Avnet sells to?

Mr. Welch: So they will take in products, and I'll just give an example from one of the customers that they lost. They would take in products from semiconductor company Analog Devices (NASDAQ:ADI), and they would then sell them. Analog Devices works with a whole variety of industrial and automotive and medical companies. And if Analog Devices is selling to a company like General Motors (NYSE:GM), then they would use their direct sales force. But if they're selling to a smaller industrial company, it might be a couple of thousand dollars a year worth of goods. Analog Devices doesn't want to have a dedicated sales person to work with those smaller customers, so they'll use Avnet. And Avnet will handle the sales process, and they'll walk the customers through what their options are and maybe provide some extra services on top of that.

When Analog Devices merged with Linear Technology, then that combined company moved their business to Arrow (NYSE:ARW), which is the largest competitor to Avnet. But there is still a whole host of semiconductor companies, some larger ones, some smaller ones, and a number of potential purchasers of those devices, whether in the industrial or medical or defense industries. Again, it's generally the smaller or midsized buyers who are using the distributors like Avnet because they're getting some extra services, and they're getting a combination of products that would be too difficult to source on their own.

TWST: Anything on the horizon for Avnet that investors might be interested in?

Mr. Welch: I think the biggest thing will be their success in fixing their enterprise resource planning software implementation. They tried to implement a system in the U.S. over the past year or so and that didn't work out for them, so they needed extra inventory to maintain service levels, preventing cash flows from being used for other purposes. They weren't able to meet their clients' needs as much as they had planned, so they now have a new approach. They are going to use an ERP software program that they've successfully deployed in their international operations, and they are going to implement that in the U.S.

1-Year Daily Chart of CubeSmart

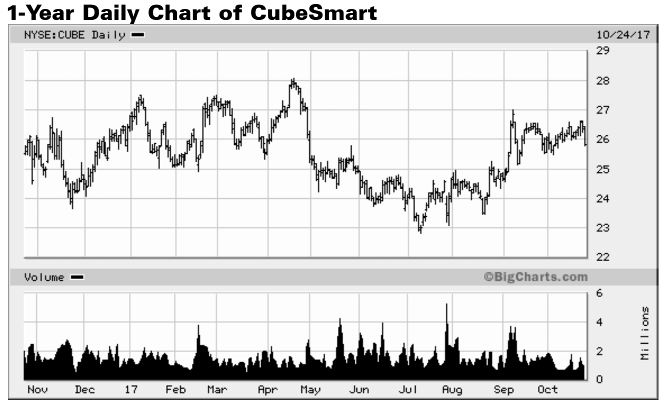

Chart provided by www.BigCharts.com

It's going to be a multiquarter process. Those are very complex systems, and it takes a while to get them in place. But again, over the next two, three, four quarters, you might not see that big increase in efficiency and reduction in the inventory that Avnet has to hold on behalf of their customers. You may not see that in the short term, but if you look out beyond 12 months, then you should start to see some meaningful benefits that should flow through to earnings growth, cash flow growth, and that should be used beneficially for investors.

TWST: And do you want to mention one final company?

Mr. Welch: Yes, and would it be helpful to talk about a company that we sold?

TWST: That would be fine.

Mr. Welch: To give some insight into how we think about selling companies, we sold SYSCO Corporation (NYSE:SYY), the food distributor, earlier this year after holding the stock over three years. We originally bought the company when they were looking to merge/acquire US Foods (NYSE:USFD), and that merger was overturned for antitrust reasons. But SYSCO management has done an excellent job since then: cutting costs, maintaining decent sales growth, and returning more capital to shareholders through dividends and share repurchase. And as the stock approached the mid-50s earlier this year, we sold out of our position and put the proceeds to work in a better opportunity. Typically, when we're selling positions purely for valuation reasons, then we tend to scale out of a position. And if we have concerns about the business fundamentals, then typically we'll sell more aggressively if we lose confidence in those business fundamentals.

TWST: And now changing gears a bit, did you want to talk a little bit about what investors are concerned about as they look at the rest of this year and into next year?

Mr. Welch: Yes. We focus on bottom-up stock selection, and that comes down to a combination of valuation of individual companies, individual stocks as well as the business fundamentals. On a valuation standpoint, stocks are trading at the third-highest valuation of all time by a few different measures including price to sales and total stock market capitalization versus GDP. So these high valuations are supported in part by low interest rates, but it's been hard to find a lot of attractive new opportunities this year, and our turnover rate in the Mid Cap portfolio has declined in part because of that.

On the other hand, business fundamentals are still good. Sales growth overall is modest, but corporate profit margins, net profit margins, remain at or near all-time highs. We're somewhat cautious — this many years into an economic upswing — about assuming further major gains in sales growth and profit margins, but some individual companies have opportunities, and we've talked about some of those today.

TWST: And do you see the Millennials starting to get more involved in the market?

Mr. Welch: Yes. Well, it's interesting. Millennials are getting involved in a number of ways. Some are really taking the time to learn a lot about the business and invest in active managers. Some are investing in passive strategies and just saying they're going to earn market returns. We'll see how that works over time.

I've heard some people say, "I'm not going to take the risk of active management; I'm going to just invest in a passive index." And sometimes it's not clear that people understand that if you invested in a passive index during the financial crisis, you lost 55% to 60% of your money in the S&P 500 from the peak to the trough, and active managers have the opportunity to protect that money. And many of Diamond Hill's strategies, though they had losses, they protected clients' principal better than the indexes did during that downturn in the market. And then we're also seeing a lot of different trends in terms of financial advisers, robo-advisers, things like that. I haven't focused on that as much, but certainly Millennials are getting involved in a lot of different ways.

TWST: Thank you. (ES)

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