Value Investor INSIGHT
The Leading Authority on Value Investing
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Pedal to the Metal

Mark Cohen and Raphael Rabin-Havt of Stone House Partners explain why they choose to run such a concentrated portfolio, how they manage through the dramatic ups and downs that high concentration can bring, what change at a company is most likely to attract their interest, and why they think today that Scientific Games and Twitter are mispriced.

Editor's Note: *Mark Cohen of Stone House Partners has built an outstanding performance record since he started his firm in 2010, earning a 22.3% net annualized return, vs. 13.7% for the S&P 500. It has not, however, been a smooth ride. He concentrates on a handful of stocks at a time, usually smallish in market cap and in companies for which the market isn't seeing the value-compounding potential he does. "We're upfront with ourselves and our investors about volatility in the portfolio," he says. "We believe that just goes along with giving ourselves the long-term opportunity to outperform."*

Having originally spoken with us earlier this month about three ideas in his portfolio, Cohen let us know a few days ago that as one idea had fallen in price, Twitter, he had sold out of another we'd discussed to double down further on Twitter. Such is life for a concentrated, high-conviction investor.

You invest in only a handful of stocks at a time. Can you generalize about the characteristics they tend to have in common?

Mark Cohen: We're trying to find businesses with unique products and cultures, large market opportunities, clear and advantaged business models, and leaders who are focused exclusively on creating long-term per-share value. Ideally it's a business not that many people are following, where our primary research into the industry and company can lead to actionable insight. We try to buy when we believe the potential growth in free cash flow per share is much greater than the market thinks, while the probability of permanent capital loss is much lower.

One of the first companies I got to know well as an analyst is Copart [CPRT], the biggest player in salvage auto auctions. It's a unique company founded by a uniquely skilled individual named Willis Johnson, who in 1972 sold his house and used the proceeds along with loans from family members to purchase a car dismantling yard in Rancho Cordova, California.

ON ENDURING VOLATILITY:

We err with investors on the side of being overly communicative rather than not communicative enough.

Soon after, he took over a nearby salvage auction yard and from there he's built Copart into a company with more than $2 billion in annual revenue and a market cap over $25 billion. He turned over the reins as CEO more than 10 years ago, but is still the executive chairman.

A few things stand out about Copart. It's been mostly off Wall Street's radar, primarily because management hasn't seen the need to cultivate relationships with analysts. The company hasn't needed capital to grow and doesn't have a lot of patience for the Street's typically short-term orientation. I've been following the company for more than 16 years and the stock is up more than 25x since then, but never did I hear anyone pitch this as the next 25-bagger investment. Few people saw the long-term potential Willis did to roll up the business and continually improve Copart's relative competitive advantage while doing so.

The business isn't difficult to understand, but to get the ins and outs requires a lot of phone calls and visits with people running local salvage yards, which is the type of research I like to do. Copart also drives home the importance of recognizing and aligning yourself with owner managers who have both the strategic acumen to lead a company forward and also know how to build and maintain a winning culture. Willis always looked for ways to improve the company or make it more efficient, didn't have to come up with an idea to love it, and was willing to sacrifice short-term earnings if he knew it would benefit the company in the long term. He cared that employees were happy and thought if they were they'd always make the extra effort when called upon.

As you can see, I could go on here. Copart is a pretty unique company, but it has a lot of the elements we want to be present in the companies we own. If all of them looked like this I'd be thrilled.

Talk about how you look for ideas.

MC: We have very few hard and fast rules, but we tend to focus on companies based in the U.S. with a couple hundred million to a couple billion dollars in market cap. Everyone wants to buy a great company in a dynamic industry that's run by a gifted founder – and pay a discounted price to boot. We want that too. But the truth is the supply of those companies at very good prices is quite limited.

We often look for companies going through some sort of transition for the better, often accompanied by a change in CEO. We pay a lot of attention when a gifted manager takes a new CEO job and we try to get up to speed quickly to understand what attracted him or her to the opportunity and what changes are likely to come. Turnover at the top is a real catalyst and the market isn't always quick to fully assess what that change can bring.

We'll talk later about our largest holding, Scientific Games [SGMS], but a central part of our thesis revolves around the arrival of Jamie Odell as a special adviser to the board in 2019 and his taking over as Executive Chairman of the company in 2020. He had been the CEO of gaming equipment and systems supplier Aristocrat Leisure from 2009 until 2017, a period in which the company's market cap grew from $1.3 billion to around $7.5 billion. Since he's arrived at Scientific Games, more than 20 key members on the product, operations and sales teams at Aristocrat have joined him. A leader like Jamie Odell coming out of retirement to take a new opportunity is usually going to be interesting to us.

What attracted you to TravelCenters of America [TA], a position you put on in the third quarter of last year.

MC: This is the third-largest player in the truck-stop business in the U.S., behind two privately held companies, Love's Travel Stops and Pilot Flying J Travel Centers. These are businesses with large sites in prime locations that naturally enjoy pretty high barriers to entry. You might remember that Berkshire Hathaway bought just under 40% of Pilot in 2017, with the expectation to take that to 80% by 2023.

Here again, a key driver of our interest was the arrival of a new CEO, Jon Pertchik, in late 2019. After doing diligence, we concluded he had a significant opportunity to improve the company's cash flow on the current revenue base, and also to expand through franchise unit growth.

One sticking point here is the company's convoluted corporate-governance setup. TA is controlled by the Portnoy family. While TA owns about 50 of its locations outright, the Portnoys control the real estate investment trust that is TA's primary landlord. The whole thing is riddled with potential conflicts of interest, but at the multiples we were paying last summer for the stock – about 2x EBITDA – we thought the upside to the downside was very much in our favor just from operating improvements. The stock is still extremely cheap relative to the underlying asset values, but when the price nearly doubled since last summer without any change in corporate governance, we decided to take our money off the table in the first quarter of this year and redeploy it elsewhere.

You've had to endure some pretty sharp drawdowns in putting up so far an excellent record. Were you prepared for that going in?

MC: I try to stay focused on long-term compounding and believe the best way to do that successfully is to own a small number of names in which we're able to develop very high conviction. This obviously can result in considerable volatility, so having a temperament that can handle the short-term ups and downs is key.

We can't do this without investors who fully understand in advance that we very likely will have to ride through rough patches in order to meet our long-term goals. We're extremely transparent with our investors and want to err on the side of being overly communicative rather than not communicative enough. Our investors often own multiple funds like ours, so while each one may not be diversified, their portfolio of investments probably won't be as volatile as any one fund. Nobody feels the pain of a drawdown more than me.

Walk through your broader investment case today for Scientific Games.

MC: The company has two primary businesses. It invented the instant-winner scratch-off lottery and dominates that business as a service provider to lottery sponsors around the world. It used that as a springboard and source of capital to expand into the gaming-equipment business, where it is a leading global supplier of slot machines and other equipment and sys-

Mark Cohen

Getting to Yes

One aspect of investment management that appeals to the entrepreneurially minded is that if you think you're ready, the barriers to starting your own firm aren't that high. There are some legal and administrative costs, but for the most part you can just hang out your shingle, invest whatever money you can cobble together, and start building a track record that you hope will allow your firm to grow and prosper.

The cobbling together of money, of course, isn't always trivial. Mark Cohen faced that when he – not yet 30 and less than five years into his tenure as an analyst for hedge-fund firm Force Capital – decided in 2008 to go out on his own. The financial crisis and ensuing recession made raising money difficult, but his big break on that front came in early 2010 when he went to see Willis Johnson, the founder and chairman of auto-salvage business Copart, who he had gotten to know in following the company for Force Capital. Johnson didn't particularly care about cultivating relationships with Wall Street, but Cohen had made an impression. "He said if you do the type of work on all your companies that you do on me and my company, I think you'll be successful," says Cohen. "It's hard to get that first outside investor to say yes – he was the first one who did."

tems used by casinos. Setting aside 2020 for the moment, in 2019 the land-based gaming business accounted for roughly 65% of that year's $1.3 billion in total EBITDA. The lottery business earned most of the rest, with smaller contributions from high-growth areas of investment including a Netflix-like service for online gaming content and a sports-betting system already used by companies like Wynn, Golden Nugget and FanDuel.

As I mentioned, the watershed event for the company was Jamie Odell's arrival in 2019. While Scientific Games' lottery business is rock solid, grows steadily and generates a lot of cash, the gaming side hasn't been as nimble or innovative in capitalizing on the company's strong intellectual-property heritage or in evolving its product mix to meet evolving customer demands. Doing the latter is what Aristocrat Leisure did so well during Jamie's tenure, and it's a big deal that many of the top product people with him there have joined him at Scientific Games.

Jamie has talked about Scientific Games' broad portfolio of products and differentiated position in digital gaming and sports betting, things he didn't have at Aristocrat. We – and they – see a very large opportunity to increase innovation, operate more effectively and efficiently, generate more recurring revenue, and significantly increase margins and free cash flow on the gaming side of the business. That's not just as the world comes back to normal from the pandemic, but well beyond as well.

The market applauded when financier Ronald Perelman sold his controlling stake in the company last fall. Do you see that as a positive as well?

MC: The existence of a controlling shareholder isn't necessarily a bad thing, but we think it says a lot that Jamie was able to attract such an outstanding group of investors to effectively de-control the company. No one holder today owns more than a 10% stake.

How do you see the product and operating initiatives underway translating into upside for the company's shares, now trading at just over $38?

MC: Driven primarily by broad-based improvements in the core gaming business, we believe the company by 2023 can generate $12 per share in free cash flow. If we're right about that and the business is then firing on all cylinders as we expect, there's no reason that level of profits can't earn at least a 12-13x free-cash-flow multiple. That would result in a $150 share price in two to three years.

This outlook doesn't ascribe much upside to either the online gaming or sports-betting franchises the company continues to build. Those could be substantial businesses and stores of value in their own right one day.

Raphael Rabin-Havt: One other thing to mention here is that the company is currently going through a full strategic review and that there's a possibility it considers selling the lottery business or other assets. We don't have a strong opinion on that, but we would expect the company

INVESTMENT SNAPSHOT

Scientific Games
(Nasdaq: SGMS)

Business: Designs, develops and markets intellectual property and technology systems serving lottery, casino, online gaming and online sports betting industries worldwide.

Share Information (@3/30/21):

Price	**38.18**
52-Week Range	5.51 – 52.88
Dividend Yield	0.0%
Market Cap	$3.58 billion

Financials (TTM):

Revenue	$2.72 billion
Operating Profit Margin	5.2%
Net Profit Margin	(-20.9%)

Valuation Metrics
(@3/30/21):

	SGMS	S&P 500
P/E (TTM)	n/a	44.7
Forward P/E (Est.)	23.3	22.6

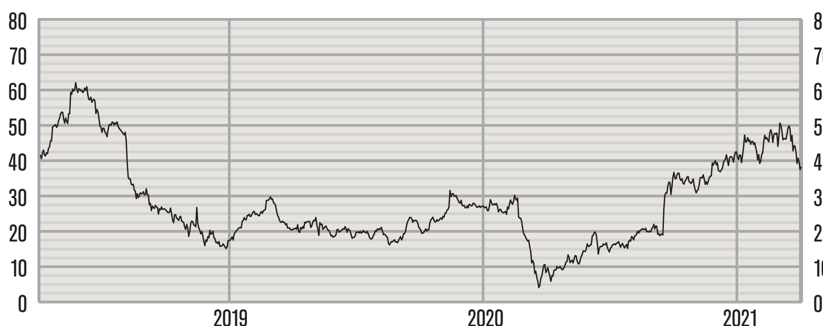
Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Caledonia Investments	9.9%
Fine Capital Partners	9.6%
Vanguard Group	7.3%
BlackRock	6.0%
Goldman Sachs	3.6%

Short Interest (as of 3/15/21):

Shares Short/Float	7.4%

SGMS PRICE HISTORY



THE BOTTOM LINE

The company under broad new leadership has considerable opportunity to improve innovation, operating effectiveness and profits in its core gaming business, says Mark Cohen. If the stock earns a 12-13x multiple on the $12 per share in free cash flow he believes the company can generate by 2023, it would more than triple from today's level.

Sources: Company reports, other publicly available information

to make the right choice for shareholders either way.

Twitter [TWTR] is a much bigger market cap company than you typically invest in. Walk though why it makes the grade for you today.

RR: I've been a long-time user of Twitter and have always found it a valuable service, both for investing research and during a period when I worked as an editorial researcher for Maureen Dowd at *The New York Times*. You'd be amazed by how embedded Twitter is in an organization like the *Times* – it's like a newswire or a Bloomberg terminal for them. You have to be using it constantly or you run the risk of missing something important.

As useful as the service is, the company for a long time as a business was a total mess. Mark Zuckerberg got it right when he called Twitter "a clown car that fell into a gold mine." Nothing about it was properly monetized and they didn't seem capable of doing even basic things to improve that. Even when Jack Dorsey returned as CEO in 2015, he said his primary job was to fix the user experience and get user growth back on a positive path. Figuring out how to make money on it all still wasn't a priority.

That started to change in 2019 and accelerated last year after Elliott Management and private-equity firm Silver Lake took stakes in the firm and started pushing for change. We think the fruits of all that are beginning to pay off and will continue to do so in a big way going forward. They've done basic things like rebuilding and upgrading their ad serving capability. They've created more effective ad formats. They're far better able to target qualified customers for advertisers, and the ad mix is shifting strongly toward higher-margin direct-response ads. They're rolling out subscription-type products and creator-monetization tools that we think have tremendous potential. There have been times in the company's history when it wasn't always straightforward, but it's clear now that revenue and profit growth is job #1.

The stock has sold off some after a big run over the past year. How attractive do you consider the shares at today's $63?

RR: Management came out recently with guidance that by the end of 2023 monetizable daily active users would increase to 315 million, revenue would double to at least $7.5 billion, and GAAP operating margins would increase to the mid-teens. When we process all that, we consider the revenue and margin assumptions quite reasonable and not as aggressive as they could be in terms of increasing revenue per user. They also seem to assume little revenue in the guidance for new subscription products or shared revenue with creators. Given that we think Twitter has a pretty strong monopoly over its type of real-time news and information globally, we think those things can be a large and very high-margin revenue source in the not-distant future.

Open-ended growth ideas like this one are difficult to value with any precision. On the 2023 guidance, at the current share price you're paying roughly 13.5x EBITDA and 25x free cash flow per share.

INVESTMENT SNAPSHOT

Twitter
(NYSE: TWTR)

Business: Develops and maintains the Twitter social-media website, meant to be, as the company describes it, "a platform for public self-expression and conversation in real time."

Share Information (@3/30/21):

Price	**62.99**
52-Week Range	22.36 – 80.75
Dividend Yield	0.0%
Market Cap	$50.24 billion

Financials (TTM):

Revenue	$3.72 billion
Operating Profit Margin	4.7%
Net Profit Margin	(-30.6%)

Valuation Metrics
(@3/30/21):

	TWTR	S&P 500
P/E (TTM)	n/a	44.7
Forward P/E (Est.)	54.3	22.6

Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Vanguard Group	10.0%
Morgan Stanley Inv Mgmt	8.0%
BlackRock	4.7%
State Street	4.5%
ClearBridge Inv	2.6%

Short Interest (as of 3/15/21):

Shares Short/Float	4.3%

TWTR PRICE HISTORY

THE BOTTOM LINE

Raphael Rabin-Havt believes the company's emphasis on improving the monetization of its platform is paying off and will increasingly do so going forward. He argues that the shares aren't expensive against reasonable forward company guidance, which doesn't include the significant upside he sees from subscription and other non-ad revenues.

Sources: Company reports, other publicly available information

We think that's very reasonable for a company that can compound base advertising revenue at 15-20% per year for a long time. And we don't think we're paying at all for subscription or other revenue upside – that could add at least $1 billion in incremental annual sales within the next three years.

You like a lot of investors have sold some stocks over the past year that did extremely well after your exit. Any advice on how to avoid that?

RR: Hindsight in this business can be very painful, but I would say with this particular mistake that you can be harder on yourself than you should. When you look back on things, knowing what's happened in the interim, it's very easy to assume everything was clearer at the time than it really was. We try to be honest with ourselves about what we could assess at the time and learn the right lessons to keep improving. VII