

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Looking for Mispricings in Large-Cap Stocks



SAMUEL C. COQUILLARD, Managing Director, is a Portfolio Manager for individual and institutional separately managed accounts at Pacific Global Investment Management Company. In addition, he is the Portfolio Manager for the Pacific Advisors Large Cap Value Fund. Immediately prior to joining Pacific Global Investment Management Company in 2006, Mr. Coquillard was a Senior Vice President of Chelsea Management Company, an investment advisory firm. Previously, he was a First Vice President of Merrill Lynch; Senior Vice President at Chase H&Q; and Vice President, Institutional Sales, at Wertheim Schroder & Co. He received a B.A. from the University of Southern California.

SECTOR — GENERAL INVESTING

TWST: Could you please identify yourself?

Mr. Coquillard: Sam Coquillard, Managing Director, Pacific Global Investment Management Company.

TWST: Could you tell me a little bit about the firm?

Mr. Coquillard: The firm has been in business since 1991. We have mutual funds as well as a separately managed account offering and have about \$572 million under management.

TWST: Do you work on a specific fund there?

Mr. Coquillard: I work on a large-cap value fund.

TWST: Does that fund have a unique investment philosophy?

Mr. Coquillard: It is a value fund as listed in the offering. We look for companies where, in essence, we can buy a dollar for \$0.60 or \$0.70, if that's possible. It is a relatively focused fund, and most of our holdings are long-term. Basically we look for companies where we believe we have some perception or insight that has been overlooked by the market. As a result, a mispricing has taken place.

We invest in companies that we can understand with management we believe is trustworthy and shareholder friendly and that have, as I said before, some kind of competitive advantage, a moat — as Mr. Buffett or Mr. Munger might say — around their business. One that could help us make reasonable assumptions about their business going forward based upon its strategic model. The fund is a small portion of my role with Pacific Global. Separately managed accounts are the core of my business.

TWST: Why is now a good time for investors to look at a large-cap value fund?

Mr. Coquillard: There are a lot of large-cap names that have been left behind in this market rally. When I look at some of these

companies, I'm surprised by the valuations. Take **Disney** (NYSE:DIS), which quite frankly has not done terribly well over the last year or so. It's trading around 15 or 16 times earnings. The truth of the matter is that **Disney** is being penalized for **ESPN**. That makes some sense, but **ESPN** is about 30% to 35% of the total earnings for **Disney**, and it does have some subscriber problems insofar as cord cutting.

But they have certainly made strides that have allowed them to move toward new and different ways to distribute their product. When you look at that, you have to ask, is this management capable of figuring out a way to manage the decline and secure the **ESPN** subscriber base? I believe CEO Bob Iger certainly can. He is a very creative executive and has done a great job. Over the last three to five years **Disney** has traded at 19 or 20x earnings, so picking it up at 15 or 16x earnings is attractive compared to its historical trading range.

TWST: What other businesses, if not **ESPN**, would be promising for investors that **Disney's** involved with?

Mr. Coquillard: **Disney**, in filmed entertainment, has been hitting the cover off the ball. Though 2017 will follow a very successful fiscal 2016 in terms of film releases, this year is off to a very good start. "Rogue One," the new film that's part of the "Star Wars" saga, was just released to a stellar box office. Additionally, a sequel to "Guardians of the Galaxy" is due to be released, as well as "Cars 3" and a new "Pirates of the Caribbean."

The company opened Shanghai **Disney** resort in June. It is the second largest of the parks behind Orlando. Shanghai includes six lands, shopping districts and two hotels. The company believes that Shanghai may break even in May 2017. Finally, on the consumer products front, the company continues to execute well and expects a good 2017 despite a difficult 2016 "Star Wars" comp.

TWST: Is it still a possibility that Disney might try to spin off or sell ESPN?

Mr. Coquillard: It's funny you bring that up. I saw that commentary, and I think the idea was initially brought up by John Malone. Of course they could. And you're talking about a management that's made excellent deals since it's been in place, for example, the purchases of **Pixar**, **Marvel** and **Lucasfilms**. **ESPN** could potentially be spun off or sold. It's certainly something they might consider.

TWST: Or in the other hand, do you think they might have confidence in the brand itself, and if things were reworked a little bit, it might turn more profitable?

Mr. Coquillard: **Disney** has been making a lot of investments in new platforms. They have the Major League Baseball platform **BAMTech**, Video on Demand, **DirectTV Now** and **Sling TV**. They have exposure with these new over-the-top programming services, such as **Direct TV's Now** and **PlayStation Vue**. It's a balancing act. **ESPN** used to be the crown jewel. It just printed money. Now that the public is going more toward the skinny bundle, the company continues to look for new platforms to present this product, which is obviously excellent. So I think it's a balancing act. On the one hand, they're trying to find new places to present their product. On the other hand, they may be potentially open to some kind of deal that might make a difficult situation better.

TWST: Did you want to mention another company?

Mr. Coquillard: Let's look at **Apple** (NASDAQ:AAPL). If you take net cash off the balance sheet, most of which is overseas, and as you know we now have a new administration that might treat that cash more favorably, **Apple** is trading about 9 or 10 times earnings. My sense with **Apple** is that people certainly understand that they're in the hardware business and, recently, that's looked down upon. I believe that the **Apple** service business might be a focus of concentration. It's more of a business that you might refer to as an annuity. They have services such as **Apple Store**, **Apple Pay** and **iTunes**.

it's hard to get out. I think as people start to appreciate **Apple's** services more and how impressive they are, it will help the valuation. It certainly creates a barrier to entry, and it gives them some pricing power.

Just look at what **Apple's** done: They have created a product that will continue to grow, has good margins and is a point of entry to several of their other products. My sense is that, for lack of a better name, the **iPhone 8**, which is coming soon, might be a significant new product. If you add that to the fact that they might be able to repatriate \$150 billion to \$200 billion that's overseas — in a more agreeable fashion from a tax point of view — combined with the rapid growth of the high-margin services business, and the valuation, which is around 9 to 10 times earnings net of cash, **Apple** might be attractive.

TWST: Did you want to mention another company?

Mr. Coquillard: Another company is **Citigroup** (NYSE:C). It's reasonably priced, and it's still less than one times book. A higher interest rate environment may be in the offing, which would help them. The knock on **Citigroup** of late has been that it gets about half its revenue outside the U.S. They have operations in Mexico and Brazil which have been problematic but in which they are now investing. They took over the **Costco** (NASDAQ:COST) account from **American Express** (NYSE:AXP), which they believe will become a positive for them in the second half of 2017. I'm sure you remember the ruckus that took place when **American Express** lost that business.

Citigroup Holdings, if you recall, is the so-called bad asset bank that was created in 2009 to house about \$600 billion of troubled business and toxic assets. Management has been successful in burning off **Citigroup Holdings** over time. It's now less than about 3% of total

assets, and pretty soon, as I understand it, they will stop listing them separately. It's become a much smaller piece of the pie, and it's burned off enough that they don't have to worry about it quite so much.

With the upcoming political environment, you may have a situation where banks send more capital back to shareholders by way of

Highlights

Sam Coquillard discusses his firm's large-cap value fund. Mr. Coquillard looks for companies where there has been some perception or insight that has been overlooked by the market, and as a result a mispricing has taken place. He invests in companies he can understand with management he believes is trustworthy and shareholder friendly. He also wants businesses that have a competitive advantage. Mr. Coquillard says there are a lot of large-cap names that have been left behind in this market rally, and he is surprised by the valuations.

Companies discussed: Walt Disney Co (NYSE:DIS); Apple (NASDAQ:AAPL); Citigroup (NYSE:C); Costco Wholesale Corporation (NASDAQ:COST); American Express Company (NYSE:AXP); Hostess Brands (NASDAQ:TWNK); Apollo Global Management LLC (NYSE:APO) and Wal-Mart Stores (NYSE:WMT).

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Apple services alone generated around \$24 billion to \$25 billion of revenue in the last fiscal year. So it represents a big portion of the revenue pie; it's 13% or 14%, and it's growing at a rapid clip. It also has much better margins. I think when you're a guy my age with an **Apple** phone, you appreciate the power of their ecosystem. I'm not as technologically savvy as many others, including my teenage children, but I can tell you that it's a wonderful product, and once you get into it,

share repurchases and increased dividends. In regards to **Citigroup**, they bought back a significant portion of their shares in the third quarter, I think it was 1.5% to 2% of the total share count. So when they get the chance to do it, they're very, very aggressive.

TWST: And how much risk do you think there is from what might be happening in the next year or two in Europe regarding other countries leaving the EU or even in China?

Mr. Coquillard: The truth is that we don't really know what the result of the Brexit vote is going to be. There are some voices out there that say it's going to be very difficult and somewhat of a disaster, and others that suggest the British economy will do better without the yoke of the obligations and restrictions of Brussels. I'm not sure ultimately Brexit will be that terrible for Britain. I can't guess who will secede next, possibly Italy.

1-Year Daily Chart of Walt Disney Company

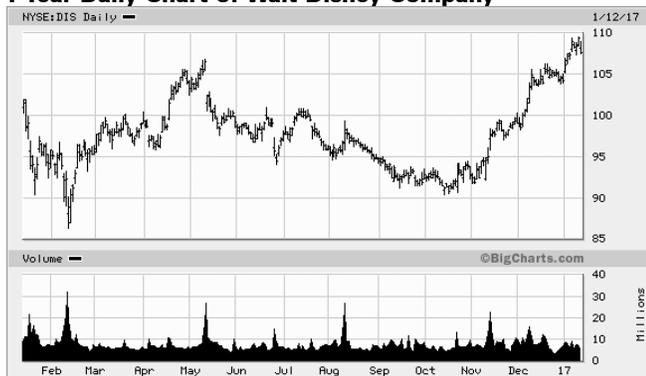


Chart provided by www.BigCharts.com

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And as far as China is concerned, the real risk is their debt. From what I understand, some Chinese banks and other institutions including those that indulge in shadow lending have a significant amount of debt, a portion of which, when it's not paid back in a timely fashion, shifts into the investment column. I'm not quite sure how you can do that, but I've read a few things that concerned me in that regard. If there's anything on the horizon that might be a little bit problematic, it would be the Chinese debt. That does concern me a bit.

TWST: And that could affect Citigroup and similar banks that have investments in that region?

Mr. Coquillard: Citigroup is the most international of the banks based in the United States. The Chinese economy is obviously huge and intertwined with all of our financial institutions; that could be a real difficulty for all financial institutions, not just Citigroup.

TWST: Did you want to mention another company?

Mr. Coquillard: One of the things I do is look for names that are not necessarily well-known or well-covered, because of course, we're looking for a pricing advantage. As I like to say, we're trying to buy a dollar for \$0.60 or \$0.70, and sometimes the way you do that is by finding smaller names that are off the radar.

For example, **TWNK** (NASDAQ:TWNB), which is **Hostess Brands**, a name almost anyone in the world knows. This company went bankrupt. An investor group consisting of **Apollo Global Management** (NYSE:APO) and **Metropoulos** bought the sweets goods business and some manufacturing capability. What ran **Hostess**

into bankruptcy twice was basically weak management, labor disputes, failing finances, poor marketing and union difficulty. They supposedly had very tough unions with onerous work rules that made things quite challenging. I read somewhere that the drivers of their trucks couldn't even unload them; that was against union rules. Different products, like Wonder Bread and Twinkies, had to be delivered separately, which made the business less efficient.

So **Hostess**, a company with iconic brands that had been around for a long, long time, went into bankruptcy twice, came out the second time with some new owners from the private equity side and created a baking technology referred to as extended shelf-life technology. What that means is that products that would make it on the shelf for about 25, 26 days previously could now make it for 65 days. That changed the entire profile of the company and continues to change it.

When you look at a name like **Hostess** and see the changes that have taken place, because A, they no longer have the legacy liabilities, including any pension obligations; B, a significantly reduced union membership; and C, this new baking capability that has changed the company dramatically, there is a lot of upside potential. They had 8,000 employees. Now they have around 1,400. They have very little in the way of employees covered by collective bargaining. They've cut their products from 150 to around 90. And the key here is this: When

1-Year Daily Chart of Citigroup Inc.



Chart provided by www.BigCharts.com

they have a product, it goes to a distribution center, and from the distribution center, it goes to the stores by way of third-party delivery companies, as opposed to the prior direct-to-store delivery model which was expensive and inefficient.

So they cut their employees, which has cut their cost dramatically; they've cut the number of bakeries from 11 to three, and the reason they can do that is because of this technology. The products still stay fresh during that timeline and, as such, they've made the company much more profitable. Prior to their last bankruptcy, **Hostess**

had around mid-20% market share in the indulgent goods category, and now they have around 16% to 17%. So they're fighting to get back that market share, but if they do it, and I think they can, it will be very good for the company.

TWST: Do you think they might be introducing some new brands, or will they rely on the ones that people know well?

Mr. Coquillard: They've made some acquisitions, like **Superior Cake Products**, which helps with their product mix, but what they've done really well is brand extension. For example, they have deep-fried Twinkies, which are frozen and sold by **Wal-Mart** (NYSE:WMT). There are many ways to leverage their brands. There are rumors that **Hostess** Twinkies, Sno Balls and CupCakes-flavored ice cream is on the way.

TWST: Taken as a group, the large-cap stocks, do they stand a benefit a lot from what President-elect Trump has talked about, what he might be doing in the next administration?

Mr. Coquillard: Yes and no. On the one hand, as we talked about earlier, if some of these companies, like **Apple**, could get a lot of the money that has been stuck overseas, that would be wonderful. But as everyone knows, **Apple** manufactures a great deal of its product overseas, so if we get into some kind of trade altercation with our trading partners, that would not be good. So the answer is yes and no. We will see.

I'm hoping that we realize the good parts, such as corporate tax reforms, particularly where we lower the tax rate for American companies, where the repatriation of money could take place at a less onerous rate of taxation. If that could happen it would be great, but getting into trade wars with our trading partners Mexico and China, that obviously isn't very good for anybody.

TWST: Would it be hard for a company like Apple to get their suppliers to maybe open up shop in the United States and make the stuff here? Would that just not be a reasonable thing to expect, or is that a possibility?

Mr. Coquillard: Anything is possible, but I'd have to tell you, I would find it somewhat unlikely. That's a lot of infrastructure to just pick up and move, and obviously that would be very difficult. I'm sure that it's not high on their priority list. I would think that **Apple** would rather not even consider that.

TWST: I would guess the cost might end up going up too?

Mr. Coquillard: I would think so, and yes, that's the other side of the equation. It's well and good to move companies stateside, but the consumer would be potentially impacted in a very negative fashion. It doesn't seem that the consumer is taken into account at all, at least when the new administration talks about these things. There is a cost; it could potentially make products in the U.S. more expensive.

TWST: What advice would you give investors now at the start of 2017, given some of these trends that are out there?

Mr. Coquillard: I always tell people that one of the most important things is to buy companies for substantially less than you believe they are or could be worth going forward. If you get that margin of safety, which obviously is Mr. Graham's most famous concept, you've given yourself A, some leeway to be a bit wrong; and B, the ability to withstand the fluctuations in the market, which are natural and unavoidable. If you chase a stock or idea, and you buy what's going up and sell what's going down, it probably won't work out very well in the long run. So the one thing I always say is that I strive to create a gap between price and value and make sure that I pay a reasonable price for the value I expect to receive.

TWST: When it comes to the Millennial generation, do you have any specific advice for them?

Mr. Coquillard: That's a tough one. I guess the one thing I'd say is to start investing now. The main thing that young people don't understand is that the money you save when you're young may very well be the money you live off of over time, if it is invested well and compounds at a reasonable rate of return. That early investment may be the money you retire on.

When you get older, get married, potentially have children, and buy a house and pay for education and other expenses, a lot of what you earn at that later time is going to go straight from you to someone else who is providing those goods and services to you and your family. So no matter what, start saving and investing and taking an active interest in your financial future right now, at this very moment. You can't put it off, because the one advantage Millennials have is time, and time is the most important thing in the investment world. The ability to compound over a longer timeline is huge. So you should use it.

TWST: Thank you. (ES)

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