VILASCAPITAL
MANAGEMENT LLC

April 2019

Dear Vilas Fund Partner,

The Vilas Fund, LP, rose 34.3% in the first quarter of 2019. The biggest gains were generated in NMI Holdings, MGIC, Viacom, Citigroup and Lincoln National. The main detractor of performance in the quarter was CVS.

In general, we are finding better investment opportunities today than at virtually any time since I started in the business twenty-six years ago, especially relative to current earnings, interest rates on bonds, real estate cap rates, and private company equity prices. Our portfolio is currently trading at 8.2 times 2019 net income estimates and 7.3 times 2020, the cheapest in my career. To those who say the market is too high, there is too much risk in stocks, and everything is overpriced, we suggest they should hire us.

In the depths of the financial crisis, valuations of equities, when compared to fixed assets and book values, were lower than today. However, many companies were either losing money or barely profitable. Valuations today are higher versus book values and assets but far lower on an earnings basis. It is as if the market is predicting another painful economic downturn and investors have sold equities to prepare. The question is fairly simple, then: what if the economy continues to chug along? The value portion of the stock market should revalue upward quite rapidly and recover a good portion of its massive underperformance when compared to growth shares.

Since 2006, value stocks (IVE vs IVW) have underperformed 11 of the 13 calendar years and when they beat growth, it wasn't by much. Cumulatively, through this week, it has been a 122% differential (up 52% for value vs up 174% for growth). This appears to be the longest and most severe draught for value investors since data collection began. It will go our way eventually as there are too many people paying far too much for today's darlings, both public and private. Further, the ten-year yield of 2.5% (pre-tax) isn't attractive nor is real estate. We believe the value part of the global equity market is the only place to earn solid risk adjusted returns and we believe those returns will be higher than normal. Why? These stocks are cheaper than they normally have been, and interest rates are much lower than normal when compared to inflation. Larry Fink, the founder and CEO of BlackRock, recently said he sees the risk of a “melt up” as so many investors are underweight stocks and overweight bonds and cash. We agree.

We believe that our companies will grow earnings 6-8% annually over the next 5 years. In addition, these companies are returning significant capital, to the tune of 5% cash-on-cash, via dividends and share repurchases. And finally, we believe the valuation multiples of our holdings should expand from roughly 7 times next year’s earnings estimates to roughly 10 times, a nearly 50% increase. Adding all these factors together, the expected return of our unlevered equity positions should be in the high teens to low 20% range, annually, over the next 5 years.

The Fund is, again, short a modest amount of Tesla common shares and $500 strike price calls. We have benefited materially from these positions to date. With a poorly constructed balance sheet, ongoing operating losses, debts coming due, tax credits disappearing, competition that is accelerating, and no meaningful barriers to entry, we believe that insolvency will be the eventual outcome for Tesla. The Fund has a couple of other very small short positions in highly inflated companies, mostly in far out of the money call options, that together will more than pay our management fees if we are correct.

Examples of some of our most interesting long positions:

Air Lease (AL)

Air Lease Corporation is an aircraft leasing company run by a highly experienced and capable management team. The company has grown earnings over 20% annually over the last 5 years and has a return on equity in the mid to high teens. On a cash earnings basis, adjusted to reflect the fact that they don’t pay cash taxes due to very high depreciation levels, the stock is trading at roughly 5 times forward earnings and 0.8 times book value. A tremendous bargain for long term investors as we believe the proper multiple should be roughly twice these levels.

With growth in earnings, we believe the expected return of Air Lease common stock is in the low 20% range.

Citigroup (C)

Citigroup continues to produce modest revenue and earnings growth, to the tune of 6% annually over the last 5 years, but the company is returning roughly 13% of its market capitalization in dividends and share repurchases annually. Thus, at today's price with no valuation expansion, investors should earn 19% if the future equals the past. We believe Citigroup is being managed much better than at any time in the last 40 years and that the future will prove to be better than the past. Therefore, the shares are trading too inexpensively, and a 50% valuation expansion should be the result. If true, owning these shares should be a home run.

CVS and Walgreens (CVS and WBA)

CVS and Walgreens have had a tough year. The industry has experienced slowing branded drug price inflation, lower generic inflation, and lower reimbursements than expected. We believe all these pressures are temporary. However, it is clear that Amazon has set its sights on the industry, which has dramatically depressed the multiples CVS and Walgreens are trading at. Roughly speaking, both are trading at 8.5-9 times current year earnings estimates, compared to 16-18 times, on average, in the past. Their dividend yields are 3.7% for CVS and 3.2% for Walgreens, both significantly higher than the 2.9% yield on the 30-year US Treasury. Walgreen's has raised its dividend 45 years in a row, and we expect this trend to continue. When the temporary headwinds subside and partially reverse, we expect the earnings of both to return to the high single digit earnings per share growth range. Additionally, we don't expect Amazon to be very successful with its strategy given the fact that most people need immediate access to medicine, the incumbents will mail your prescription for free already, and that copays are fixed regardless of where your prescription is filled. Having the option of quickly driving to grab your prescription at roughly 10,000 locations each, often open 24/7, is a valuable service and network effect that we don't believe will go away. These shares should produce an 18% return without multiple expansion, driven by dividends, retained earnings to be used for expansion, debt repayment or share repurchases, and profit growth from rising prescription volumes. Adding in a 50-70% valuation expansion, and future returns should rise to the mid-20% range over the next 5 years.

Honda (HMC)

Honda makes the best cars on the planet, from a reliability and cost of ownership perspective, and is trading at a 20% discount to the level it bottomed at in the 2008 financial crisis when car sales fell 40%. Unlike the US majors, Honda earned a profit every year during the financial crisis and, therefore, should trade at much higher levels than its competitors. With over 40% of its market capitalization in cash, a 3.5% dividend, earnings that have grown 6.2% annually over the last decade, and a large retained earnings position (they only pay out 25% of earnings in dividends), Honda should produce a 20% return without valuation expansion. Given that it is trading at only ⅔ of book value (which consists of cash and plant and equipment), we believe that expected returns will be significantly higher as the valuation expands to 1.2 times book value, a level more consistent with its average post the financial crisis.

Lincoln National (LNC)

Lincoln National is one of the top 5 or 6 life insurance companies in the United States. They also have a significant presence in fixed and variable annuities. The stock is currently trading at 6.9 times this year's earnings estimates at 6 times 2020. With a strong dividend, opportunistic share repurchases, a low teens return on equity and accelerating growth, partially due to the fact that retirees currently prefer safe returns that are lower than higher returns with equity market volatility, Lincoln National is a fantastic bargain that should produce high teens returns for owners from today's price.

Conclusion

We are very excited about our positioning and believe that future returns will make up for the volatility and flattish results over the last five years. We continue to be earnings and balance sheet focused in a revenue and "story" dominated market. While we are not sure when these fantasies will end, we are sure they will and that outsized returns will accrue to those who remained disciplined, as occurred in the early 2000's.

Sincerely,

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