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Iván Martín: The Contrarian Investment Philosophy of One of Spain's Highly Regarded Value Investors

We recently had the pleasure of interviewing highly regarded Spanish value investor Iván Martín about his philosophy. Iván shares insights into contrarian investing, what he looks for in CEOs, how Spanish companies stack up in terms of competitiveness on a global scale, among other topics. Iván names one of the CEOs he admires most, shares an investment case study, and recommends two books for honing one's contrarian investment approach.

The Manual of Ideas: Tell us about the genesis of Magallanes and the principles that have guided you since then.

Iván Martín: I have always dreamt of having my own asset management company. In this way I fulfilled two aspects that were very important to me: to become an entrepreneur and to implement my investment philosophy with total freedom.

Mr. García Paramés introduced Blanca Hernández and myself several years ago and encouraged us to launch an independent value oriented investment company. Blanca, Mónica and I started Magallanes Value Investors in December 2014 with €30 million in AUM. Our core mandate has always been to preserve and grow the capital of our clients, thereby generating long-term returns above standard market returns.

Investors are our top priority. They represent the most important part of Magallanes. We aim to be a reference in value investing. We understand value investing as a philosophy of life applied to investing. Alignment of interests, long-term vision, integrity and independent thinking are the most relevant aspects of our philosophy.

MOI: How do you define your "investable universe" and how do you generate ideas?

Martín: We define ourselves as long-only equity value investors. We actively look for listed companies worldwide with a special focus on Europe.

We generate ideas through a few different channels. Roughly one of every three ideas is generated through research and analysis and we spend the majority of our time reading and doing research.

We also discover great ideas through observation, as Peter Lynch used to do. We pay attention to the world around us. We observe which products and services fulfill client's expectations. Over the years, this method of generating ideas has proved to be both fun and cost efficient for both parties. It is fun as you, as a consumer, are the real beneficiary of the products and services. It is cost efficient as you do not have to pay anything to anybody for bringing you the idea.

Some of our best investments have also been a result of being contrarians. Thinking different and going against the herd has been another source of important ideas. In this regard, we are constantly looking for heavily penalized stocks.

Although it is a residual part of our idea generation process, we also take into consideration companies that are going through difficult times. Turnarounds and special situations, such as dilutive capital increases to fix the financial structure, are among the topics we usually look at to find ideas in this regard.

MOI: You have stated that, "We do not buy expectations, we buy realities which are trading below their fundamental value". Please expand on this statement in the context of your stock selection criteria and the types of businesses you have favored historically.

Martín: "We do not buy expectations" means that we do not put too much emphasis on the future when valuing the business of a company. The margin of error when you deal with expectations is enormous, so we try to minimize this risk by analyzing the company both as it is today and as it has been for years. This has to do with identifying ideas that, for some reason, are temporarily trading below their intrinsic value.

On the other hand, we tend to avoid the so called "future-event-dependent ideas", those stocks where most of the value comes from future expectations and a lot of factors have to move in your favor to make money.

We actively look for companies that are trading well below their fundamental value based on their past financial information, in other words, those companies that are trading at a discount. For us, buying cheap is the safest way to invest. You only need to take a contrarian view and be patient.

Our portfolio contains a wide range of different investments, from consumer staples to telecom stocks. The most common type of company in our portfolio is mid-cap industrial, generally family owned, with low or no debt and a proven market leadership in the niche segment it operates.

MOI: What sources of competitive advantage have you found to be most durable?

Martín: As you state in your question, the most important thing is how durable a competitive advantage is, not just the competitive advantage itself. We find it very dangerous to invest in companies with strong and fully recognized competitive advantages by the market, as it generally is already reflected in a high stock price.

It usually means you are paying expensive prices "in recognition" of those great qualities of a company. When you pay an expensive price for a stock you increase the risk of losing money.

Based on our experience, the right moment to jump into a good company with a strong competitive advantage behind is when nobody thinks that company really has one. It usually happens with small, overlooked and off-the-radar stocks.

Having said this, we have found that "switching cost" is the most durable and resilient type of competitive edge. It can turn painful and costly for a client to switch a product once getting used to it.

MOI: When it comes to equity analysis, how do you assess the quality and incentives of management? Which CEOs do you admire most?

Martín: As in portfolio management, past track-record is a good indicator to measure the capabilities of a CEO. We like top executives who have an excellent track record in shareholder value creation. We are glad when we find professionals who have been able to successfully turn a business around or just make a company even more profitable. On the other hand, CEOs with a poor past record are a clear red flag.

The perfect CEO thinks and acts as an owner. Believing in the project and being generously remunerated according to the future success of the company are the factors we like the most to see when assessing the quality and incentives of management. From a quantitative point of view, this translates into a remuneration scheme that takes into consideration the company´s profitability as compared to the capital employed. Figures measured in a per share basis (i.e. earnings per share) also help to better track the performance of a CEO.

I most admire the CEOs of our mid-cap family owned companies. For example, Antonio Amorim of Portuguese company Corticeira Amorim, the world's largest cork producer. This is a perfect example of what the right attributes of a great CEO can do in an "old-fashioned" business as cork is. Under his ten-year tenure, Mr. Corticeira has been able to quadruple earnings per share while delivering an outstanding return on invested capital well above 20%, with almost no debt on the balance sheet. These are the kinds of CEOs we love to partner with.

MOI: Do you typically seek dialogue with the management teams of your investee companies?

Martín: It is part of our investment process but we prefer to speak to middle management and investor relation representatives. Never ask a CEO how his company is doing, he always will respond with nice and beautiful words. Based on our experience, it has always been much better and useful to make direct questions about processes and financial statements to those who are not so "passionate" about the business but closer to the daily life. This also protects you from the so called "halo effect" of a powerful CEOs staging, making it easier to discern reality from fiction.

MOI: Would you describe a case study that reflects your investment approach?

Martín: Among our best ideas was the case of Lingotes Especiales SA, a Spanish auto parts specialist in brake systems. In the last three years, we have multiplied by seven our initial investment. We discovered Lingotes in a typical "Magallanes Way", a combination of research and observation. We very often noted that premium cars and motorcycles usually deployed Brembo brake systems.

We began to analyze the sector and discovered that while Brembo was the market leader in Europe, just around the corner here in Spain, there was a player with 12% market share called ¨Lingotes Especiales¨.

That was the starting point of a wonderful investment process that started with an on-site visit to the Lingotes Especiales foundry and machining facilities in Valladolid, Spain, followed by extensive research into the history of the company. Apart from realizing that it was totally unknown to the rest of the market we also found out that it had common roots with its big competitor Brembo. Founded by several families in 1968 as an iron foundry it is not until 1997 when it dramatically transforms itself into a new company, by the influence and advice of a former Brembo executive, dedicated to the machining and assembly of automotive components, essentially brake discs and drums, fly-wheels and pressure-plates.

At the time of purchase, the company was quoted with a market cap below €35 million and nobody covered the stock. It was trading at a low single digit multiple with net cash on the balance sheet. The high free cash flow profile generation allowed the payment of generous dividends, even the purchasing and amortization of treasury stocks. It was completely overlooked by other investors. Our base case valuation valued the business at least twice its market value at that moment. It had the potential to be even more, depending on whether you applied the multiples of its peers. It goes without saying that a car's safety is profoundly impacted by its brake system. This represents a very strong and long-lasting competitive advantage for Lingotes Especiales in the form of switching cost for OEMs players, the buyers of these products. The minimum cost of brakes and drums compared to the total cost of a car and the crucial role they play in terms of safety are so powerful that most of OEMs are very reluctant to change providers.

In-house research and observation led us to discover a real jewel. It took time and effort. We had to take the lonely road, doing our own in-depth research, trusting in our own capabilities and finally we invested in Lingotes Especiales decisively. Time did the rest. The value investing path is most of the time a lonely way.

MOI: How do you think about the art of valuing a business? To what extent do industry-specific considerations or industry comparables play a role, and to what extent do you focus on "shareholder earnings" or free cash flow?

Martín: For us, valuing a business is the least time-consuming part of the investment process. The most important thing for us has to do with understanding the business, the genesis of the company, how they make money, competitive advantages if any, competitors, and so on. We do most of it by reading financial statements up to ten years of history. Then we crunch the numbers and try to figure out whether the company will exist or not in the next five to ten years.

Complex multi-period discount models and multi-Excel spreadsheets give the false feeling of certainty and infallibility. In some way, it fulfills the uncomfortable situation of dealing with incomplete information. Relying too much on the power of math and models can be a disaster when it comes to finance, a field characterized by uncertainty. Most investors deploy too much effort in accuracy and perfection, keeping themselves from potential good investments. In my opinion, the key point in valuation has to do with the ability to deal with imperfect, poor, and confusing information most of the time.

From a practical point of view, when valuing a company, we apply a plain-vanilla method, consisting in discounting the normalized free cash flow of a company across a cycle. Then we compare our valuation to those multiples paid by the industry. Remember that the value of a stock does not come solely from the DCF model. A stock is worth what someone is willing to pay for it, regardless of what your DCF model tells you.

MOI: How do you strike the right balance between being concentrated in your best ideas while remaining sufficiently diversified to keep downside risks under control?

Martín: As I mentioned before, the successful investor has to be able to operate under uncertainty. This means that sometimes the thesis behind an investment can be completely wrong. So diversification is a good protection against this risk. The worst risk is permanent loss of capital, which usually happens as a result of high indebtedness or fraud. In this regard, we tend to concentrate our portfolio on those companies with the healthiest balance sheets whose CEOs have the cleanest and most successful record in their fields.

I don't recommend concentrating the portfolio among investments with the highest upside potential. High potential of revaluation does not necessary mean safety of principal. As long as an investment can offer a good protection if things move against you, I prefer to invest in a +20% expected-return-stock rather than in a multi-bagger one.

MOI: You have stated that, "Value investing is easy to understand but difficult to execute". Would you please elaborate on this statement?

Martín: From a rational point of view, value investing is among the easiest things to understand: "buy cheap". This doesn't just apply to value investing, but to innate human behavior. People always want more for less, in some way.

It usually happens to me when I explain my profession to people who do not know what I do for a living and neither know a word about investments. It usually goes like this:

> *…and, what do you do for a living?*
>
> *Well, I am an investor, a value investor.*
>
> *A "what" investor?*
>
> *Value, it means basically that I try to buy cheap stocks.*
>
> *Ah, I understand. That sounds pretty simple, doesn't it?*

Things get complicated when I go deep into details. Buying cheap requires most of the time buying the ugly, the scorned, the out-of-fashion, the overlooked company. This explains why they are trading cheap. Most of the people simply cannot fathom this. Buying cheap requires a certain level of suffering, so I understand why it's not everyone's cup of tea.

People quickly understand the mechanism but cannot get by with the implementation of it. Being a value investor requires a tempered and rational attitude towards investments.

MOI: What is the single biggest mistake that keeps investors from reaching their goals?

Martín: Emotions. In other words, the successful investor is an unemotional person when it comes to investments. The point when you don't make decisions based on your own analysis but on someone else's opinion is the point when you are doomed to fail.

MOI: What are your observations on the competitiveness of Spanish businesses on a European or global stage? What changes would you like to see in Spain?

Martín: Spain compares badly in terms of competitiveness within its European peers and the rest of the world. In my opinion, most of it has to do with the low productivity rates in Spain.

Some changes that could eventually improve this situation would be reducing the weight and presence of public administration, cutting taxes, especially corporate ones, encouraging a higher level of business investments, and promoting the creation of new projects and companies, and deregulation of markets to encourage stronger competition.

MOI: Which one or two recent books have given you new insights into the art of investing?

Martín: *Deep Value: Why Activist Investors and Other Contrarians Battle for Control of Losing Corporations,* by Tobias Carlisle. This book really tests to what extend you are a true contrarian value investor. While reading it I had several good memories of successful legendary value investors such as Graham and Klarman.

Another book I've recently read and strongly recommend is *The Templeton Touch,* by William Proctor. There is no doubt that Sir John Templeton has been one of the greatest investors of our time, but what caught my attention the most was his culture of always doing a little bit more than the rest. This attitude does really make a difference, his "doctrine of the extra-ounce". After studying the case of Sir John Templeton, I truly think his doctrine could be considered as a universal principle of success, not only in investments but also in life.

MOI: Thank you very much, Iván, for sharing your wisdom with our members.