ANDERSON INVESTMENT ASSOCIATION NEWSLETTER

We are pleased to present the second edition of the AIA Student Investment Newsletter, sponsored by the Laurence and Lori Fink Center for Finance & Investments. As always, the goal of the newsletter is to showcase the investing talents within the UCLA Anderson community, feature insightful interviews with investment management thought leaders, and strengthen the network among students, faculty, alumni and the industry at large.

In this issue, we were fortunate to chat with Causeway Capital CEO Sarah Ketterer about value opportunities across the globe and the firm’s unique convergence between fundamental and quantitative research. It’s been a turbulent market environment since our last issue, and Anderson investment management students have been busy uncovering a number of compelling investment ideas. Second-year MBA student Amitesh Bajad shares his buy thesis on retailer Williams-Sonoma, while first-year student Sam Kendrick is bullish on Lannett Company, a generic drug maker. We hope you enjoy the second edition of the AIA Student Investment Newsletter. We welcome your ideas for future issues.
STUDENT IDEA: WILLIAMS-SONOMA INC. (NYSE: WSM)
BY AMITESH BAJAD ('16)

WILLIAMS-SONOMA INC. (NYSE: WSM) - BUY

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<th>1/12/2016</th>
<th>Shares Outstanding (mm)</th>
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**Business Description:** WSM is a leading multi-channel retailer of home furnishing products. It derives 51% of sales from e-commerce, the highest across all U.S. multichannel retailers. The company has a portfolio of recognized brands that allow it to target multiple segments in the industry. These include Pottery Barn (43% of sales), Williams-Sonoma (21%), West Elm (14%), Pottery Barn Kids (13%) and Pottery Barn Teens (6.0%). As of Nov 2015, WSM operated 623 stores and generated 95% of its sales from the U.S. WSM was founded in 1956 and is headquartered in San Francisco, California.

**Investment Thesis:** WSM generates solid free cash flow (5.0%+ yield) while delivering moderate growth and earning excellent returns on capital. The recent stock market sell-off and temporary gross margin concerns have weighed on the stock, resulting in a great entry point for investors who can look beyond noise at the solid underlying fundamentals.

1. **Under-appreciated growth prospects:** A recovering housing market and best-in-class ecommerce platform provide WSM the ability to deliver steady top-line growth of 5.0-7.0% over the next four to five years, while generating EPS growth of 10-12%. Since 2000, the company has grown at -10x CAGR of the broader home furnishing retail space. Primary driver of WSM’s revenue growth will be the fast expanding West Elm brand that has tripled in sales over the past six years. The brand has resonated with customers and will continue to take share from regional players in a fragmented market segment. I cautiously estimate that West Elm will grow at -15% annually over the medium term on a comparable basis. Top line will be supported by low/mid-single-digit revenue growth at Pottery Barn, benefiting from share gains and housing market recovery. Other brands, such as the namesake Williams-Sonoma, are mature will make muted contributions to growth. On top of this, increase in square footage will add 1.0-2.0% of growth each year, most of which will be under the West Elm concept. At just 84 stores nationwide as of Nov 2015, West Elm’s store count is well below that of WSM’s mature brands (200 for Pottery Barn), indicating room for more store openings since end market size is comparable. I have not taken into account growth in the company’s international operations, which are presently small (~5.0% of revenue) but offer optionality in revenue growth.

2. **Margin concerns are exaggerated and ignore secular benefits:** Markets have punished the stock after a gross margin decline of 110bps in recent Q3 results. Management attributed this contraction to temporary West Coast port disruptions, which caused increased shipment and fulfillment related costs. I believe management’s decision to incur additional costs to maintain customer service levels was right, and these additional costs should not last beyond one or two quarters. It should also be noted that WSM completely offset gross margin decline by reducing marketing spend. Around 50% of marketing expense is still related to publishing of catalogs, which indicates some room for cost savings as the industry increasingly relies on low-cost, individually customized digital newsletters. There are some margin uncertainties on account of the company’s international business, particularly because international stores are a mix of company-owned and franchisee models. I believe management would provide greater visibility on the economics
of international business as it grows and becomes meaningful. However, market is largely ignoring the secular benefit to margins as WSM derives an increasing portion of its sales from the online channel, which has operating margins 1,000bps above those derived from store sales. Online channel share has increased from 39% in FY10 to 51% in Q3’15, and if the current rate of sale shifts continue, WSM will derive 58–60% of its sales from online by FY19, which itself would provide a margin benefit of 100–120bps.

3. Solid free cash flows and shareholder returns: With high returns on capital and modest capex requirements, I expect WSM to continue to generate FCF of $250mm–$300mm over the intermediate term. FY2015 FCF levels imply a 5.0%+ yield at current market price. Management has a track record of returning FCF to shareholders in the form of dividends (2.5% yield) and repurchases. Management compensation is tied to EPS growth, indicating that repurchases will continue — which, at these prices, is certainly a good way to allocate capital.

Valuation: WSM is presently trading at a forward P/E multiple of 14.7x, which is a minor discount to the market, as opposed to a historical premium of around two turns. At the present multiple, the market is pricing WSM cheaper than the S&P 500, which is expected to see an earnings decline in FY2015. The company’s peer group (see table) is presently trading at a mean forward P/E of 13.3x and TEV/EBITDA multiple of 6.2x, slightly below the 6.8x multiple for WSM. This premium is narrow for a high-quality business like WSM. I think there is room for WSM’s multiple to expand as margin concerns ease and EPS growth is reinforced. I believe that a P/E multiple of 16x is fair for WSM, which, applied to estimated earnings two years forward yields a price of $75, implying an up side of more than 40%.

A DCF valuation based on a two-tier framework utilizing a WACC of 8.0% and terminal value growth rate of 2.5% results in a price of $79, broadly confirming the price target derived using relative valuation.

In a bear case scenario involving weakness in housing markets, I assume that earnings growth slows down significantly to 5.0% and the P/E multiple contracts further by 2x turns. In this scenario, WSM’s price would decline to $46, or 14% below current stock price. The stock, therefore, offers a compelling risk-reward ratio at these levels.

Principal Investment Risks

Competition and promotional intensity: WSM could face increasing competition from home furnishing peers and larger retailers like Amazon and Target as they increasingly diversify into this space. The promotional environment in the online space could intensify, resulting in price discounts and erosion of margins. The company so far has mitigated the impact of promotions through tight cost controls and sales leverage. With the highest e-commerce penetration across all retailers, WSM is well ahead of competition in implementing a multichannel strategy and has benefited significantly from shift in consumer preferences toward online shopping. The company’s database of half of all U.S. households has allowed it to target marketing programs effectively while cutting expense. The online-only competition lacks brand recognition and does not compete effectively in the premium segment. In my opinion, a customer purchasing a $2,000+ bed or sofa would typically want to see the item in person before making a purchase decision and ordering online, making multichannel presence crucial. This is probably the reason that Amazon has so far not been able to establish its prominence in furniture retail; but it remains a credible threat.

Weakness in consumer sentiment and housing markets: The company’s revenues are positively correlated to consumer confidence and housing markets. The housing markets have witnessed an uneven recovery. In addition, any decline in consumer sentiment because of spillover effects from global uncertainty could pressure WSM’s results.

Recommendation And Price Target

Target price: Target price range = $75-$79/share. Current share price = $53.40, implying 40–48% upside.

Recommendation: WSM is a BUY.

Amitesh Bajad is a second-year full-time MBA student at UCLA Anderson. He spent the past summer interning as an equity research associate at RBC Capital Markets in San Francisco, where he helped cover aircraft lessors, credit card companies and business development companies. Prior to UCLA Anderson, he worked as a credit analyst at JPMorgan’s Mumbai office, conducting research and due diligence related to large loan transactions. Bajad graduated as an electrical engineer and worked for a year with Fidelity Investments as a database programmer before transitioning into banking.
AIA: For the benefit of our readers, can you tell us about your initial path to investment management?

SK: I came out of investment banking and had a very detailed background in valuation and finance. I was never that great at accounting, but my strengths were always in valuation, which I was able to parlay into investment management. I left investment banking in 1990 and went to work for Hotchkis and Wiley, led by my father John Hotchkis (‘58) and the late George Wiley. In order to avoid nepotism, the firm hired me as a consultant to get access to the financial database business I started after leaving investment banking. At the time, Hotchkis and Wiley focused on domestic equities with a value approach and I was asked to provide data on international equities. After about six months of consulting, I was given a full time offer to co-found an international equity strategy. After a couple of years of working 24/7 to convince existing clients to invest in something they had never seen before, I was introduced to my current business partner, Harry Hartford. He accepted the job offer, and immediately moved his family to Los Angeles from Dublin, Ireland. We built a business in international equities using a similar value approach, but one that also took into account a multicurrency environment. It became apparent to us at the time that investors were selecting regional markets first and stocks second, and we thought this process was backward. We were both convinced that the bottom-up approach made the most sense: find the right companies, get them at the right price, and then figure out where you are invested from an industry, sector and regional perspective.

AIA: What led you to launch Causeway Capital and how has the firm evolved?

SK: In 1996, Merrill Lynch bought all of Hotchkis and Wiley. The international group — consisting of Harry, a few others and me — signed five-year employment contracts with Merrill. During that time, we not only grew international equity assets, we also added some very important individuals to our team who still work with us today. That was really the seed of Causeway’s formation. In January of 2001, we learned that Merrill Lynch was planning to sell the business that they had bought only five years prior, and we did not want to be sold because it would not be good for our clients after having just endured the previous transaction. Given the very long-term nature of investment management and the critical importance of stability, acquisitions and divestitures are antithetical to running a good money management firm. So we decided that we needed an alternate plan in order to keep our very talented team together. This led us to form our own firm in June 2001. It was a rather breathless time because almost everyone from our team followed us of their own volition. They called us, and we scraped together all the money we had personally and found some seed capital several months later. Although we regained most of our former clients, fee revenues arrived with a considerable lag, while the costs hit us immediately. As a result of this mismatch, we ran at a loss for three years before becoming profitable in year four. The support and loyalty of our former clients, following us to our startup, contributed significantly to our success. With performance in the top decile of managers in those years just after the bursting of the
telecommunications, media and technology (TMT) bubble, Causeway had a real business. By 2001, the world was ready for value investing again. Investing styles very much move in cycles and we benefited from that cyclical upturn. We positioned our client portfolios in a number of economically defensive stocks and very few in the hotter categories of TMT. So we started seeing more inflows and we had to accelerate hiring more people.

As a firm run by portfolio managers we had to slow the sales and marketing effort in order to assimilate the rising assets under management. In 2005, we closed our international equity strategy to new investors and then began to work on other ways of growing. We were especially interested in expanding our efforts in quantitative investment research. At the time, quantitative tools were not widely used by competitors. We were obsessed with the integration of multifactor risk models into our portfolios, and ensuring we were evaluating every investment candidate on a risk-adjusted return basis.

We continue to use our own proprietary multifactor risk model as our main tool for portfolio diversification. This was heretical in the early part of the last decade because most of our peers were capping market weights by geographies and sector. We thought this approach was meaningless and we spent years explaining to our clients and their consultants why it is important to understand not just company-specific risk but also systematic risks. We also believed it was critical to look beyond multifactor models like Fama-French by incorporating a number of additional fundamental risk factors to better understand volatility and whether performance is directly attributed to a strategy’s mandated style.

In 2007, our new head of quant joined Causeway and we launched our quantitative emerging markets strategy. Following that, we had our first hedge fund type strategy, blending fundamental long and quantitative short, a rare combination. All active equity managers must justify fees by delivering returns at an acceptable level of risk. Investors can always buy equity exposure cheaply through passive strategies. The world has moved away from the roots of Causeway to something much more sophisticated. It is my job to make sure we continually innovate by delivering attractive products such as our new small cap strategy, which also blends quantitative and fundamental research. If you visit the 15th floor of our building, you will see that we have alternate offices, interspersing quant specialist with fundamental experts. Seating arrangements sound mundane, but it is really important because managing an asset management firm is about managing people. If you put them on different floors or different time zones, they will not talk to each other.

AIA: Speaking of that, it is interesting to delve into your system of convergence between the quantitative and fundamental processes. Can you walk us through initial screening to the ultimate buy decision for an individual stock and how those two processes complement each other?

SK: The weekly screens we use for fundamental strategies (international and global equity) sift through 3,000 stocks with a market cap greater than $1 billion globally, predominantly in the developed markets, and are augmented by emerging markets-specific screens. Our quantitative colleagues create and take the screened stocks and score them as potential portfolio candidates. Our six research cluster groups (financials, industrials, consumer, health care, etc.) determine the fair value of about 200 of these screened stocks. This process involves taking a 360-degree view of the company and its industry, evaluating management and the financial statements, and determining the cyclical versus structural changes affecting the business. We also use our risk model to dissect the various components of a candidate’s systemic risk to understand better how we may be concentrating risk. After internal review and critique of assumptions that drive the price target, the cluster groups decide whether to graduate a
candidate to our ranking of risk-adjusted return. For these ranked stocks, each portfolio manager must determine an appropriate model portfolio weight for his/her stock, then decide when or if we should buy (or sell).

In our quantitative emerging markets strategy, we use screens and an optimization process to arrive at portfolio weights. Unlike Causeway’s international and global value portfolios, our emerging markets strategy deliberately contains tracking error risk (deviation from benchmark) and offers clients a broad portfolio with country, sector and individual stock limits versus the benchmark. The top-down screens we use in emerging markets are much more complex and fairly dynamic, requiring our quantitative colleagues to continually evaluate and retest these models to ensure that they are keeping ahead of markets. The bottom-up portion of the emerging screen has a value tilt, but also captures some technical (price momentum) features.

**AIA: Looking out at the current investing landscape, where, geographically, are you finding some of the most compelling value opportunities?**

**SK:** We’re finding value in anything that’s economically cyclical because nobody else wants it. I was just looking at statistics from September and October showing the greatest historical [pricing] gap we’ve ever seen between so-called quality/defensive stocks and the more cyclical stocks — this being especially pronounced in emerging markets. We look at that based on consistency of earnings, price to book and other measures. So we don’t define quality as financial strength; it’s really defined as consistent earnings or non-cyclical earnings. And we’re seeing that investors are willing to pay anything for it with multiples in the mid to high 20s, but won’t pay anything other than single-digit multiples for cyclical stocks.

**AIA: Let’s move to individual positions. Causeway invests heavily in Japan, which continues to deal with a number of well-publicized economic headwinds. East Japan Railway Company derives most of its operating income from railway transportation and related shopping space. What did you find attractive about the stock?**

**SK:** East Japan Railway comes out of our industrials cluster from PM Jonathan Eng (‘97). The idea with this started in late 2012 with the devaluation of the Yen to the U.S. dollar and hence to the Chinese renminbi since it’s largely pegged to the dollar. The devaluation was huge — roughly 40-plus percent. So Japan was on sale and we started seeing statistics that Chinese tourists were traveling and shopping. With the corruption crackdown you couldn’t necessarily flaunt a lot of luxury goods, but you could go to Tokyo and take a vacation.

So going back to rail, ridership skyrocketed and it continues to go up; and we’ve bought into an airline as well. We want access to those tourist dollars and the investment has little to do with the Japanese economy, or at least not indigenous Japan. As ridership is growing, we’ve also seen an increase in value from redeveloping the company’s properties in and around rail stations. So there is a latent value there since those assets are not marked to market. We also think the three Japanese railway companies are better managed than they’ve been in the past. It all looked pretty attractive and I would normally say now that they’re close to fully valued, but the earnings momentum remains positive.

**AIA: Regarding China, your team published an interesting and well-timed article back in July discussing the government’s misguided financial policy as well as longer-term investment opportunities relating to China’s Belt and Road initiative in South and Central Asia. Could you talk about your views on the recent market gyrations there and also how the Belt and Road initiative is influencing your portfolio decisions?**

**SK:** As an indicator of our optimism about some of these companies, we didn’t sell our Chinese stocks during the rout last summer. We own H shares [mainland Chinese stocks listed in Hong Kong] and we have really good research coverage on those companies, which increased our level of conviction. We’ve sent five people, including me, to China in the last two months. After investigating different sectors, we think the country has a tremendous amount of fiscal flexibility to soften the blow and that they will transition from heavy industry and fixed asset investment to a more consumer-led economy. This transition won’t happen overnight and will probably take longer than most of our clients’ investment horizons.

China’s Belt and Road Initiative is just part of the same process. The Chinese government has only allocated around $90 billion to this initiative thus far. At 10 times that level of investment, Belt and Road becomes more directly investable and is better positioned to absorb some of the country’s excess industrial capacity. One of our current positions, China Merchants, may benefit from this external expansion as China ramps up its
investment abroad. They are the largest port operator-owner in China, and they do a great job of buying port properties in other strategic locations. It’s one of those great businesses with captive customers who do not have much of a choice when it comes to price increases. So we can’t invest directly in Belt and Road right now, but we can maintain our weighting toward Chinese domiciled companies with the expectation of a very well engineered soft landing.

**AIA:** You and your team view yourselves as contrarian investors in many respects, so we’re curious to learn more about your position in Volkswagen AG. What is the market missing and what’s going to drive the price recovery?

**SK:** We bought it in April 2015, about five months before the news broke on the diesel emissions fraud. This lowly valued, underperforming auto stock appealed to us from the perspective of restructuring and revival of European consumer spending. Jonathan Eng is responsible for VW, and believes that the company has the most cost to cut of any automotive manufacturer. This presents the contrarian with a real opportunity.

So after the sell-off, when the emissions scandal was revealed in their diesel fleet, the stock dropped 20 percent the first day and 18 percent the next. I don’t hold the team accountable for fraud. You’ll find in your investment management careers that if a company wants to lie to you, they can; it is difficult to sniff out in advance. But then you need to make an active decision on what to do with the position once you know about the fraud. Our decision was to not only keep the stock but to buy more. We learned from our clients that most of their managers had chosen instead to sell.

From our perspective, one of Causeway’s key tenants is financial strength. We simply don’t buy the stock of companies without superior financial strength. If we do, something has gone terribly wrong, like a company that makes a huge acquisition financed through debt or, in the case of oil and gas, a company’s top line collapses with the plunge in the commodity price. In Volkswagen’s case, they had net cash to the tune of 29 billion euros, which provided a tremendous amount of flexibility. And even if we hadn’t owned it prior to the announcement, I am sure we would own it now because we’ve talked to EPA lawyers, industry consultants and sell side analysts, and we put together this mosaic of the problems and the likely financial ramifications. Barring a global recession, the risk/reward looks very attractive relative to our other investment candidates.

With VW, we decided not to crystalize the loss for clients, but rather to chip away and buy more at lower prices. We are rebuilding the position to where it was before it fell and I suspect we’ll see a recovery like we saw with Toyota’s stock after their sticky accelerator problem in 2010. We suspect that many of the European auto manufacturers in diesel land are complicit. However, diesel-related industries, from automotive manufacturing to refining, represent an enormous European employer, which, interestingly, provides quite a bit of protection for the auto industry. The final reason we like Volkswagen is that the Porsche and Audi brands are worth just about the entire VW market capitalization. You get the rest — the VW brand, plus Man, Skoda, Bugatti and Bentley — for free.

Taking a contrarian position in a controversial stock takes a certain type of bravery. For several weeks we discussed VW at every client meeting and rebutted some of what clients were reading in the media. In these cases, quant risk models reach their limits, and it becomes a management decision to hold (and buy) the controversial position, despite reputational, business and, clearly, portfolio risk.

**AIA:** Your allocations to U.S. stocks suggest the firm has a slight overweight to financials led by Citigroup. What makes Citigroup more attractive than other money center banks?

**SK:** When we evaluate banks we have to decide on what the normalized returns on equity will be and what the path is to get there. In part, our Citigroup valuation model has an expectation of a more upward sloping yield curve in the U.S. And that’s where we could go wrong; in the macro assumption that really underpins all of our bank investments. We’re not saying that Citigroup is better managed than other U.S. banks and our choices are not really geared specifically toward U.S. banks or even global banks. Citigroup makes it into the global portfolio against all of the other global stocks across all industries. So that probably gives you an idea that we’re a little more sanguine on the U.S. economy than maybe others are, and that a rate increase on the long end of the curve will augment net interest margins. We also expect more fee income. And one of the reasons we believe Citi trades at a valuation discount relative to its peers relates to the global nature of its business and its exposure to Latin America and Asia. This negativity toward emerging markets ignores the inevitable cyclical upturn.
**AIA:** Going back to the business, we’re interested to get your view on the future of quantitative-based strategies in general.

**SK:** We’ve got seven people working in quantitative research and expect to hire more in the next year. One of those hires may include a specialist in accounting to analyze statements from a quant perspective. There’s a lot of testing that we can do in the world of accounting to find more valuation anomalies and financial characteristics we can exploit statistically. I’m certain that a significant portion of Causeway’s growth over the next 10 to 20 years will come predominantly from quantitative-based strategies as we build scale.

It is quite remarkable what quantitative investing can do and the reputation has improved since the 2007 debacle, which we weren’t even involved in because most of it emanated from the U.S. And if you look at the pattern between quantitatively managed portfolios versus fundamental, what’s fascinating is how inversely correlated they tend to be. This means that a client can invest in both a quant manager and a fundamental manager and get some level of diversification across their entire portfolio. Or, the way Causeway looks at it, we can put the two investment processes in the same portfolio and create a more attractive risk-return profile than if they were separate.

**AIA:** We enjoyed reading your recent op-ed in the Wall Street Journal discussing certain misconceptions surrounding the gender wage gap and flaws found in policy designed to address the issue. Could you discuss some of the initiatives you’re involved in to improve the situation?

**SK:** In that op-ed, I suggest that having government regulate how the private sector compensates employees may lead to some very unfortunate and unintended consequences. If an employer fears legal ramifications of hiring a so-called protected segment of the workforce, then (as we’ve seen in Europe with their high levels of unemployment) the employer won’t take the risk. In asset management, diversity of background leads to a more optimal result for clients. For the last several years, Causeway has taken steps to find more women to hire as research analysts. This is important because those junior analysts become more senior and may become portfolio managers, and might eventually manage the firm in the future. A few of my female colleagues and I will be on a flight tomorrow morning to visit business schools to identify qualified candidates, and then I’m off to meet with first-year MBA students at the Women in Investing conference, where we’ll review stock pitches and discuss investment idea generation. I just joined the advisory board of Girls Who Invest, founded by a former client and dedicated to reaching young women in college and grad school to entice them into a career in investment management.

**AIA:** Finally, what is your best advice for those trying to break into the investment management industry?

**SK:** My advice is don’t be a generalist. Try to get industry-specific knowledge. We find people are particularly successful if they come from areas such as investment banking, where they’ve had to do a lot of valuation work and they’ve become experts in some industries. It’s difficult hiring someone when they have to be trained in an industry from scratch and they have no basis of related knowledge. Another good feeder is management consulting because, again, there is a very intensive understanding of specific industries. And then the third one is probably obvious, which is to come from a specific industry; for instance, working for a few years at an oil and gas company or with any business where the role affords the person a chance to understand many facets of the industry, its growth potential, competitive landscape and regulatory situation.

**AIA:** Thanks so much for chatting with us, Sarah.
Business Description: Lannett (LCI) is a Philadelphia-based company that develops, manufactures, markets and distributes generic versions of branded drugs. In August 2015 Forbes named it the fastest growing company in the U.S., with a CAGR of 29% over the last 14 years. Lannett has the capability to produce drugs in a variety of forms, including solid oral, topical, nasal, patch, foam, soft gel and injectable. 94.5% of revenues come from 10 treatment areas, the most significant being thyroid deficiency, gallstone, cardiovascular and pain management. In 2007, it acquired Cody Labs, and in 2008 the facility became one of only seven licensed by the DEA to manufacture pain management drugs from poppy straw, a controlled substance. In September 2015 it announced the $1.23B acquisition of UCB’s generic subsidiary, Kremers Urban Pharmaceutical, which is Lannett’s largest acquisition to date. The TTM revenues of the combined company as of June 30, 2015, were $869MM, more than double Lannett’s pre-purchase revenues of $406MM over the same period.

Investment Thesis: Since Lannett’s announcement of the acquisition of Kremers on September 2, which initially caused its stock to surge, share prices have fallen 37.1% and it now trades at a discount to its peers. I believe Lannett is currently undervalued for three reasons: 1) the market fails to appreciate management’s strong track record producing niche drugs with high margins; 2) many of the macro concerns in the pharmaceutical industry are being improperly associated with Lannett; and 3) the news of Kremers’ losing a major customer is overshadowing the value of the acquisition. Catalysts exist in the near term when the value of acquiring Kremers becomes clear to the market and the political conversation about drug regulation clarifies. LCI is a BUY with a one-year price target of $66.

Management has a track record of successfully targeting and manufacturing high-margin products: Unlike larger generic drug companies that focus on Paragraph IV approvals, which create an initial 180-day window in which no generic competition is allowed, Lannett targets niche products where it sees limited competition either because the drug is difficult to produce or there is an additional regulatory barrier. Using this strategy, management has grown Lannett organically and consistently, beating analysts’ earnings estimates the last 14 quarters and achieving gross margins in 2015 of 75.3%, an amount is significantly above its competitors’ average gross margins of 52%. The driver of this growth has been management’s ability to produce difficult-to-manufacture drugs that consistently meet FDA standards. For example, in 2014 and 2015 Lannett was able to increase the price of Levothyroxine, the thyroid deficiency drug that accounts for 37% of its 2015 revenues, because one of its competitors was unable to meet the FDA’s bioequivalence standards. Central to Lannett’s high-margin strategy was the acquisition of Cody Labs and its entry into the pain management market for controlled substances, which currently accounts for 6.7% of revenues but that Lannett expects to account for 50% by 2019. Drugs made from controlled substances face limited domestic competition and zero foreign competition because of DEA regulation and therefore have higher gross margins, which historically have averaged above 60%. Lannett’s acquisition of Kremers is a continuation of this strategy, as it is also licensed to manufacture controlled substances and currently has eight such drugs in its pipeline.

Macro concerns are overblown in regard to Lannett: The pharmaceutical industry has been grabbing headlines in recent months for controversies that do not relate to Lannett. Valeant brought attention to “specialty pharmacies,” which Lannett does...
not sell. The Pfizer/Allergen merger brought attention to tax inversions, but Lannett is incorporated in the U.S. Turing Pharmaceuticals’ overnight price increase of the generic drug Daraprim from $13.50 a pill to $750 hits closer to home, as Lannett has increased prices on some of its products. But all of Lannett’s price increases have been modest: Levothyroxine costs on average $6 per dose and Digoxin $0.76. The regulatory changes Hillary Clinton proposed on September 21, 2015, sent share prices down across the pharmaceutical industry, including Lannett’s, but her proposed $250-per-month spending cap would have relatively less effect on Lannett and its cheap products. Clinton’s second proposal, to increase funding of the FDA, would lead to quicker approvals and more competition, but Lannett’s difficult-to-produce drugs would still provide some barrier to entry, as would the DEA’s regulation of its controlled substance products. I believe Lannett is oversold in response to these macro concerns considering that its seven main generic drug competitors (TEVA, MYL, AKRX, IPXL, TARO, SGNT, MNTA) face the same issues. But their shares have only dropped an average of 5.65% since September 21, while Lannett’s stock is down 36.9% over the same period.

While the current conversation is focused on regulatory concerns, it is worth keeping in mind the macro tailwinds that benefit the generic drug industry, namely: the U.S.‘s aging population, a historic $65B worth of branded drugs coming off patent between now and 2019, and the industry’s resilience in bear markets and recessions.

**Benefits of Kremers acquisition are being overlooked because of customer loss:** On Lannett’s November 5 conference call, it reported the loss of a Kremer customer that accounted for $87MM in revenues and $45MM of EBIT in 2015. Management’s defensive tone on the call did not help the matter, and despite beating earning estimates, shares have since tumbled 19.9%. Management believes that it can easily replace the customer, but even if one assumes that the revenues, which account for 10% of the combined company, are not replaceable, the sell-off is excessive because of the acquisition’s numerous benefits. One of Lannett’s most significant risks is its revenue concentration, with Levothyroxine and Digoxin accounting for 37% and 16% of revenues respectively. This risk is compounded by the fact that both are manufactured by the same third party, JSP Labs. After the Kremers acquisition, however, the risk is mitigated because Levothyroxine and Digoxin only account for 19% and 8.0% of TTM revenues, even with the $87MM customer loss accounted for.

This revenue diversification extends to new treatment areas like ADHD, as well as to future products. Kremers has 18 drugs currently on the market and 11 more products pending approval with the FDA. The acquisition is also in keeping with Lannett’s vertical integration strategy, as Kremer owns a 381,000-square-foot manufacturing facility in Seymour, Indiana. Post-acquisition efficiencies present themselves as well: Lannett estimates annual cost savings of $40MM beginning in 2019. Finally, because Lannett had no debt prior to the deal, its leverage after the acquisition is a modest 3.5x EBITDA.

**Valuation:** Management has yet to give detailed estimates that reflect the Kremer acquisition, which is one reason shares are trading at such a discount: the market is incorrectly equating uncertainty with risk. Management has stated, however, that it expects the acquisition to be accretive to 2016 earnings projections by 5.0% and 2017 earnings by 20% (I’ve adjusted these estimates to reflect the lost customer). Given that revenues after the acquisition are on course to double in 2016, these are conservative estimates and are in keeping with management’s style. Although Lannett’s revenue concentration will be less of a concern post-merger, Lannett will most likely still trade at a discount to the industry average of 16.45x forward EPS. I project Lannett’s share price in one year, trading at 13x its forward EPS, to be $66.18. A DCF calculation with an 11% discount rate, 8.0% growth in years 3 to 10, and 3.0% terminal growth for the subsequent 10 years yields an intrinsic value of $71.34 per share.

**Downside protection:** There are significant risks associated with Lannett, but I believe that these are largely factored into the current share price. Lannett’s industry-leading gross margins, largely attained through price increases, leave it vulnerable to new competition. This vulnerability is reflected in its industry-low multiple of 9.1x forward EPS. If gross margins fell to an industry average of 52% and revenues of the post-acquisition company contracted 22%, then 2016 EPS would be $2.89 (a 29% drop from 2015). If flat growth were projected for 2017, then I believe Lannett’s P/E multiple would expand because much of the risk inherent in its current price would have materialized. In this case, 12x forward earnings would not be an unlikely multiple, as it is still well below average and would equate to a share price in one year of $34.68, which is only a 6.2% drop from current levels.
Principal Investment Risks: Risks include additional competitors in Lannett’s key products categories, reliance on JSP Labs for the manufacturing of Levothyroxine and Digoxin, additional federal regulation, integration issues with Kremers, licensing issues with the FDA or DEA, and wholesale distributor consolidation, which could increased bargaining power against Lannett.

Recommendation And Price Target: LCI is a BUY with a one-year target price of $66.

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UPCOMING EVENTS

February 12, 2016: Fink Center Stock Pitch Competition
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March 9, 2016: Private Equity Roundtable
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May 23, 2016: Fink Investing Conference
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