



# **Bonner Private Portfolio**

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JANUARY 2017

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January 4, 2017

**RE: We're Investing in the Greatest Demand for Jet Engines Since World War II**

Dear Partners,

I was thinking of how to describe to you the dramatic production change that lies ahead for the company I'm recommending today – and what makes this change so compelling. Then I came across this note from the *Financial Times*:

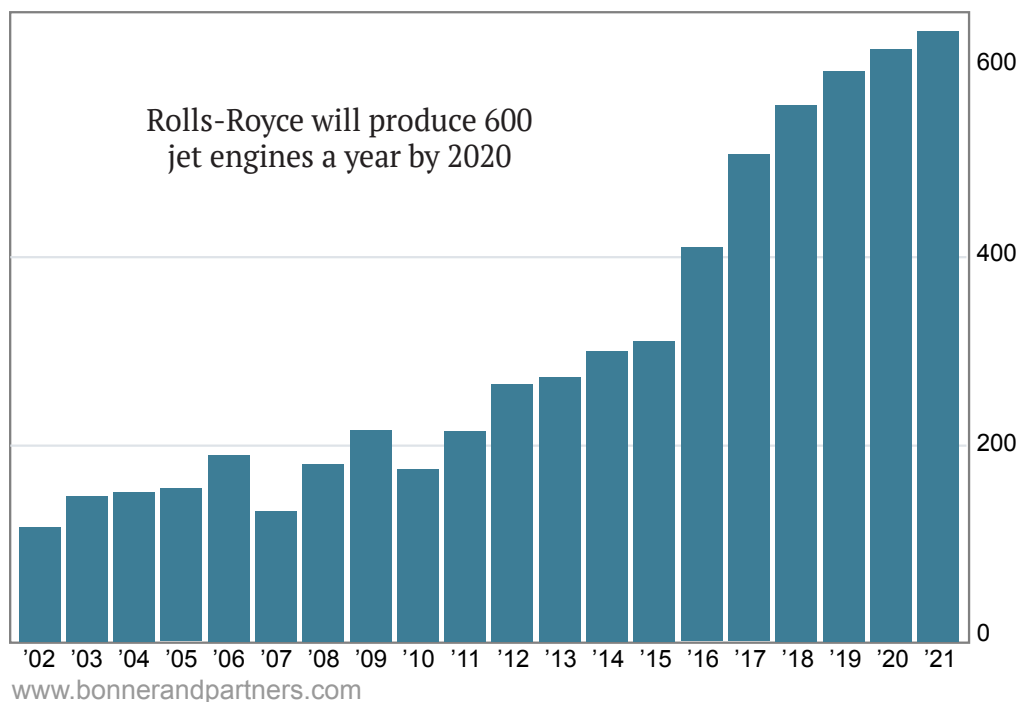
The company intends to double annual production by the end of the decade, which will allow it to churn out 600 jet engines a year – **more than at any time since the Second World War.** [emphasis added]

The world's current fleet of aircraft is old. And air traffic continues to grow. As a result, there is a deep order book for new engines that stretches well into the 2020s.

Our new buy builds jet engines. Its Trent engine has exclusive placement on nearly the entire Airbus fleet of wide-body planes. (A wide-body is basically an aircraft with two aisles. Examples include the Boeing 777 and Airbus A330.)

And it has a backlog that all but guarantees future growth. Take a look at the chart below.

**Trent Engine Production**



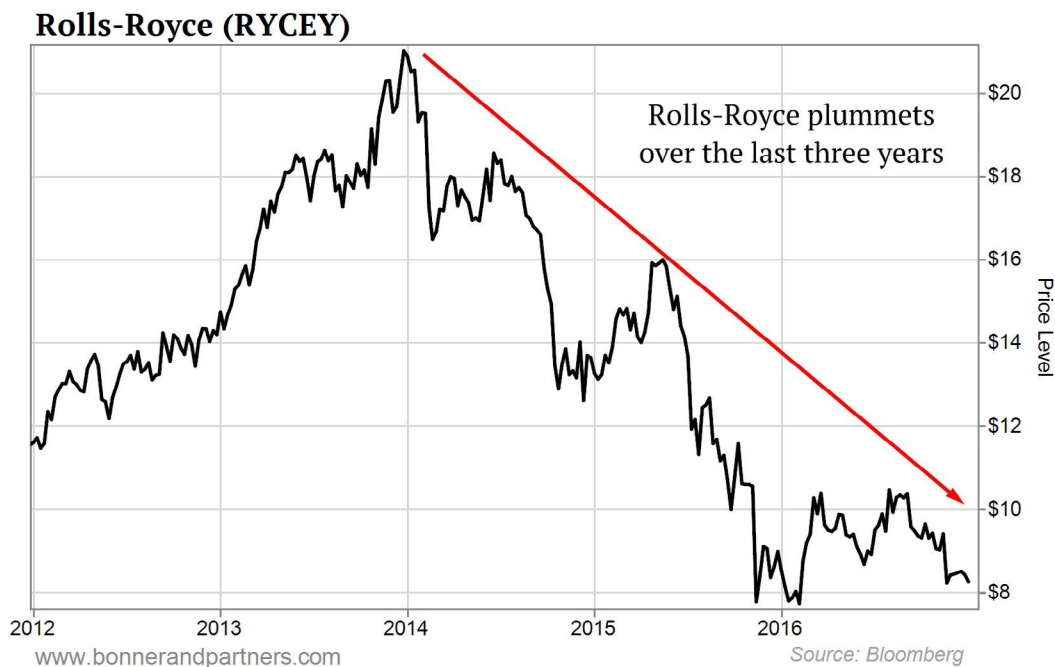
That's our thesis in a nutshell. It is hard to find companies with such guaranteed revenue growth. But it gets better...

Rolls-Royce's business model is the coveted "razor-razorblade model." Here is Arman Gokgol-Kline, a senior analyst at Sequoia Fund (of which Rolls-Royce is a top 10 holding), at the fund's Investor Day held at the Plaza Hotel in New York City in May:

The business is a razor-razor blade model. You sell the razor, in this case the engine, for little to no profit, if not a slight loss. Then you get 20-to-30 years of razor blade sales — service and spare parts — at nice margins.

Let me emphasize: 20 to 30 years of "razor blade sales... at nice margins." Rare indeed. Such assets usually command luxurious prices in the stock market.

But as I'll explain, the company has struggled to produce all those engines. In the last two years, it's revised its profit outlook downward five times. Early in 2016, it cut its dividend for the first time in 25 years. The stock, once over \$20 per share as late as 2014, now trades for under \$9.



We smell an opportunity...

### **A Major Turnaround Is Well Underway**

**Rolls-Royce Holdings PLC (RYCEY)** has a long history. It was founded in West Sussex, UK, in 1906 by Henry Royce and Charles Rolls, who wanted to build luxury cars. Their iconic cars were the main business of the firm until 1973, when they created Rolls-Royce Motors as a standalone company.

Rolls-Royce began making aircraft engines at the start of World War I. Today, it makes engines for

the commercial aviation, defense, nuclear, marine, and power-generation markets. Aviation makes up two thirds of revenues and is the focus of our story.

Rolls-Royce had to invest a lot of money up front to prepare for the ramp-up of its new Trent engines. And the transition didn't go well. The company had repeated cost overruns and delays. The stock tanked, and pressure started to build to make a change.

In July 2015, a new CEO named Warren East took the reins. East was the CEO of ARM Holdings, a semiconductor firm. During his tenure as CEO (2001-2013), ARM shares delivered a compounded annual return of over 11%.

East is an engineer, and since taking the helm at Rolls-Royce, he's made a number of changes to get the firm back on track. These include flattening the organization chart and cutting middle management.

Some of these changes have already borne fruit. For example, Rolls-Royce has cut the time it takes to assemble the Trent 1000 engine from 40 days to 30. East wants to get it down to 20.

He will also give investors more disclosure about performance. Rolls-Royce's financial statements are complex for most investors. They obscure a real gem...

The reason is that Rolls-Royce sells its engines at a loss. So as sales ramp up, overall profits at Rolls-Royce look depressed. But with every sale, it also gets a service contract that usually lasts 10-15 years. The customer pays a fee based on engine use for the length of the contract. Moreover, certain parts have to be changed out after so many hours (for an additional fee), whether the part is still good or not. (The firm calls this package TotalCare.)

Rolls-Royce says that for every dollar of engine sales, it will earn four dollars in service revenue. It's a wonderful business for the company.

We've spent a lot of time trying to model Rolls-Royce and figure out what it could look like as Trent engine production climbs toward that 600 figure. In this, we've had some help...

Steven Wood of Greenwood Investors owns Rolls-Royce in his fund and shared his own detailed model of the company with us. You may remember Steven from our August letter. We traveled with him to Italy. Right after that trip, Steven headed off to the Farnborough Airshow in Hampshire, UK. This is an important airshow, with over 100,000 visitors each year. It brings in \$70 billion-plus of aircraft orders.

We were thinking of going, as Rolls-Royce was on our radar even then. Steven has spent countless hours with the company, breaking down its results *per engine model*. To us, it's a work of art.

There are a lot of moving pieces in this model: engine sales (and retirements), engine utilization, service revenue per engine, as well as assumptions about expenses.

To boil this down, we present, on a consolidated basis, what we think Rolls-Royce could generate by 2020:

### Rolls-Royce Free Cash Flow by 2020

(In billions)	2016	2020
Revenues (£)	13.25	15.66
Operating income (£)	1.18	1.99
Operating margin	8.9%	12.8%
Free cash flow (£)	(77)	1.35
Free cash flow (\$)*	(95)	1.67

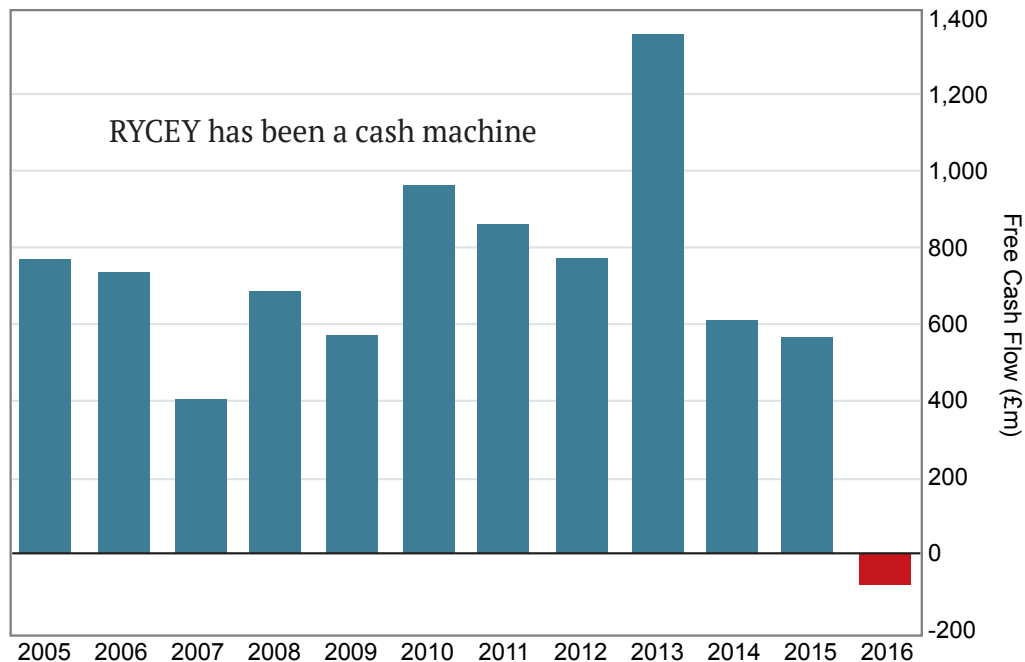
\*Based on pound-to-dollar exchange rate of 1.23

We’re focusing on 2020 because that is the year that engine sales start to level off. That’s the “steady state” that Rolls-Royce should be able to maintain for years. But we have a big ramp-up to get there.

Historically, Rolls-Royce has been a cash machine. For context, see the historical free cash flow (FCF) that Rolls-Royce generated below. But it’s never had the order book it has today.

Also, the operating margin is worth a quick highlight: GE, Rolls-Royce’s main competitor in a duopolistic industry (meaning two dominant industries cover that market) – earns 20%-plus operating margins in its civil aerospace business. So Rolls-Royce, with its operating margin of 8%, has plenty of room to improve.

### Rolls-Royce’s Historical Free Cash Flow



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In short, Rolls-Royce should generate about \$1.6 billion in free cash flow in 2020. If you put a 20x multiple on that cash flow, then Rolls-Royce is a double by 2020:

### Rolls-Royce's Expected 2020 Return

Financials	2020
Free cash flow (billions)	\$1.6
Shares outstanding (billions)	\$1.8
FCF per share	\$0.91
FCF multiple	20
Value per share	\$18.20
Price today	\$8.50
Upside	114%
Annualized return	21%

That's a good target price for a top-quality business with the predictable and long-term cash flows Rolls-Royce will soon enjoy.

Our friend Steven Wood has numbers higher than ours. In a Thanksgiving note to his clients, he wrote:

We are confident that 2016 represents the trough in Rolls-Royce's financials, and have gained even greater conviction that free-cash-flow will be ramping to over £1.00 per share [\$1.23] before the end of the decade.

Our own per-share estimate is \$0.91. If Steven is right, our estimated upside will prove far too low.

What could go wrong? Rolls-Royce could fail to execute on its plan. Or those new orders for planes could be deferred. Or miles flown could fall, which would hurt service revenue. Or one of the other divisions could deliver results poor enough to drag down the overall numbers. There are lots of moving parts in this business, as we've said.

But we think the share price has baked in an awful lot of bad news. Meanwhile, the road to at least \$1 billion in free cash flow seems clear. Even if our estimates are off, we should be able to get out without losing money. In other words, our downside is low and our upside is at least a double.

**Let's see how Rolls-Royce meets CODE:**

**Cheap?** We think Rolls-Royce is cheap based on the free cash flow it will generate as the Trent

engine platform ramps up. By our estimates, Rolls-Royce's stock could more than double by 2020.

**Owner-operator?** While we do not have a true owner-operator here, we do have ValueAct Capital. The well-regarded San Francisco-based fund run by Jeffrey Ubben owns a \$1.68 billion stake in Rolls-Royce, about 11% of the company. It's one of their top five positions. More importantly, ValueAct has a seat on the board of directors. We like their involvement.

Also, CEO Warren East has been an active buyer of stock. Over the past year and a half, East has purchased nearly 200,000 pounds (\$246K) worth of shares at an average price of 6.45 pounds (\$7.93).

**Disclosures?** Rolls-Royce has one of the most complicated income statements we've seen, thanks to the nature of its engine contracts. But Rolls-Royce has tried to simplify its financials and help investors understand the company. In November, it held an investor day and provided a 29-page slide deck to walk through the accounting. So, although it took some extra work to understand them, we think the disclosures are good.

**Excellent financial condition?** Rolls-Royce has a clean balance sheet with very little debt and an investment-grade rating. The company is in excellent financial condition.

We think this is a business we could own for years.

**Recommendation: Buy Rolls-Royce (RYCEY) up to \$9.50 per share. Make it a 3% position to start.**

**Note:** You may also buy the UK-listed shares if you wish. They trade under the ticker RR.

We might get some bumps in the share price in early 2017 as Rolls-Royce rolls out its new simplified accounting (which will show losses at first). If the market gives us a chance to buy more at a lower price, we'll do so.

## Portfolio Review

In next month's letter, we'll do a year-end review of our performance so far. We'll also share Bill Bonner's portfolio with you, so you can see how he's done by following our recommendations.

In last month's letter, we reviewed all our positions in detail. Our views have not changed since. However, a couple of interesting things happened since our last letter, which we'll highlight here...

First, [\*\*Ralph Lauren \(RL\)\*\*](#) sold off heavily beginning in November, falling from about \$114 per share to under \$89 – a 22% drop. The selloff gave us another swing at the piñata, so to speak. [We took it, doubling up on the position.](#)

**Recommendation: If you own 100 shares of RL, buy another 100 (if you haven't already).**

So far as we can tell, a seemingly weak holiday season inspired the drop. Anecdotally, many retailers have cut prices to move apparel. Miriam Gottfried, who covers retail for *The Wall Street Journal*, has conducted price checks and wrote about the price cuts at Macy's, Gap, and other stores. She found sweaters, pants, vests, shoes, etc. at 30%-50% off. A few days before Christmas, she tweeted: "The \$998 black leather pants we've been following at Ralph Lauren were \$482.99 this week [vs.] full price last week."

More anecdotal evidence that it could be a rough holiday season came from Bed Bath & Beyond. It reported ugly third-quarter results and the stock fell 9%.

It's the usual short-termism at work. There is a lot more to Ralph Lauren than a play on holiday sales. As we detailed in our initial buy, there is a turnaround at work and a lot of potential upside over the next couple of years as it takes root. We already have proof that things are moving along fine... See [last month's letter](#), where we highlighted RL's own third-quarter earnings report.

Beyond Ralph Lauren, [we also doubled up on Fairfax Financial \(FFH.TO\)](#). Fairfax announced the biggest deal in its history, acquiring insurer Allied World. The market sold off Fairfax initially. The stock was down almost 6% at one point in the day, probably because of the premium Fairfax will pay to buy Allied. But the market quickly reversed that opinion as it digested the details of the deal. We think it's a good deal for both parties, as it creates a stronger company.

Once again, we got a chance to increase our position in a name we like at a price less than what we first paid for it.

**Recommendation: Double your shares of Fairfax if you haven't already.**

Switching gears, higher interest rates and the prospect of better profits for financial stocks helped boost our stakes in AIG, CIT, and Berkshire. At the time of writing, we're up about 24%, 20%, and 12%, respectively, including dividends. And all three are near 52-week highs.

The only position that is down by any significant amount is [Astellas Pharma \(ALPMY\)](#). We're down 18% including dividends. (We got our first 15-cent dividend last quarter.)

As we've explained, this is mostly due to the fall in the value of the yen versus the U.S. dollar. The latter has been strengthening all year, but especially post-U.S. presidential election. A weaker yen means our yen-denominated investment in Astellas is worth less. Over the longer term, though, we think this largely evens out. (Astellas shares in Tokyo are only down slightly since we added Astellas to our portfolio. This shows you that it isn't as if something at Astellas is behind the decline.)

**Recommendation: Buy Astellas (ALPMY) up to \$20 per share and make it a 4% position.**

Just to share more of our thinking on the portfolio: At the top of the list of stocks we'd love to buy more of is [Vivendi \(VIVHY\)](#). We don't have anything new to report. The stock has backed off its 2016 high, but the business continues to do very well. We have our eye on it.

**Recommendation: Buy Vivendi (VIVHY) up to \$20 per share. Make it a 3% position.**

We wouldn't mind adding to [Equity Commonwealth \(EOC\)](#), either. The stock got some coverage in *Barron's* in December. The financial paper included it among their top five picks for 2017:

Commonwealth has been reorganizing since Sam Zell became its chairman in 2014, selling properties into a strong commercial real estate market. Over the past two years, the company has parted ways with over \$4 billion in properties.

Further sales are likely, which could help push the stock up from its recent \$29.50. JMP [Securities'] Mitch Germain puts the net asset value at \$33 to \$34 a share. In the next year, the stock is apt to close that gap or come close.

Commonwealth has \$2.5 billion in cash, or about \$19 a share, on its balance sheet. That gives it options, should the property market turn down. Zell has a track record of making shareholder-friendly moves, and the outcome here could turn out positively, as well.

We peg net asset value at \$35 and we agree with *Barron's*. EQC is a low-risk, cash-rich holding that shouldn't hurt us. And it gives us decent upside – with free options if Zell does something creative with all that cash. We're up about 12% here, as the stock pulled back a touch when rates rose and the market sold off real estate stocks. If it inches down a little more, we might increase our position here as well.

**Recommendation: Buy Equity Commonwealth (EQC) up to \$30 per share. Make it a 5% position.**

Finally, there is our Swiss luxury goods maker [Richemont \(CFRUY\)](#). It's our smallest position at about 2.8%. We love the business long-term. We like the cash-rich balance sheet and the guy in charge, Johann Rupert (who is also the largest shareholder). We've been hesitant to add to our position until we get a firmer sense that the bottom is in for luxury goods. It's been slower to recover than we would've guessed, but it seems certain that 2017 will be better than 2016. It's something we're watching closely.

**Recommendation: Buy Richemont (CFRUY) up to \$7 per share. Make it a 3% position.**

That wraps up the portfolio review. We own an eclectic bunch of names from all over the world. But in each case we've got the four elements of our CODE working for us. We're in a good position for 2017.

## Best New Books of 2016

A partner wrote in to ask: *What are the best books you read this year?*

I have a steady flow of books that arrive at my house every week. I read widely, but for purposes of this list, I'll confine myself to my three favorite investing books published in 2016. And I'll throw in one economics book from 2015 that I highly recommend.

At the top of the list: [Intelligent Fanatics Project \(IFP\)](#) by Sean Iddings and Ian Cassel. Ian is a friend of mine, an independent investor who started MicroCapClub. *IFP* reminds me a lot of my own latest effort, *100 Baggers*. Both try, in their own way, to find the secret sauce behind some of the market's biggest winners.

"Intelligent fanatics" essentially refers to those rare founders who can turn a little business into a big business. Charlie Munger, vice chairman at Berkshire Hathaway, coined the phrase.

*IFP* covers eight such fanatics – there’s a chapter on each. Here they are, along with their astounding returns:

### Eight “Intelligent Fanatics”

CEO	Company	Leadership Duration	Annual Return
John H. Patterson	National Cash Register	33 Years (1884-1921)	27% <sup>a</sup>
Simon Marks	Marks & Spencer	37 Years (1924-1967)	16% <sup>a</sup>
Sol Price	FedMart, Price Club	38 Years (1954-1993)	40% <sup>c</sup>
Les Schwab	Les Schwab Tire Centers	47 Years (1952-1999)	22% <sup>a</sup>
Herb Kelleher	Southwest Airlines	30 Years (1971-2001)	25%
Chester Cadieux/ Chet Cadieux	QuickTrip	30 Years (1984-2014)	20% <sup>b</sup>
F. Kenneth Iverson	Nucor	33 Years (1965-1998)	17% <sup>d</sup>
3G Partners	Garanita, Anheuser-Busch InBev	44 Years (1971-2015)	30% <sup>e</sup>
<p>a: Estimate based on growth and/or financial data.            b: Estimate given by Chet Cadieux KU School of Business Presentation.            c: Cumulative record for both FedMart and Price Club since inception.            d: From Kevin Iverson, <i>Plain Talk: Lessons from a Business Maverick</i> (New York: Wiley 1997), 183.            e: Estimated cumulative record for both Garanita and Anheuser-Busch InBev.</p> <p>Source: I. Cassel and S. Iddings, <i>Intelligent Fanatics Project</i> (2016)</p>			

The case studies are fun to read and also important. The more we can recognize the patterns behind great success, the better we can filter through the thousands of stocks that are out there and focus on the ones that could truly be special.

I also enjoyed [\*Capital Returns: Investing Through the Capital Cycle: A Money Manager’s Reports 2002-15\*](#) edited by Edward Chancellor. The book is essentially a collection of reports written by analysts at London-based Marathon Asset Management. It is the follow-on to the earlier *Capital Account: A Money Manager’s Reports on a Turbulent Decade (1993-2002)*. (Which is, by the way, also excellent.)

The 2016 book ranges widely over many topics. The introduction covers Marathon’s capital cycle investing model. The basic idea is to try to understand how the flow of capital into (and out of) an industry will impact its future profitability.

Cycle theory predicts that when a lot of money flows into an industry, its future profits will likely fall. (Think competition. Remember the boom to fund fiber networks in the run-up to the 2000 bubble?) Likewise, when money flows out of an industry, it often leads to an improvement.

From there, Chancellor grouped the reports into two parts. Part I covers “Investment Philosophy.”

The essays here are timeless and sometimes cover historical episodes of interest. For example, an essay on the cod industry from the 16th century to the present serves to show Marathon's capital cycle theory in action. Besides that, it's just really fascinating to see how an industry evolved over a long period of time.

There is also a section on management. And in there you'll find an essay titled "The Wit and Wisdom of Johann Rupert." It's all about our man at Richemont. Definitely recommended.

Part II, titled "Boom, Bust, Boom," covers larger cyclical events such as the European crisis, China's problems, and lots more. There is a case study on the Anglo Irish Bank, for example. And several essays on bubbles and manias. All of this makes for enjoyable reading. The chapters are often only 2-3 pages but give you much food for thought.

The last of the investing books is [\*Quality Investing: Owning the Best Companies for the Long Term\*](#) by Lawrence Cunningham, Torkell Eide, and Patrick Hargreaves. From the preface:

This began as a small internal project at AKO Capital, an equity fund based in London that has enjoyed a compound annual growth rate more than double that of the market.

Eide and Hargreaves are the portfolio managers who gathered all the material. Cunningham is a professor and well-known author of over a dozen books. He helped them get it all into shape. The result is a book that will help you recognize the "patterns evident in quality companies." AKO got their great results by buying quality assets and holding on.

The basics of what makes a great business are here and discussed in some detail. Smart capital allocation. A high return on capital. Multiple sources of growth. Good management. Other patterns to look for include recurring revenue, brand strength, and market-share gainers.

The book has a European focus, so many of the names covered may be unfamiliar to you. We added a few to our watch list as a result of reading this book. One was Luxottica, the Italian eyewear company. The stock still seems expensive, but what a business! It's stable with great brands that generate high profit margins, such as Oakley and Ray-Ban. Plus lots of room to grow. Another is Handelsbanken, a Swedish high performer with a great corporate culture.

Again, lots of case studies and hard-won wisdom lie between these covers. It's a useful book to help think through what makes for a truly quality business.

The last book I'd recommend is an economics book: [\*Why Minsky Matters\*](#) (2015) by L. Randall Wray. Hyman Minsky (1919-1996) may be my favorite dead economist. I have all of his books. He was born in Chicago and taught for many years at Washington University in St. Louis and later at the Levy Institute at Bard College.

He is very good with money and banking. As a former banker myself, I can tell you that Minsky seems to be one of the few economists who get that banks don't lend out their deposits. (They create deposits "out of thin air." They don't have to accept deposits first.) No wonder, since Minsky actually served on a bank board during the Great Depression. If you think banks lend out a portion of their deposits, I urge you to get the book and pay careful attention to Chapter 4.

Minsky's Financial Instability Hypothesis is another aspect of his work that I favor. It is a robust model that explains a lot about how markets move from boom to bust and back again. There is a nice explanation of it in this book.

Wray is an economics professor himself and was a student of Minsky's. He worked as his teacher's

assistant in St. Louis. There is probably nobody writing today who knows Minsky better than Wray. So you have a good guide here. I've met Wray before and interviewed him in the past. He has done marvelous work on the nature of money and monetary systems.

I care a lot less for Minsky's world-improving schemes. He was, as all economists seem to be, kind of a policy wonk – full of ideas about how to run things. But for his understanding of money, banking, and the financial cycle, I think Minsky is superb. Minsky's own work can be hard to read, but Wray has done a credible job of making him more accessible.

That's my list for 2016. Happy reading!

If you've read other valuable investing books this year, let me know [here](#).

### **A Visit With the Bonners**

I was at the Bonner's home in Baltimore for a party on the night before Christmas Eve. The house looked festive, with a twinkling Christmas tree, glowing fireplace, and decorations on the mantle. There was a big table overflowing with food: oysters and baked ham and paté. There was wine and cheese and a particularly tasty hors d'oeuvre that I kept going back to: a date with the seed cut out and an almond in its place, all wrapped in bacon with a toothpick through it.

There was a good crowd of people there. Bill and Elizabeth's sons and daughters were there, as well as neighbors and old friends and business partners. Bill jokingly introduced me as a "financial genius," adding: "He better be, because we're investing in his recommendations!"

"Bill, don't worry," I told him later. "Your money is in good stuff." I told him the portfolio was doing well overall. (Although we know he doesn't care about that. As Bill has told me before, we'll see how it looks years from now.) We've stayed true to the plan we laid out at the start: the patient and careful creation of a well-researched portfolio of stocks that will last and build wealth over time.

I later told this anecdote to Thompson, our lead analyst. He laughed. "We dream about his portfolio," Thompson said. Indeed, we do. I'm sure we think about it much more than Bill does.

Look for our year-end performance review next month!

We'll write you again on **February 1**.

Sincerely,



Chris Mayer with Thompson Clark

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