December 7, 2022

Dear Partner,

The Bonhoeffer Fund returned -13.7% net of fees in the third quarter of 2022. In the same time period, the MSCI World ex-US, a broad-based index, returned -10.9% and the DFA International Small Cap Value Fund, our closest benchmark, returned -10.0%. As of September 30, 2022, our securities have a weighted average earnings/free cash flow yield of 19.7% and an average EV/EBITDA of 3.4. These metrics are associated with a portfolio that has projected earnings/free cash flow growth of about 10%. The DFA International Small Cap Value Fund had an average earnings yield of 14.5%. These multiples are lower than last quarter primarily due to share price declines more than earnings declines. The difference between the portfolio's market valuation and my estimate of intrinsic value continues to be greater than 100%. I believe the gap will close over time and the portfolio quality will continue to increase as we increase allocations to faster-growing, higher-quality firms.

Bonhoeffer Fund Portfolio Overview

As described in previous letters, our investment universe has been extended beyond value-oriented special situations to include growth-oriented firms using a value framework. This includes companies that generate growth through transition and consolidation. There have been modest changes within the portfolio in the last quarter in line with our low historical turnover rates. We sold some of our slower-growing names and invested some of our cash into Berry, described in the case study below.

As of September 30, 2022, our largest country exposures include: South Korea, United States, United Kingdom, South Africa, Philippines, and Italy. The largest industry exposures include: distribution, telecom/media, real estate/infrastructure, and consumer products.

We added to some smaller positions within the portfolio and are investigating additional consolidation plays with modest valuations in industries that have nice returns on invested capital such as chemicals, leasing, distributors, and specialty finance.

Compound Mispricings (31.7% of Portfolio; Quarterly Average Performance -14.1%)

Our Korean preferred stocks, the nonvoting share of Telecom Italia, Wilh. Wilhelmsen, and some HoldCos all feature characteristics of compound mispricings. The thesis for the closing of the voting, nonvoting, and holding company valuation gap includes evidence of better governance and liquidity. We are also looking for corporate actions such as spinoffs, sales, or holding company transactions and overall growth.

Lotte Chilsung's preferred shares is a compound mispricing which has become more interesting as its price has declined and cash flow has increased. The company is Korea's largest beverage firm which also provides alcoholic beverages. The firm owns a large plot of land in the Gangnam district of Seoul, South Korea. Lotte has introduced new healthy beverages (including zero sugar and mineral water beverages), as well as renewed alcoholic beverages (such as soju) and is expanding internationally in places like the Philippines. Earnings are projected to increase by 12% per year over the next three years. Since the holding company transaction in 2017 (and our investment), Lotte Chilsung has had quarterly disclosures in English and developed a corporate strategy focused on returning excess capital to shareholders via a goal of distributing 30% of profits going forward. The preferred shares receive dividends in excess of the common shares. The current dividend yield of preferred shares is 4%. Below is an intrinsic value for Lotte Chilsung based on comparable firm multiples and including a 50% discount to the estimated development value of the land Lotte Chilsung holds in Gangnam, Seoul.

Lotte Chilsung (₩bn)								
	EBITDA	Multiple	Value	% of Value				
Beverage & Liquor Ops	₩390	8.8	₩3,421	77%				
Gangnum Real Estate			₩950	21%	50% of sale value		₩89,962	
Lotte Aktar Beverage			₩48	1%	52% of Akhar Beverage (October 2018)			
Cash			₩332		3/2022 cash			
Debt			-₩1,395		3/2022 debt			
Valuation (₩bn)	FCF (₩bn)		₩2,685	100%			Hold co Disc	20%
Shares (m)	₩137		10.560000					
Value Per Share	₩13,011	NI Mult	**₩254,273**	Discount				
Common Shares		12.0	₩156,000	-38.6%	63%	Tang BV	₩648	Ex Real Esate
Preferred Shares		5.5	₩71,004	-67.1%	204%	BV/Share	₩61,392	
						RoTE	21.2%	
EBITDA Multiple								
		Upside				Tang BV		
7	**₩202,100**	185%				PP&E	₩2,121	
8	**₩231,672**	226%				NWC	₩367	
9.3	**₩270,115**	280%				Debt	₩1,395	
10	**₩290,815**	310%				Tang BV	₩1,093	
						BV/Share	₩103,542	
EBITDA Multiples						RoTE	12.6%	
Korean Alcohol Comps	7.9	Hite Jinro & Muhak						
		9.8	6					
International Beverage Bottlers	9.6	Coca-Cola Cons, Coca-Cola Europe, Coca-Cola FEMSA, Coca Cola Amatil, Arca Continental,						
		Icecek Cola-Cola, Coca-Cola HBC						
		7.1	13	8.9	14.9	8.7	6.1	8.3

Another holding, Telecom Italia (TI) is still in negotiations about the sale/merger of their core network. The delay of the decision of regulators due to new elections, proposals of nationalization of the core network, and deteriorating short-term performance have weighed on the price of the shares this past quarter.

Also, in the past quarter, the common preferred discount for LG Corp remained steady at 20%, while the holding company discount increased to 70%. This is, in part, due to the decline in value in some of LG's largest subsidiaries (like LG H&H) and their associated sales in China. With a larger-than-normal discount and LG's strategy to reduce the discount by increasing dividends and buybacks, the upside should be high once the subsidiaries' values recover. Below is an estimate of LG Corp's intrinsic value.

LG Corp											Stock Price	
											LG Electronics	₩92,000
											LG Chemical	₩715,000
		Implied						Net			LG Uplus	₩11,950
	EBITDA	Multiple	Value	% of Value		Mkt Cap	% Owned	Debt	MVIC		LG H&H	₩626,000
											LX Semicon	₩87,900
LG Electronics	₩4,910,000	3.5	₩5,050,552	14%		₩14,986,800	33.7%	₩2,178,000	₩17,164,800		LX Internationa	₩40,000
LG Chemical	₩3,938,082	12.5	₩16,108,619	46%		₩49,292,100	33.3%	₩58,000	₩49,350,100		LX Hausys	₩35,350
LG Uplus	₩2,490,000	3.2	₩1,883,471	5%		₩5,217,370	36.1%	₩2,649,000	₩7,866,370			
LG Household & Health	₩1,170,000	7.8	₩3,120,234	9%		₩9,177,160	34.0%	-₩49,000	₩9,128,160			
LG CNS *	₩228,000		₩2,196,400	6%		₩2,584,000	85.0%					
Serve One *	₩248,000	10.0	₩2,480,000	7%								
Other			₩3,846,000	11%		Includes Royalty & Lease Value of won3.47tr						
Net Debt/Cash			₩565,000	2%		Invest Hold Co Discount			20%			
Total			₩28,200,221									
	Earnings	Multiple	160.32			Shares Outstanding		Corp Exp	Cap @10%	% of NAV		
NAV			₩175,897					₩197,017	₩1,970,170	6%		
				Disc to NAV								
Common Price			₩84,000	62%		157%	Pfd Upside					
Preferred Price			₩61,700	72%								
* EBIT												

Public LBOs (42.4% of Portfolio; Quarterly Average Performance -11.8%)

Our broadcast TV franchises, leasing, building products distributors, plastic packaging, and roll-on/roll-off (RORO) shipping fall into this category. One trend I've noted in these firms is growth creation through acquisitions which provides synergies and operational leverage associated with vertical and horizontal consolidation and the subsequent repurchasing of shares with debt. The increased cash flow from acquisitions and subsequent synergies are used to pay the debt and the process is repeated. The effectiveness of this strategy is dependent upon a spread between borrowing interest rates and the cash returns from the core business and acquisitions. Recently, interest rates have been increasing, and this has reduced the economics of this strategy; but a large spread still exists if assets can be purchased at the right price.

One example of public LBO firms we have in the portfolio is Ashtead Group plc (Ashtead). Ashtead is an equipment rental/leasing firm that operates in the United States, Canada, and the United Kingdom. Ashtead's growth model is achieved through overall market growth, including the continued increase of leasing over ownership of equipment (5-6% per year), opening new stores in clustered footprints, and synergistic M&A (8-10% per year). These are enhanced by opportunistic operational leverage from scale and share repurchases (5% annual growth). The current penetration for general tool equipment rental (70% of sales) is 55%, but for specialty equipment it is on average only 10% (30% of sales). Thus, the runway for growth through penetration is long. Ashtead's operational leverage is illustrated by their net income margins being up 120%, with a 5x increase in revenues over the past 10 years. These factors should lead to 18-21% EPS growth going forward. Ashtead has had 19% and 31% EPS growth over the past five and 10 years, respectively.

The cluster strategy creates a local infrastructure where new products can be supplied/leased for high incremental margins. Part of Ashtead's strategy is to lever up to purchase: (1) new locations to geographically expand, and (2) complementary equipment leasing firms and then pay the debt down with cash flows post acquisition, similar to private equity funds. Ashtead has done this many times over the past 10 years. This strategy is similar to that of Asbury's, described in previous letters. In comparison to other equipment firms, Ashtead has amongst the highest asset turns and margins. This has resulted in 21% to 43% returns on equity over the past five years. Below is an estimate of the fair value of Ashtead based upon future cash flows utilizing this model.

Ashtead					EPS Growth	26%					£ 50.60	9.48	5-yr fwd PE		10% growth PE
											6.3%	15.80	Earnings/FCF Yield		28.5
	2021	2022	2023	2024	2025	2026	2027	2028	2029						
Revs	£ 5,232	£ 6,548	£ 7,943	£ 9,134	£ 10,505	£ 12,080	£ 13,288	£ 14,219	£ 15,214			Revenue Drivers			
Growth		*25%*	*21%*	*15%*	*15%*	*15%*	*10%*	*7%*	*7%*			7-10% Organic (mkt growth (3%), share & penetration (3%))			
												3-4% M&A & share buybacks			
ATCF	£ 743	£ 1,125	£ 1,373	£ 1,579	£ 1,816	£ 2,088	£ 2,297	£ 2,458	£ 2,630			Historical op leverage			
Margin	*14.2%*	*17.2%*	*17.3%*	*17.3%*	*17.3%*	*17.3%*	*17.3%*	*17.3%*	*17.3%*						
														Target Price	$152.09
Cash FCF	£1.68	£2.55	£3.20	£3.80	£4.50	£5.34	£6.05	£6.68	£7.36		Shares	442	$22,365.20	IRR	24.6%
Growth		*51%*	*26%*	*19%*	*19%*	*19%*	*13%*	*10%*	*10%*						
	Repurchase Rate														
Shares	3%	442	428.74	415.88	403.40	391.30	379.56	368.17	357.13						

Ashtead currently trades for an EPS multiple of about 15.8x and an earnings yield of 6.3%, with low 20% EPS growth. Ashtead's BBB-rated debt (with an EBITA coverage ratio of 7.6x) is currently yielding 6.2%. Given a conservative projected EPS growth of 10% per year, Ashtead should trade at 29x earnings using Graham's formula of 8.5 + 2 * growth rate. Applying this multiple results in about a 2x return today and a 3x return in five years.

Distribution Theme (36.1% of Portfolio; Quarterly Performance -0.5%)

Our holdings in car and branded capital equipment dealerships, convenience stores, building product distributors, automobile transportation logistics, and capital equipment leasing firms all fall into the distribution theme. One of the main KPIs for dealerships and shopping is velocity or inventory turns. We own some of the highest-velocity dealerships in markets around the world. Over the past two years, there have been challenges in some markets hit by COVID, like South Africa and Latin America; but we are seeing recovery now that vaccines have been approved and distributed.

One of our holdings in the distribution theme is Asbury Automotive (Asbury), an automobile dealership firm. Asbury's growth model is through same-store sales growth (4% per year), internet distribution (10% per year), and synergistic M&A (5% per year). These are enhanced by opportunistic operational leverage from scale and share repurchases (5% annual growth). Over the past 10 years, Asbury's net income margins are up 120% with a 5x increase in revenues. These factors should lead to about a 20% EPS growth going forward. Ashtead has had 19% and 31% EPS growth over the past five and 10 years, respectively.

As can be seen below, a large portion of future growth is based upon the growth of internet sales. Both Asbury and Lithia have internet strategies which capture a younger demographic who do not visit dealerships with the same frequency as older folks. Asbury, through its online platform Clicklane, has found internet purchasers have very little overlap with existing customers; 95% are new customers. Asbury's strategy is to target customers who are within 20 miles of an existing Asbury location vs. online-only competitors (like Carvana) and Lithia. Asbury has had a per-store growth rate of 67% over the last year and only sells cars online in about 60% of its current footprint. This growth rate will decline going forward as the markets mature, but it will be bolstered as Clicklane is rolled out to the remaining 40% of Asbury's footprint.

What complicates the outlook going forward is Asbury's growth plan and the cyclicality of the auto dealership business. Asbury has the highest margins (due to local clustering) and inventory turns when compared to US companies, leading to high returns on equity of 33% to 41% over the past five years.

Asbury					EPS Growth	26%									
	2021	2022	2023	2024	2025	2026	2027	2028	2029		$181.00	2.27	5-yr fwd PE		5% growth PE
											19.9%	5.03	Earnings/FCF Yield		18.5
Revs	$9,837	$15,818	$20,000	$26,000	$33,900	$38,985	$44,833	$49,316	$54,248						
		61%	26%	30%	30%	15%	15%	10%	10%			Revenue Drivers			
												SSS growth 4%			
NI	$549	$796	$738	$988	$1,284	$1,559	$1,793	$1,973	$2,170			Acquisitions - Unit growth 10%			
	5.6%	5.0%	3.7%	3.8%	3.8%	4.0%	4.0%	4.0%	4.0%			Internet (10%)			
EPS	$24.78	$35.97	$34.38	$47.45	$63.55	$79.59	$94.36	$107.01	$121.35				Market Cap	Target Price	$1,472
		45%	-4%	38%	34%	25%	19%	13%	13%		Shares	22.131	$4,005.71	IRR	52.1%
	Repurchase Rate														
Shares	3%	22.131	21.47	20.82	20.20	19.59	19.00	18.43	17.88						

Asbury currently trades for an EPS multiple of about 5.0x and an earnings yield of 20%, with low 20% EPS growth. Asbury's BBB-rated debt (with an EBITA coverage ratio of 6.7x) is currently yielding 7.3%. Given a conservative projected EPS growth of 5% per year, Asbury should trade at 19x earnings using Graham's formula of 8.5 + 2 * growth rate. Applying this multiple results in about a 4x return today and an 8x return in five years.

Telecom/Transaction Processing Theme (39.6% of Portfolio; Quarterly Performance -14.3%)

Within this theme, the increasing use of transaction processing in the markets of our respective firms, as well as the rollout of fiber-optic and 5G networks, is providing growth opportunities. Given that most of these firms are holding companies and have multiple components of value (including real estate), the timeline for realization may be longer than for more mono-industry-focused firms. Most of these firms have been strong given their continued growth in telecom and processing revenues.

TIGO is a Latin American telecommunications firm that provides high-speed internet, cable, and wireless to nine markets. The firm has a #1 or #2 position in eight of these markets. TIGO is also in the process of separating both its towers business (about 10,000 towers) and its TIGO Money business for either sale or co-investment. Based upon historical tower sales by TIGO and comparable transactions and trading prices for Latin American tower businesses, we think the towers are worth about $1.4 billion or $8.00 per share. Given the current price of TIGO, the stub has an implied value of about 5.7x 2022 FCF or 1.5x projected 2026 FCF. Given the liquidity from recent rights offering, TIGO's debt level is low, and the company will be in the position to buy back shares next year while continuing to invest in its fiber rollout. There is additional value outside the core business in TIGO's data centers and TIGO Money (see our case study in the Q3 2021 letter). Given a conservative projected EPS growth of 10% per year (vs. the 25% projected FCF growth rate), TIGO should trade at 22x earnings using Graham's formula of 8.5 + 2 * growth rate. Applying this multiple results in about a 2.5x return today and a 7x return in five years. Below is an updated value of TIGO's equity given the rights offering, management's current forecast to 2024, and no value for TIGO's data centers or TIGO Money.

TIGO																	
					5-yr FCF Growth	24.8%											
	2021	2022	2023	2024	2025	2026	2027	2028	2029		$13.58	1.456851	5-yr fwd FCF		10% growth PE		
											17.6%	5.68088	Earnings/FCF Yield		21.9		
Revs (Prop)	$5,468	$5,746	$6,047	$6,373	$6,726	$7,108	$7,522	$7,972	$8,462								
		5.1%	5.2%	5.4%	5.5%	5.7%	5.8%	6.0%	6.1%			High Single digit growth of cable			8.0%	39%	3.09%
												Low Single digit growth of mobile			2.0%	61%	1.23%
EBITDA	$2,232	$2,356	$2,510	$2,677	$2,858	$3,056						0.5% Economy of scale growth					4.32%
	40.8%	41.0%	41.5%	42.0%	42.5%	43.0%											
FCF (Prop)	$225	$175	$300	$425	$500	$640	$715	$797	$888		Shares	176.3	$2,394.15		$92.71		
	4.1%	3.0%	5.0%	6.7%	8.9%	9.0%	9.5%	10.0%	10.5%			Towers	$1,400.00	$7.94	47%		
													$994.15				
FCF/Sh	$1.28	$0.99	$1.70	$2.45	$2.95	$3.87	$4.46	$5.14	$5.93								
		-22.2%	71.4%	44.1%	20.3%	31.2%	15.1%	15.2%	15.4%								
Revs										Growth							
Mobile	$3,354	$3,421	$3,489	$3,559	$3,630	$3,703	$3,777	$3,852	$3,929	2.0%							
HFC	$2,114	$2,326	$2,558	$2,814	$3,095	$3,405	$3,746	$4,120	$4,532	10.0%			$30.17	$17.01			
	$5,468	$5,746	$6,047	$6,373	$6,726	$7,108	$7,522	$7,972	$8,462								
		5.1%	5.2%	5.4%	5.5%	5.7%	5.8%	6.0%	6.1%								
Buyback Model																	
	176.3	176.3	176.3	173.3	169.4	165.3	160.3	155.2	149.9	Shares Outstanding (net buyback)							
50%	0.00	0.00	3.00	3.86	4.17	4.92	5.10	5.31	5.55	FCF Buyback %							
	40	45	50	55	60	65	70	75	80	Assumed Share Price							

Consumer Product Theme (12.4% of Portfolio; Quarterly Performance -7.1%)

Our consumer product, tire, and beverage firms comprise this category. The defensive nature of these firms has led to better-than-average performance. One theme we have been examining is the increase in sales of adult products (tobacco, cannabis, gaming product offerings) and the large consolidation opportunities in smaller convenience stores internationally.

Real Estate/Construction Theme (26.2% of Portfolio; Quarterly Performance -8.9%)

In my opinion, the pricing of our real estate holdings has been impacted by both a recession and the communist takeover in Hong Kong, as well as the continued COVID shut down in China and its effects on Hong Kong tourism. The current cement and construction holdings (in US/Europe via Builders FirstSource and Countryside, and in Korea via Asia Cement) should do well as the world recovers from COVID shutdowns and governments start infrastructure programs. Our Hong Kong real estate firm (Asia Standard) should do well if China reverses its COVID shutdown and travel recovers. Asia Standard still sells for 5% of book value including its mark-to-market changes in its real estate and investment portfolio.

Changes in Interest Rates

Over the last nine months, the US has had one of the fastest increases in interest rates since the 1970s. Real interest rates went from negative 1.0% last year to almost 2.0% real at the current time. This has created an unusual pattern of declining real stock and bond prices at the same time. Historically, these times have occurred when there has been inflation in the economy (1946-48, 1973-74, and 1977-78).

In a declining or stable interest rate environment, bonds provide a safe alternative to stocks. Over the real long term, real interest rates have declined about 0.16% every 10 years since 1300.[1] The current estimated long-term real rate is about 0.7%. Interest rates have risen due to inflation, which has historically been caused by shortages. The duration of the inflation is dependent upon how long the

[1] Rogoff, Rossi, and Schmelzing, *Long-Run Trends in Long-Maturity Real Rates 1311–2021*, 2022.

shortage or lack of substitutes lasts. We are currently dealing with shortages related to the COVID-induced shutdowns. Measures of supply- and demand-side inflation support this assertion[2]. A similar situation occurred after World War II, when the US was transitioning from a wartime to peacetime economy with inflation and declines in real stock and bond prices. The Korean War extended this posture to the early 1950s. By the time the declines were completed, the equity markets were set up for a 15-year bull market. The 1970s were similar, but it was longer lasting, as it took longer for oil/gas supply to increase and demand to slow down. Today, the situation is different, as we are in an energy transition which should reduce long-term oil/gas demand; but we need to bridge the supply, which has not been done adequately.

If we look at what the investment masters (Graham, Buffet, and Neff) were purchasing and observed in the 1970s, there are some interesting lessons, which are listed below.

(1) Invest in high-return-on-capital businesses that earn royalties on more capital-intensive businesses (Graham)[3].
(2) Invest in less-recognized growth businesses and moderate and cyclical growth stocks (Neff); see last Q's letter for a detailed description[4].
(3) Invest in bonds trading at a discount to par, government bonds with special features (savings bonds), net/nets, deep value, and workout situations[5].

The performance of these strategies was very good during and coming out of the high inflation and high real interest rate periods that occurred in the 1970s. One observation that's particularly relevant today is that bonds have become more competitive with stocks, and under the correct set of circumstances, they can have competitive returns to equities.

Penetration/Density Economics

A common feature of some of the companies Bonhoeffer invests in is the applicability of penetration or density economics. Most of the distribution businesses have this characteristic, both geographically (as they are local businesses) for new product types using existing channels and for new distribution channels (internet). Some also have the opportunity to provide their own branded products to capture product, as well as distribution margins. These characteristics are useful in estimating potential TAMs and the length of growth runways for their firms. It is also easier to penetrate an existing market than to grow by adding a new geographic or product market. Increased penetration can also be the source of operational leverage, as the same infrastructure is used to service new customers.

An example is Ashtead, whose growth is large given increases in general tool rental penetration vs. other more-mature European countries and Japan and the low specialty penetration. The penetration of clusters will also help growth, as only about 40% of Ashtead's locations are clustered. The penetration of

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[2] Federal Reserve of San Francisco tracks supply-side and demand-side inflation (https://www.frbsf.org/economic-research/indicators-data/supply-and-demand-driven-pce-inflation/). The current bout of inflation is primarily supply induced.
[3] Train, *The Money Masters*, 1980.
[4] Neff, *John Neff on Investing*, 1999.
[5] Graham, *The Intelligent Investor*, 1973.

the existing market is illustrated by rental market share, which stands at 12% today and is expected to grow to 20% in the future. A similar dynamic can be seen in Asbury. They have a nationwide market share of less than 1% geographically. Clicklane is only rolled out to 60% of Asbury's footprint; used cars are also sold at 60% of Asbury's stores and Asbury's service repair service (Total Care Auto) is sold in 60% of Asbury's locations. So penetration should add significantly to Asbury's revenue growth. In both cases, we can see the operational leverage of clusters/penetration due to increased profit margins as revenue increases. These firms get better as they get bigger.

Conclusion

As always, if you would like to discuss any of the philosophies or investments in deeper detail, then please do not hesitate to reach out. Until next quarter, thank you for your confidence in our work and have a safe and fun holiday season.

Warm Regards,

Keith D. Smith, CFA

CASE STUDY: BERRY GLOBAL (BERY)

Berry Global (BERY) is the largest rigid and flexible plastic and nonwovens packaging firm serving home, health and personal care, and food and beverage customers located in the United States, Europe, and emerging markets. BERY is part of Bonhoeffer's consolidation theme and has characteristics of a public LBO. BERY is the Rodney Dangerfield of plastic packaging firms in that they have reduced debt to peer levels and the valuation of 7.3x earnings has not rerated to peer levels of 13-14x earnings. Over time, as BERY repurchases shares, the rerating should accelerate.

BERY is consolidating the plastic and nonwoven packaging industry in the US, European, and emerging market markets. BERY has historically been the low-cost producer of the packaging market. In 2019, BERY made its largest acquisition—RPC, a European-centered competitor whose focus was more on the custom portion of the packaging market—for $3.5 billion. BERY financed the acquisition with debt which increased BERY's Debt/EBITDA to close to 5.3x. RPC increased BERY's footprint in Europe, as well as in the emerging markets. BERY generates 50% of its revenue from the US and Canada, 35% from Europe, and 15% from emerging markets.

The plastic packaging market is still very fragmented. Currently, BERY has a global market share of 4% of the global rigid plastic packaging and flexible plastic packaging market. About 53% of BERY's sales are from rigid packaging and 47% are from flexible packaging. The top four market participants have only 20% of the flexible packaging plastics market and 24% of the rigid packaging plastics market. BERY has historically realized 5% synergistic cost savings from its acquisitions. Historically, BERY's leverage has been a restraint on acquisitions, but with the leverage levels below 3.8x, BERY now has the capacity to incur debt to finance acquisitions. However, higher recent interest rates will increase the IRR that any acquisition will have to exceed before it is viable. Thus, share repurchases given the modest valuation and dividends make sense in the absence of any accretive acquisition opportunities.

Given BERY's large size, BERY receives a greater discount on its primary cost of goods sold supply—resin—than its competitors. Resin is about 50% of the final price by BERY's cost of goods sold or about 42% of sales. About 70% by volume of BERY's customer contracts have resin "pass through" pricing provisions.

Historically, BERY has operated with higher levels of debt than its competitors. When BERY was owned by Apollo, its debt level was as high as 7.0x EBITDA. The higher level of debt has led to BERY's equity trading at a discount to its peers. BERY has reduced its debt by $3.0 billion since its acquisition of RPC in 2019, resulting in a debt/EBITDA to 3.8x by FYE 2022. With a debt level below 3.8x, BERY has begun returning cash flows to shareholders via buybacks (10% of shares outstanding in FY 2022), dividends, and further reducing debt.

BERY's remaining debt stack includes $8.1 billion of fixed-rate or swapped-rate debt with a weighted average rate of 4.6% and $1.2 billion of floating rate debt at LIBOR+1.75%. Interest rate expense will increase by $3 million dollars for each 0.25% increase in LIBOR. So the sensitivity to rising rates is nominal.

Packaging is used in most consumer and health care/medical products. Packaging is typically 5-10% of total product costs. Packaging is designed into most products, so once an initial decision is made on a packaging provider, the retention rate is high for a given product. Given the stability and long-term growth of consumer and health care/medical products, cash flows from these customers are stable. Thus, a firm like BERY, with large exposure to food and beverage and medical/healthcare products customers (65% of sales), also has steady cash flows.

BERY's customer base is very diverse, as the largest customer is less than 5% of sales and the top 10 represent 15% of revenues. Most customers are repeat customers, with 85% and higher customer renewal rates. This is due to: (1) the design-in of packaging in specific consumer/healthcare products, and (2) the multi-national nature of customers, where changing vendors can be expensive and time consuming due to the different regulations across countries. The more custom vendors have more stickiness than low-cost vendors like BERY due to custom molds for packaging and the specialized services provided. Most customers like to have multiple vendors to reduce dependence upon one packaging vendor. Thus, when acquisitions occur, some customer volume is reduced to ensure vendor diversity. BERY's largest customers include food and beverage (30%) and home, health, pharmaceutical, and personal care products (35%); specialties and distribution make up the remainder.

BERY's capital allocation strategy includes: (1) reinvesting for organic growth (4-5% of sales), (2) pay down of debt to a 3.9x Debt/EBITDA level (which has already been achieved), (3) share repurchases (estimated to be 10% of shares outstanding next year), (4) dividends ($1.00 per share), (5) divestitures, and (6) acquisition with IRRs well above BERY's current WACC. Historically, BERY has generated 3-4% per year organic growth, 2-3% per year in mergers and acquisitions, and recently 5% per year from repurchases, for a total growth rate of 15-17% assuming flat margins. For 2023, management expects 3-4% organic growth, 8-10% growth from common share repurchases, and 2% from dividends, for a total return of 13-16% assuming flat margins.

BERY missed FY 2022 EBITDA targets due to: (1) not being able to pass all of the inflationary costs through to their cost-conscious customers, (2) the strong US dollar, and (3) the reduced demand for health care products post-COVID. Inflation should subside, as well as the US dollar weakening over the next 12 months. These are temporary issues and should be resolved over the next year, in addition to paying back more debt and buying back more stock.

Despite these challenges, BERY was able to generate a return on equity in the mid 20%s. BERY has generated mid 20%s or higher returns on equity over the past five years and thus continues to be an interesting investment. In FY 2022, BERY was also able to increase sales by 10%, with an EPS increase of 7%.

Plastic and Nonwoven Packaging Business

Packaging represents between 5-10% of consumer product cost. According to Vision Research, the size of the global rigid plastic packaging market was estimated to be $182 million in 2021 and was predicted to grow to $275 million by 2030—a 5.5% CAGR. According to MarketsandMarkets, the size of the flexible global plastic packaging market was estimated to be $161 million in 2020 and was predicted to grow to

$201 million by 2025—a 4.5% CAGR. BERY has about a 4% market share of both the rigid and flexible plastic packaging market.

There are five types of commercial packaging/containers: flexible plastic, rigid plastic, paper and board, glass, and metal. Plastics represents 37% of all packaging and is expected to represent 40% by 2025. Thus, the expected organic growth rates of flexible plastic packaging (4.7% per year) and rigid (3.1% per year) were higher than the expected growth rates for other materials such as paper and board (2.6% per year), glass (2.1% per year), or glass (1.4% per year).

The largest firms in the plastic packaging business include Amcor plc ($13.9 billion revenue), BERY ($13.2 billion), AptarGroup ($3.2 million), Pactiv Evergreen ($5.4 billion), Silgan ($5.5 billion), Sealed Air ($5.3 billion), and Sonoco Products ($5.5 billion). BERY is positioned as the low-cost competitor using standardized components to reduce costs versus shorter-run customized competitors like Amcor.

One ESG-related issue with plastics is the mistaken view that plastics are environmentally harmful versus other packaging options. Plastics use less energy than other packaging solutions and are one of the most environmentally friendly packaging options. Plastic recycling improves the friendliness of plastics, and this is being implemented by all of the plastic packaging companies, including BERY.

A large portion of BERY's sales (35%) are in the faster-growing segments of the medical supplies and emerging markets. Emerging markets also can be less competitive. For example, BERY has a dominant position in Brazil, where they are one of two competitors that can provided packaging solutions to consumer products firms.

Downside Protection

BERY is a cash-flowing business, using the cash flows to repay debt and return cash flows to shareholders via share repurchases and dividends. BERY is levered, but it has repaid over $3 billion in debt over the past three years from cash flows. BERY has publicly traded debt, which yields 6.2%, and is rated BBB. The debt is primarily fixed rate or swapped into fixed rate, and thus the effects of higher short-term interest rates are nominal ($3 million increased interest expense for each 0.25% increase in LIBOR). The biggest risk is a decline in cash flows from lower revenues. The effects of reduced post-COVID product demand are already reflected in FY 2022 results, and these should resume growth in FY 2023. Given BERY's large exposure to Europe, foreign exchange has adversely affected FY 2022 results. This should reverse in FY 2023 if US interest rates decline or go up by less than last year.

The analyst's projection for BERY is as follows:

	9/30/16 A	9/30/17 A	9/30/18 A	9/30/19 A	9/30/20 A	9/30/21 A	9/30/22 A	9/30/23 E	9/30/24 E	9/30/25 E	9/30/26 E	9/30/27 E	CAGR
Revenue	6,489.00	7,095.00	7,869.00	8,878.00	11,709.00	13,850.00	14,495.00	13,840.04	14,175.95	13,902.82	14,045.00	16,183.00	2.23%
% Change YoY	*32.90%*	*9.30%*	*10.90%*	*12.80%*	*31.90%*	*18.30%*	*4.70%*	*-4.50%*	*2.40%*	*-1.90%*	*1.00%*	*15.20%*	
EBITDA	1,223.00	1,327.00	1,380.00	1,530.00	2,157.00	2,224.00	2,101.00	2,093.46	2,183.98	2,217.68	2,285.00	2,541.00	3.88%
% Change YoY	*49.10%*	*8.50%*	*4.00%*	*10.90%*	*41.00%*	*3.10%*	*-5.50%*	*-0.40%*	*4.30%*	*1.50%*	*3.00%*	*11.20%*	
% EBITDA Margins	*18.80%*	*18.70%*	*17.50%*	*17.20%*	*18.40%*	*16.10%*	*14.50%*	*15.10%*	*15.40%*	*16.00%*	*16.30%*	*15.70%*	
Net Income Normalize	316.25	407.08	455.62	458.99	655.24	802.14	982.72	899.17	929.11	982.24	1,026.00	1181.359	3.75%
% Change YoY	*112.60%*	*28.70%*	*11.90%*	*0.70%*	*42.80%*	*22.40%*	*22.50%*	*-8.50%*	*3.30%*	*5.70%*	*4.50%*		
% Net Income Margin	*4.90%*	*5.70%*	*5.80%*	*5.20%*	*5.60%*	*5.80%*	*6.80%*	*6.50%*	*6.60%*	*7.10%*	*7.30%*		
EPS Normalized	2.48	3.07	3.37	3.41	4.85	5.8	7.4	7.52	8.31	9.09	9.08	10.45	7.05%
% Change YoY	*105.80%*	*23.80%*	*9.80%*	*1.20%*	*42.20%*	*19.60%*	*27.60%*	*1.60%*	*10.50%*	*9.30%*	*-0.10%*		
Free Cash Flow	517	601	634	764	947	904		892.92	930.57	995.5	940		
% Change YoY	*13.10%*	*16.20%*	*5.50%*	*20.50%*	*24.00%*	*-4.50%*			*4.20%*	*7.00%*	*-5.60%*		
% Free Cash Flow Mar	*8.00%*	*8.50%*	*8.10%*	*8.60%*	*8.10%*	*6.50%*		*6.50%*	*6.60%*	*7.20%*	*6.70%*		
Return on Equity (%)	302.56	66.19	40.61	26.47	30.13	15.22	29.64	28.19	26.45	29.4	18.21		

If these projections materialize, then management should be able to execute its business plan of debt paydown, share repurchases, and dividends.

Management and Incentives

Thomas Salmon, the CEO, has been in BERY's management since 2003, heading various divisions of the company before becoming CEO in 2016. He was with BERY when it was privately owned by Apollo Global before BERY went public in 2012. He owns or has options on 1.8 million shares—or 1.5%—of the common stock. The CEO is required to own 5x his salary in BERY common stock and options, and his salary is 10% of his compensation. Other senior managers are required to own 3x their salary in BERY common stock or options, and their salaries are about 20% of total compensation.

BERY's management incentives include short-term cash incentives 75% based upon adjusted EBITDA and 25% based upon FCF targets. The long-term stock-based incentives are based upon BERY's relative total shareholder returns to peers and return on capital employed targets.

The major shareholders include a Canadian owner-operator investment manager, a high yield/distressed investor (Canyon Capital), and index funds.

Valuation

			Senstitivity Table			
					Price	**Upside**
Current Adjusted Earnings	$7.40					
7-year Expected EPS Growth Rate	10%			0.0%	$ 54.17	0.0%
Historical EPS Growth Rate	30%			3.0%	$ 92.57	70.9%
Current AAA Bond Rate	5.1%		**Growth Rate**	5.0%	$ 118.11	118.0%
Implied Graham Mutiplier *	24.59			7.0%	$ 143.65	165.2%
Implied Value	$181.95			10.0%	$ 181.95	235.9%
Current Price	$54.17			12.0%	$ 207.49	283.0%
* (2*Growth Rate + 8.5)*(4.4%/AAA bond rate)						

The key to the valuation of Berry is the expected growth rate. The current valuation implies no increase in earnings into perpetuity using the Graham formula ((8.5 + 2g)) with the conservative assumption that the AAA bond rate of 5.1% will continue over the long term. The historical 10-year earnings growth has been 30% per year including acquisitions and the current return on equity of 28%.

A bottom-up analysis based upon market growth rates of flexible and rigid plastic markets and a 50/50 split between rigid and flexible plastic results was used to estimate an organic growth rate of 4.0% to 5.0% for Berry. Over the past six years, BERY has grown sales by 14.3% per year, about 10% in excess of the market growth rate, primarily due to acquisitions. Over the next five years, BERY has plans to increase share repurchases to about 8-10% per year, start a dividend of about 2% per year and using a realized organic growth of 1-2% per year resulting in a total return growth rate per year of 11-14% per year. This EPS growth rate (9-11%) is lower than the historical EPS growth rate of 30%, the 35% growth of operating margins with a doubling of revenues, and the current 28% return on equity with about an 85% customer retention rate. The resulting current multiple is 25x while BERY trades at an earnings multiple of 7.3x. If we look at firms with similar growth prospects and debt levels, they have earnings multiples of 13 to 22x. If we apply 14x earnings to BERY's FY 2022 earnings of $7.40, then we arrive at a value of $104 per share, which is a reasonable short-term target. If we use a 12% seven-year growth rate, then we arrive at a value of $207 per share. This results in a five-year IRR of 31%.

Growth Framework

Berry															
					EPS Growth	9.3%									
	2021	2022	2023	2024	2025	2026	2027	2028	2029		$ 54.15	4.37	5-yr fwd PE		7% growth PE	
											14.6%	6.83	Earnings/FCF Yield		22.5	
Revs	$13,850	$14,495	$13,827	$14,161	$13,945	$14,045	$16,183	$16,992	$17,842							
		5%	-5%	2%	-2%	1%	5%	5%	5%			1-2% organic growth				
												2% dividends				
NI	$802	$983	$899	$929	$982	$1,026	$1,182	$1,241	$1,303			8-10% Repurchase		Inv Turn	$278.68	
	5.8%	6.8%	6.5%	6.6%	7.0%	7.3%	7.3%	7.3%	7.3%			11-14% Total growth		IRR	39%	
EPS	$5.94	$7.93	$7.98	$8.61	$9.49	$10.33	$12.39	$14.00	$15.88		$ -	130	$7,039.50			
		33%	1%	8%	10%	9%	20%	13%	13%							
Buyback																
	135	124.0	112.7	107.9	103.5	99.4	95.4	88.7	82.1							
40%	5.83	11.34	4.79	4.37	4.13	3.91	6.76	6.62	6.52							
	55	65	75	85	95	105	70	75	80							

Another way to look at growth and the valuation of companies is to estimate the future EPS of FCF/share five years into the future and see how much of today's price incorporates this growth. In this framework, the assumption of 40% of net income will be used for share repurchases, and the remainder of the net income will be used for debt paydown and dividends. Using the same revenue and operational leverage described above results in a 2027 EPS of $12.39, or 4.4x the current price. If we assume a steady-state growth rate from 2027 on of 7%, then this results in a fair value Graham multiple of 22.5x, or $279 per share higher than to the five-year forward valuation above of $207 per share.

Comparables

Below are the US and international firms engaged in the plastic packaging market.

Plastic Packaging Comps	Price	Book Value	Earnings	Inv Turns	EBITA Margin	RoE	P/E	P/BV	Debt Interest Rate	Earnings - Debt Yield	Net Debt/ EBITDA	EBITDA Int Coverage
Amcor	11.87	2.75	0.53	5.29	11.4%	19.3%	22.4	4.32	5.7%	-1.2%	2.8	12.95
Berry	54.17	25.73	7.4	6.54	10.6%	28.8%	7.3	2.11	6.2%	7.5%	3.8	7.36
Sealed Air	51.16	1.51	3.81	4.63	17.8%	252.3%	13.4	33.88	6.4%	1.0%	2.9	7.15
Silgan	51.71	15.36	3.61	6.65	14.2%	23.5%	14.3	3.37	6.0%	1.0%	3.9	7.54
Sonoco	60.47	19.78	4.41	7.23	11.9%	22.3%	13.7	3.06	5.6%	1.7%	2.7	12.29
Pactiv Evergreen	11.48	8.22	1.58	5.48	9.5%	19.2%	7.3	1.40	7.0%	6.8%	4.1	4.35

Benchmarking

Compared to other plastic packaging firms, BERY has one of the highest inventory turns and lower margins, but higher returns on equity than most of the comparables. This is in line with BERY's approach as the low-cost vendor. The low-cost position with higher throughput (inventory turns) allows BERY to generate one of the highest returns on equity amongst its peer group. The EBITDA coverage ratio for BERY is in the midpoint of these comps and above more highly levered comparable Pactiv Evergreen. Despite the leverage more typical of the comps, BERY is valued like the more highly levered comparable Pactiv Evergreen and 7.3x earnings.

Potential Upside/Catalyst

The primary catalysts are:

- share repurchases of about 10% per year;
- paydown of debt;
- recovery in sales from COVID-induced decline;
- reversal or stabilization of US dollar exchange rate vs. Euro; and
- further consolidation of the global plastic packaging industry.

Timeline/Investment Horizon

The short-term target is $104 per share, which is 93% higher than today's stock price. If BERY can generate a 7-10% growth rate over the next five years and the valuation of BERY rerates to reflect a longer-term growth rate of 7%, then a value of $207 per share could be realized. This is a 31% IRR over the next five years.

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