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ValueInvestor INSIGHT

The Leading Authority on Value Investing

When Fortune Smiles

It's in value investors' nature that sharp increases in share prices can burn a proverbial hole in their pockets. Here two investors who have made great calls in VII over the past year describe how they've responded to their good fortune.

When value investors list the potential occupational hazards of investing the way they do, one item often mentioned is selling the shares of truly exceptional businesses too early. There are a number of fair and reasonable rationalizations: "The risk/reward has shifted too much," "I have more productive uses for the capital," "What I ended up buying went up too." But it's hard to classify the sale of what subsequently becomes a multi-bagger – outside of some sort of market mania around the shares – as anything but a mistake. Compounding value is a terrible thing to waste.

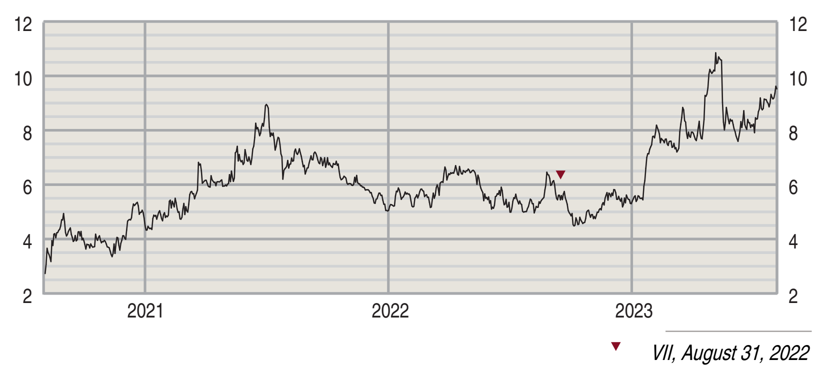
The jury is still out on its long-term ability to compound value, but fortune has certainly smiled on the stock of sandwich chain Potbelly since David Nierenberg and Damon Benedict of Nierenberg Investment Management recommended it just under a year ago [*VII*, August 31, 2022]. They had originally bought into the company as being cheap against normalized pre-pandemic earnings, but had concluded upon further inspection that it had tremendous long-term growth potential under new CEO Bob Wright. The Wendy's veteran was addressing both strategic and operational flaws and laid out a credible plan to drive higher per-store revenue and, with a focus on franchising, to increase the store count from the then 440 to closer to 2,000.

It hasn't been long, but all appears to be going according to plan. The company is already hitting its multi-year goal of $1.3 million in annual revenue per store and overall same store sales as pandemic effects fade are increasing rapidly, in the first quarter this year by 22%. In the already reported first two months of this year's second quarter same store sales rose more than 14%, nearly 5x the average for fast-casual restaurants. Potbelly in June was also added to the Russell 2000 index, resulting in a large increase in the stock's daily liquidity and giving Nierenberg's confidence that Wall Street will take a greater interest in it beyond the one analyst who publishes on the company today. The company's shares now trade at around $9.50, up close to 75% since last August.

INVESTMENT SNAPSHOT

Potbelly
(Nasdaq: PBPB)

PBPB PRICE HISTORY



Share Information (@7/27/23):

Price	**9.52**
52-Week Range	4.31 – 11.14

Valuation Metrics (@7/27/23):

	PBPB	S&P 500
P/E (TTM)	25.6	20.4
Forward P/E (Est.)	41.8	20.7

ORIGINAL BOTTOM LINE – August 31, 2022

David Nierenberg believes under new leadership the company is reversing key previous strategic missteps and has a long runway of growth from increasing store penetration and density across the U.S. "We're throwing a long ball here," he says, estimating the discounted fair value of the stock today – using differing discount rates – at $10 to $17.

NEW BOTTOM LINE

With the company operationally firing on all cylinders and his view of its long-term potential unchanged, David Nierenberg has sold no shares despite their sharp price increase this year. He's generally learned "not to pick our flowers too early," he says.

Sources: Company reports, other publicly available information

While the value investor's natural reaction might be to want to lock in some of those quick gains, Nierenberg and Benedict have so far resisted that temptation. They bought more shares as the stock waffled through the end of last year, building what they consider a full position that they haven't touched since. The company, they argue, is firing on all cylinders from an operational perspective, pricing to reinforce its value proposition in customers' minds, investing in technology to deliver food faster and with greater accuracy, enhancing its successful customer-loyalty program and digital marketing chops, and improving employee recruitment and retention. It also recently hired Lynette McKee to run its franchising operations, who Nierenberg considers a "rock star" after successful stints in similar roles at Burger King and Dunkin' Brands.

"We're invested with people we have increasingly come to know and trust, in a business we don't have to be rocket scientists to understand, and there's been no change in how we're looking at the company's long-term potential, which we think seven or eight years out will produce a $45 or more stock," he says. "There's no reason for us to do anything when the stock goes from $5.50 to $9.50."

There might be plenty of reasons to sell one day, he says, citing as general examples signs of empire building by management, a materially adverse change in the competitive or regulatory environment, were the trusted CEO to leave, or if the stock's valuation just "goes absolutely crazy." He's learned that for him, however, it's best to err on the side of letting his winners run. "After enduring all the pain of the types of turnarounds we typically invest in," he says, "while we obviously have to stay very close to what's going on, we've concluded it's a terrible emotional as well as financial mistake to pick our flowers too early."

Giverny Capital's David Poppe has also had good fortune so far with his recommendation of Installed Building Products' shares last fall [*VII*, October 31, 2022]. While he was skeptical at the time of the near-term outlook for the U.S. housing market, he saw tremendous long-term opportunity for the installer of residential and commercial insulation as it capitalized on its scale advantages to take market share and also to expand its ancillary services offered to builders looking increasingly to outsource discrete tasks and simplify their operations. He thought the company's stock, then trading at $87 and at only 11x estimated 2022 earnings, significantly undervalued its long-term value-creating prospects.

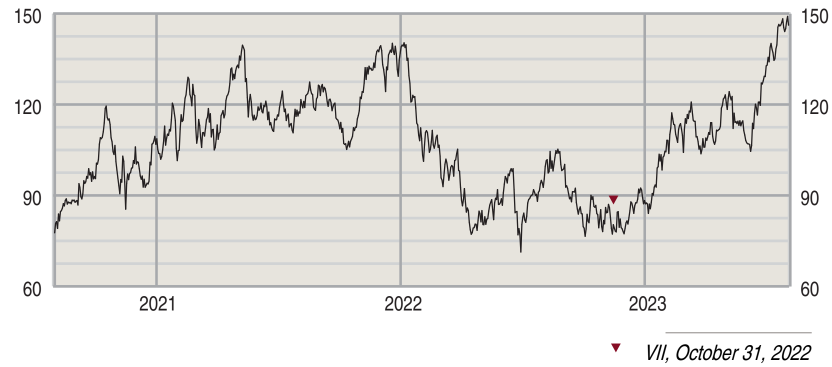
Now nine months later, the surprise on the upside for IBP has been the health of the U.S. home construction market. Despite higher interest rates, new home construction has been surprisingly strong, which Poppe attributes to low unemployment rates, a better-than-expected U.S. economy, abnormally high residential rental rates, and the fact that the U.S. market remains structurally short of residential housing stock from many years of underbuilding. On the back of consistently strong earnings, IBP shares now trade at around $146, up nearly 70% from last October.

While the stock now trades at just over 17x estimated forward earnings, Poppe says he hasn't been at all tempted to sell or trim his IBP position. He believes all the elements of his investment thesis remain intact and he has great confidence in the capital stewardship of Chairman and CEO Jeffrey Edwards, who owns 17% of the outstanding shares. "This is a simple,

INVESTMENT SNAPSHOT

Installed Building Products
(NYSE: IBP)

IBP PRICE HISTORY



Share Information (@7/27/23):

Price	**146.17**
52-Week Range	74.69 – 150.88

Valuation Metrics (@7/27/23):

	IBP	S&P 500
P/E (TTM)	17.5	20.4
Forward P/E (Est.)	17.3	20.7

ORIGINAL BOTTOM LINE – October 31, 2022

The company is a much higher-quality business than the current 11x earnings multiple on its stock suggests, says David Poppe. He expects it to translate scale advantages to continued market-share growth in both residential and commercial construction. Buying the shares at today's valuation, he says, should "prove to be a very attractive proposition."

NEW BOTTOM LINE

Even after a sharp run up in price, David Poppe doesn't believe the stock's current valuation is at all unreasonable for a company that has this one's profitability and potential to compound value. "I'm hoping not to sell a share of this for a long time," he says.

Sources: Company reports, other publicly available information well-run company that is executing on a clearly defined playbook that we think makes a lot of sense," he says. "We see this very much as a compounder, translating 100% of net income into free cash flow and with plenty of places to invest. A 17x earnings multiple isn't a lot to pay for a company earning 40% returns on equity – I'm hoping not to sell a share of this for a long time."

Given the inherent cyclicality of a construction-dependent business, might it make sense to trade around this position from time to time? "I know some people can do it well, but I find it very difficult to add value in tinkering with position sizes," Poppe says. "It presumes you know intrinsic value on any given day within a tighter range than I think is possible. Even if I got it right four out of five times, that one time I missed it by selling and never getting it back again is probably the one that would hurt the most." VII