

## Crème de la Crème

Whether collecting art or portfolio companies, Francois Rochon seeks buys that will one day be deemed “masterpieces.” His eye so far has proven sharp.

While Francois Rochon dabbled with various renditions of the value investing art early on, he arrived at the invest-in-quality end of the spectrum relatively quickly. “The way I’m wired is to invest in outstanding businesses,” he says.

Such wiring has paid off nicely for his Giverny Capital investors since the Montreal firm’s founding in late 1998. Since then his core portfolio – investing mostly in the U.S. but also in Canada – has earned an annualized 10.1%, vs. 3.8% for the S&P 500 (in Canadian dollars and after fees).

Finding opportunity in “great companies trading at fair prices,” Rochon sees upside today in such areas as used-car retailing, trucking, aftermarket auto parts and metal and electrical components. [See page 11](#)

### INVESTOR INSIGHT



**Francois Rochon**  
Giverny Capital

**Investment Focus:** Seeks companies with simple businesses and sustainable growth trajectories that the market doesn’t yet – but ultimately will – fully value.

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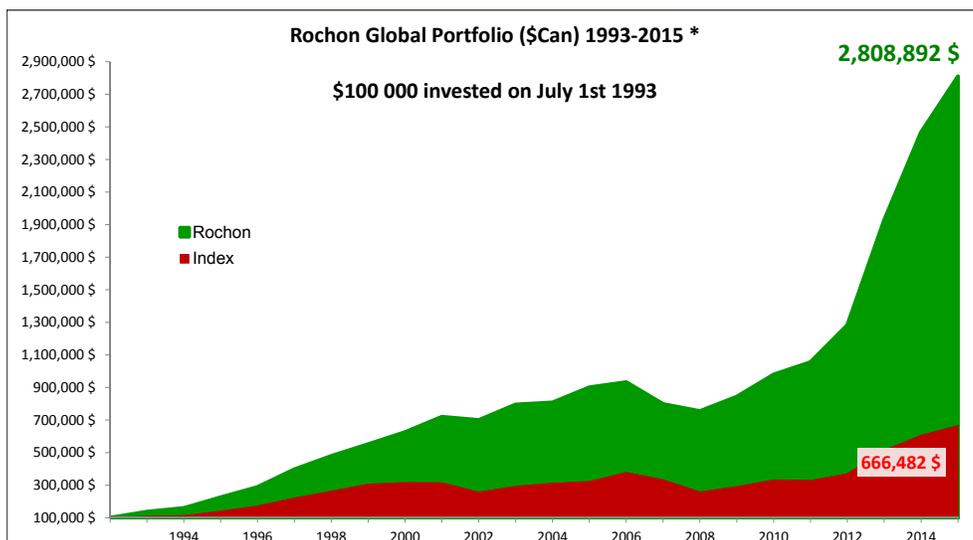
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# Investor Insight: Francois Rochon

Francois Rochon of Giverny Capital explains how he tries to keep his investing process relatively simple, how he's responded to making too many errors of omission, the "rules" he tells investors to help them maintain perspective, and what he thinks the market is missing in Precision Castparts, CarMax, LKQ Corp., Knight Transportation and Ametek.

You've described your circle of competence as "not that large." Explain why.

**Francois Rochon:** I quote all the time the Warren Buffett saying, "If a company has a lousy past and a great future, we'll miss it." We start with companies that are highly profitable, have sustainable competitive advantages and are run by honest, competent and shareholder-focused managers. We look for simple businesses that we can understand and where we believe the companies ten years from now will be selling the same basic products and services they are today. We also believe they have the potential to grow earnings and intrinsic value at twice the rate of the average company over the next five years. You can imagine that results in a fairly narrow opportunity set.

To give some examples, we've owned O'Reilly Automotive [ORLY] for more than ten years, and while it has almost quadrupled its number of stores over that time, it's basically the same auto-parts business now that it was then. CarMax [KMX] sells used cars in almost exactly the same way it did when we bought it eight years ago, but it has almost tripled its revenues. I'm not saying the products and services are unsophisticated or easy to provide. Precision Castparts [PCP] sells very sophisticated products to world-class manufacturers, for example, but it's relatively easy to understand what they do and whether they have a competitive advantage or not.

What we try to avoid is everything that is commodity in nature, particularly related to natural resources. We don't like things that are overly regulated by the government, so we avoid utilities and certain types of healthcare businesses. We will invest in technology, but we avoid companies that are difficult to value because they have to reinvent themselves all the time.

Can you elaborate on that last point? What type of technology business qualifies and what doesn't?

**FR:** We own Google [GOOG], for instance, because we consider it mostly an advertising company that is by and large in the same business today that it was 15 years ago. Compare that to Apple, which of course has been a phenomenal success, but its revenue mix and product makeup are much different today than they were five or ten years ago. It was very hard ten years ago to predict how well Apple would do, and it's still hard to predict where it will be ten years from now. The prospect of rapid change is not something we embrace as investors.

We've historically shied away from software companies for that reason, but in recent years as the sector has matured, we've increasingly found companies to own with what we believe are stable product lines and durable competitive advantages. The most recent example is a Toronto company called Constellation Software [CSU:CN]. It was founded in 1995 and has been very disciplined in assembling, primarily through acquisition, a number of specialized software products with high market shares serving a variety of vertical markets. We also consider its CEO, Mark Leonard, a truly exceptional businessman. Even in going for the first time through Constellation's financials and investor communications you're struck by the transparency, the focus, the humility and the authenticity. We're not being sold, but are treated like partners.

How did you arrive at your focus on incremental growth potential?

**FR:** Since I started managing my own portfolio, the return has been roughly 5% higher than the S&P 500 on an annual basis. That's almost entirely because the



**Francois Rochon**

## Lasting Impression

The inspiration to pursue a career in investing can come from many sources. Case in point: As a young electrical engineer in 1990, Francois Rochon visited Claude Monet's Giverny gardens in France and came away with a life goal to one day create such a place near his native Montreal, complete with a small museum for the art he aspired to collect. "The problem was I needed a lot of money for all that," he says. "I thought the stock market might provide the opportunity."

So far, so good. After spending two years at a large investment firm, he founded the aptly named Giverny Capital in late 1998 and as the firm has grown, so has his collection of contemporary art. While his original dream of a museum may still be "20 years down the road," he says, he believes his experience collecting art has made him a better investor. "It's different because I don't think you should look at art so much as a financial investment. I'm focused more on its eternal value, which means quality, uniqueness, innovation. We apply that same filter to the companies we want to own. Are they the best at what they do? Have they created a model that's innovative and unique? Independent thinkers make the best artists, as well as the best CEOs."

companies we've owned have grown their earnings at 5% per year better than the average S&P 500 company. Rather than trying to time the market or to predict economic or political trends, that's how we've chosen to try to meet our performance objectives. It sounds simple to say, but of course isn't so simple to do.

Focusing on incremental growth was just the most natural way for me, probably since I first read Warren Buffett's annual letters and Philip Fisher's *Common Stocks and Uncommon Profits* more than 20 years ago. I've also been influenced in that regard by Peter Lynch, who always emphasized understanding what makes a great business over what constitutes a great stock price. My capitalist antennae are always up for special businesses that have enduring qualities.

**Strong growth can be a result of cyclical or operating turnarounds. Does that type of growth potential attract your interest?**

**FR:** Typically not. We focus more on companies that can combine healthy organic or acquisition-related top-line growth with operating leverage. We also don't like to count on P/E-multiple expansion to meet our return objectives. If the growth is more a function of "getting back to normal," the earnings may rise, but chances are the P/E will be lower, taking away from our return. Part of our success rests on judging correctly which companies will keep their P/E because they deserve to.

**Despite your living in Montreal, you have tended to invest mostly in the U.S. Why is that?**

**FR:** Part of it is proximity, making it easy for us to experience first-hand what a company does and why it might be unique. I would also say that the U.S. is just the best environment for capitalism and entrepreneurialism in general. We often look at simple and boring businesses, but even in those there's a constant drive to improve and innovate and create value. That should be common everywhere, but it isn't.

**Last time we spoke [VII, August 27, 2010], you made the case for a giant company like Disney [DIS] as well as relative pipsqueaks like MTY Food Group [MTY:CN] and Bank of the Ozarks [OZRK]. Do you have a cap-size sweet spot?**

**FR:** We will look at every size company, but I would say our focus is probably in

## ON HOLDING PERIODS:

**Ours is increasing. I'd like to think that's because we've been a little more right about identifying great businesses.**

the \$2 to \$12 billion market-cap range. They're big enough to have well proven their business model, but still have plenty of room to grow and, hopefully, haven't yet gotten stodgy and bureaucratic.

**When do you consider a stock attractively priced?**

**FR:** Our valuation discipline is simple. We estimate what we believe a company can earn in five years and then apply the P/E we think the market should give it. If the resulting price is at least double the current share price – which would give us a 15% annual return – we're willing to buy.

As I mentioned, while we look to avoid cases where the P/E might contract, we're rarely counting on P/E expansion either. The P/E ratio of our portfolio is very similar to the P/E ratio of the S&P 500. Since we believe we own superior companies with enduring superior growth prospects, that to us means they're undervalued.

**We assume you're not a particularly active trader of your portfolio.**

**FR:** We typically hold 20 to 25 positions and our average holding period is close to seven years. While we'll cut back on a position that gets over 10%, for the most part our position sizing is a Darwinian

process. We usually let our winners run, creating bigger positions, while those that are disappointing become relatively smaller. You mentioned earlier Disney, MTY Food and Bank of the Ozarks, all of which have done extremely well over the past five years and that we still own. Disney and Bank of the Ozarks are now top-five positions because we have kept most of our shares over the years.

When a company's fundamentals deteriorate, I rarely sell right away, but I also don't add more money. IBM [IBM] would be an example. We bought a stake a few years ago and results have been disappointing, particularly last year. We've kept our shares because the stock seems very cheap and we believe IBM can get back on at least a moderate growth path and will buy back a lot of shares. But we haven't bought on weakness. As Peter Lynch says, you won't improve results by pulling out the flowers and watering the weeds.

Our average holding period is actually increasing. I'd like to think that's because we've improved our selection process and we've been a little more right than we used to be about identifying great businesses with enduring business models. If that's true, it pays to be patient. I mentioned O'Reilly Automotive earlier, which we first bought in August of 2004. Four years later the stock had gone nowhere, but eventually it started to reflect the significantly higher earnings power of the business. This is one we've trimmed over the years, but since our first purchase the stock price is up more than 10 times.

**You're always fully invested. Why?**

**FR:** One reason is that we're always finding enough to buy that we like. The other main reason is more philosophical. We want to own producing assets and stocks have been a winning strategy for doing that in the long run. The S&P 500 trades at 17-18x, depending on what you're using for earnings this year. That's close to the historical norm. So if earnings grow 6-7% on average per year in the future as they have over the last 50 years, that plus 2% in dividends would result in an

8-9% average annual return for the S&P. That's OK, and certainly better than what you might expect from some other asset classes. If we continue to find companies that we believe can do five percentage points better than that on an annualized basis over many years, why would we hold cash?

**What do you think the market is missing in Precision Castparts [PCP]?**

**FR:** Precision Castparts manufactures complex components used in aerospace, power, energy and other industrial ap-

plications that require those components meet strict tolerances and perform under harsh conditions. Around two-thirds of the business is in aerospace, where its products are throughout the aircraft, in door frames, wing beams, stabilizer parts and particularly in engines. This is a market in which reliability and product performance is extremely highly valued, so once you're established with a Boeing or a Rolls Royce or a GE, it's very hard to be displaced. One of our investors told us his son, who works for an engine maker, often says it's a bit difficult negotiating with Precision Castparts because it doesn't

budge on pricing and his firm has to accept that since there aren't many alternatives. That of course is music to our ears, and explains why the company is able to generate net margins in the high-teens, very high for an industrial company.

The stock is now trading at a low historical P/E, primarily because 15% or so of the business is tied to energy infrastructure spending that is expected to be down considerably this year. We believe that's a short-term issue and that the long-term fundamentals for the overall business remain quite strong. The aerospace industry should continue to grow at above-GDP rates, and the constant drive for more-efficient engines and high-performance aircraft plays to the company's strengths in providing high-end product solutions. Management also has proven to be very smart in making acquisitions to enhance or broaden the product portfolio, an opportunity we consider ongoing.

**How inexpensive do you consider the shares at a recent \$207?**

**FR:** The stock trades today at 15.6x our \$13.30 EPS estimate for this year, the lowest multiple it's had since the financial crisis. While we're not counting on the 20% annual earnings growth the company has had over the past ten years, we believe through organic growth and acquisitions that 12% or so is achievable. In five years that would result in close to \$24 per share in earnings. It's often not the case, but here we also expect the P/E ratio to go higher, as a company of this quality should not trade at a below-market multiple. If the multiple gets back to 18x, we'd have in five years a share price around \$430.

**You've been a long-time holder of CarMax [KMX]. Why do you still like its investment prospects?**

**FR:** We talk about trying to find unique businesses, and this is one that has really revolutionized the used-car industry. In an industry where brand reputation was almost non-existent, CarMax created a national brand known for offering fair

INVESTMENT SNAPSHOT

**Precision Castparts**  
(NYSE: PCP)

**Business:** Global manufacturer of complex metal composite parts sold to OEMs serving primarily the aerospace, power-generation and energy-infrastructure industries.

**Share Information**  
(@4/29/15):

**Price** **206.95**

52-Week Range 186.17 - 275.09

Dividend Yield 0.1%

Market Cap **\$29.34 billion**

**Financials** (TTM):

Revenue **\$10.10 billion**

Operating Profit Margin **28.2%**

Net Profit Margin **18.6%**

**Valuation Metrics**  
(@4/29/15):

	<b>PCP</b>	<b>S&amp;P 500</b>
P/E (TTM)	16.0	21.0
Forward P/E (Est.)	16.3	18.0

**Largest Institutional Owners**  
(@12/31/14):

<b>Company</b>	<b>% Owned</b>
Capital Research & Mgmt	11.8%
T. Rowe Price	8.4%
Vanguard Group	5.3%
State Street	4.2%
BlackRock	3.8%

**Short Interest** (as of 4/15/15):

Shares Short/Float 2.5%

**PCP PRICE HISTORY**

**THE BOTTOM LINE**

Though its stock has been hurt by modest exposure to energy-infrastructure spending, Francois Rochon believes the company is capable through organic growth and acquisitions of increasing profit at a 12% or so annual clip over the next five years. At 18x his 2020 EPS estimate of \$24, the shares would trade at more than double today's price.

Sources: Company reports, other publicly available information

prices on trade-ins, fair, no-haggle prices on sales, valuable warranties and superior customer service. That model has proven to be very hard to replicate.

We think the story only gets better over time. When I first bought into the company in 2007 it had roughly 2% of the market. After eight years of strong growth it should have maybe 160 stores by the end of the year and that market-share number will be pushing 5%. Clearly there is still much more share to grab.

At the same time, as CarMax gets bigger, its availability of cars improves and it is able to invest gains in operating ef-

ficiency both in lower prices to consumers and further building the brand. People buying or selling cars want to deal with people they trust, and every year that goes by should establish CarMax further as the trusted industry brand. It's not that easy to find a company that you believe can grow 15% per year for at least the next decade.

**How do they achieve that level of growth?**

FR: The current plan is to open something like 15 stores per year, which should produce 8-9% annual top-line growth. As existing stores gain further traction, we're

expecting 4-5% annual growth in same-store sales. Add in a little margin improvement and we arrive at 15% growth in EPS per year.

**At today's share price of just under \$69, are you paying a rich price for that kind of potential?**

FR: The stock trades at around 23x our 2015 EPS estimate of \$3.03. That's almost exactly the same multiple at which we bought it eight years ago, when we also thought earnings per share would grow 15% a year. We think the P/E is fair, and if the company does as well as we expect over the next five years, that same P/E will be fair five years from now. That would mean we'd benefit as shareholders from the full extent of the earnings growth.

**Does cyclical worry you here?**

FR: The stock price didn't reflect this at the time, but CarMax's business was actually pretty resilient during the financial crisis. It makes sense in many ways, as you'd expect used-car sellers to gain market share in bad economic times, but it was nonetheless very reassuring for me to see how the company fared in the recession.

This has provided a good lesson in sticking with your conviction when the market's short-term view challenges it. We've made three and half times our money on our first CarMax purchases, but had at one point, in late 2008, to live through a 70% drop in the share price. Thankfully that type of thing doesn't happen often, but when it does you have to be able to bear it.

**Do you see similar upside potential for auto-parts supplier LKQ Corp. [LKQ]?**

FR: This is also a unique company that in many ways has revolutionized its industry. LKQ means "like kind and quality," which refers to the refurbished and after-market auto parts the company provides to auto-body shops providing collision and mechanical repair. It buys used and salvage vehicles and strips them for parts

**INVESTMENT SNAPSHOT**

**CarMax**  
(NYSE: KMX)

**Business:** Retailer and wholesaler of used vehicles, operating through 146 stores in 74 markets throughout the U.S.; selling emphasis on "low, no-haggle prices."

**Share Information**  
(@4/29/15):

<b>Price</b>	<b>68.76</b>
52-Week Range	43.00 - 75.40
Dividend Yield	0.0%
Market Cap	\$14.36 billion

**Financials** (TTM):

Revenue	\$14.27 billion
Operating Profit Margin	6.8%
Net Profit Margin	4.2%

**Valuation Metrics**  
(@4/29/15):

	<b>KMX</b>	<b>S&amp;P 500</b>
P/E (TTM)	25.2	21.0
Forward P/E (Est.)	22.8	18.0

**Largest Institutional Owners**  
(@12/31/14):

<b>Company</b>	<b>% Owned</b>
T. Rowe Price	14.8%
Vanguard Group	7.6%
Primecap Mgmt	6.3%
Davis Advisors	5.6%
State Street	4.5%

**Short Interest** (as of 4/15/15):

Shares Short/Float	6.0%
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**KMX PRICE HISTORY**



**THE BOTTOM LINE**

While its innovative operating model has allowed it to create an unsurpassed national brand, the company still has a long runway for profitable growth in a highly fragmented market, says Francois Rochon. Assuming the stock earns the same P/E in five years as today, he expects earnings growth to lead to a doubling of the share price over that time.

Sources: Company reports, other publicly available information

it can recycle and refurbish. It also buys and resells parts from non-OEM suppliers in Asia. Prices vary, but LKQ's parts often sell at 25-60% lower than the comparable OEM versions.

Insurance companies, who pay for most collision repairs, love them and LKQ has used its price leadership and an aggressive acquisition plan over time to become the only player in the U.S. with a national network. That's a significant barrier to entry in a market where parts availability is so important.

Over the few last years LKQ has extended its proven model outside the U.S.,

expanding primarily in Europe through acquisitions in the U.K., Belgium, France and the Netherlands. Those markets were for the most part even more fragmented than in the U.S. and the company has gained traction relatively quickly, to the point where non-U.S. revenues today account for around one-third of the total.

**Why do you consider the stock attractive at today's price of \$25.25?**

**FR:** The stock has been relatively weak lately for two main reasons. One, given the large non-U.S. presence, is the impact

of the strong dollar. The second is a sharp decline this year in scrap prices, which has an effect because roughly 10% of revenues come from selling material left over as scrap.

Those two things may limit earnings growth somewhat this year – we're estimating \$1.42 per share in EPS, up 12% from last year – but we don't believe diminish the potential for at least 15% annual growth over the next five years, primarily driven by the international side of the business. If the multiple stays at today's 18x, we'll meet our return goals if growth comes in as we expect. While we're not counting on it, there is potential for the P/E to expand again once the short-term issues pass.

**We saw LKQ's CEO quoted in an article about driverless cars and how their success could one day put a crimp in the company's accident-reliant business model. Is that a concern?**

**FR:** Given the time frames involved for something like that to have an impact, I can sleep OK at night with that risk. This has proven to be a pretty stable business over time and I don't expect that to change anytime soon.

**From auto parts to trucking services, describe your investment case for Knight Transportation [KNX].**

**FR:** Knight is generally regarded as the best-in-class trucker in the United States. It focuses on more-profitable short and medium-length hauls, has among the most modern and competitive fleets, and is a clear leader in efficiency and cost control. Its operating ratio – operating expenses as a percentage of revenues – has averaged 83% over the past ten years, well below most competitors and resulting in company net margins that are roughly twice the industry norm.

We had owned this before, but got interested again in January when the company named its president, David Jackson, to be CEO. It didn't signal a dramatic shift in strategy or execution, but we just believe

**INVESTMENT SNAPSHOT**

**LKQ Corp.**  
(Nasdaq: LKQ)

**Business:** Largest U.S. provider of after-market, recycled and refurbished parts to vehicle repair and maintenance shops; also expanding overseas, primarily in Europe.

**Share Information**  
(@4/29/15):

<b>Price</b>	<b>25.26</b>
52-Week Range	22.90 – 29.84
Dividend Yield	0.0%
Market Cap	\$7.68 billion

**Financials (TTM):**

Revenue	\$6.74 billion
Operating Profit Margin	9.9%
Net Profit Margin	5.7%

**Valuation Metrics**  
(@4/29/15):

	<b>LKQ</b>	<b>S&amp;P 500</b>
P/E (TTM)	20.4	21.0
Forward P/E (Est.)	18.2	18.0

**Largest Institutional Owners**  
(@12/31/14):

<b>Company</b>	<b>% Owned</b>
Wells Capital	6.7%
Artisan Partners	5.7%
BlackRock	5.6%
Vanguard Group	5.5%
Wedgewood Partners	3.1%

**Short Interest** (as of 4/15/15):

Shares Short/Float	2.0%
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**LKQ PRICE HISTORY**



**THE BOTTOM LINE**

The company continues to extend its proven model both inside and, increasingly, outside the U.S., says Francois Rochon. After a temporary slowdown in EPS growth this year from currency-translation effects and low scrap-metal prices, he expects earnings – and the share price – to advance at least at a 15% annualized rate over the next five years.

Sources: Company reports, other publicly available information

he has a particularly well-articulated view of the company's path forward and how to get there. It's actually quite interesting that he took the place of Kevin Knight, one of four cousins who control around 25% of the stock and who will remain as chairman of the board and now focus in an operating role on strategic growth. He basically concluded that David Jackson would be a better CEO and stepped aside to take advantage of that. You don't see that very often.

**We wouldn't think you'd find the trucking industry overly attractive.**

**FR:** I'm not the biggest fan of the industry in general, given the high fixed costs, significant price competition and relatively high cyclicality. But even such industries can have leading players that do such a good job that they can make for successful investments – I refer to them as oases in the desert. Knight was hurt in the most-recent recession, but earnings only went down something like 10% in 2008 and another 10% in 2009. They keep costs low and the balance sheet strong, which generally allows them to improve their long-term position when there are short-term headwinds.

That said, we particularly like David Jackson's emphasis on diversifying in less-cyclical but related areas such as logistics, long strongholds of companies like C.H. Robinson and Expeditors International. He wants to deliver the best complete solution to customers, even when Knight may not be a viable choice every step of the way. That's an unusual and we think smart way of looking at things. Logistics services now makes up almost 25% of revenues, but we think it one day can be 50% of the total.

I should probably mention that lower fuel prices – which incrementally benefit truckers over railroads – isn't a big part of our thesis. It may have some short-term impact, as it probably did in a very positive first quarter, but it's not something that we're counting on as a longer-term benefit.

**At just under \$30, the stock trades at 20x this year's \$1.50 consensus EPS estimate. Are you again counting on growth to make that look cheap?**

**FR:** It's sounding a bit repetitive, but we think earnings can grow here as well at 15% per year over the next five years. That's from 4-6% annual growth in trucking and 20%-plus annual growth in logistics. The current multiple is pretty much in line with where it's been historically, so if we're right on earnings, we're willing to assume the multiple will at least be the same five years from now.

**Trucking companies have been dealing with a driver shortage and more-restrictive hours-of-service regulations. Could either or both of those throw Knight off track longer term?**

**FR:** Both are important because they can put pressure on productivity. Knight is probably less impacted because its shorter routes make it more attractive to drivers for lifestyle reasons as well as less likely to run up against new hours-of-service limits. We'll keep an eye on them, but we don't consider these big barriers to success going forward.

**INVESTMENT SNAPSHOT**

**Knight Transportation**  
(NYSE: KNX)

**Business:** Family-controlled provider of a broad range of truck-transportation services in North America, including short- to medium-haul freight, brokerage and logistics.

**Share Information**  
(@4/29/15):

<b>Price</b>	<b>29.79</b>
52-Week Range	22.24 – 34.73
Dividend Yield	0.8%
Market Cap	\$2.45 billion

**Financials (TTM):**

Revenue	\$1.14 billion
Operating Profit Margin	14.1%
Net Profit Margin	9.9%

**Valuation Metrics**  
(@4/29/15):

	<u>KNX</u>	<u>Russell 2000</u>
P/E (TTM)	21.6	70.5
Forward P/E (Est.)	19.9	19.3

**Largest Institutional Owners**  
(@12/31/14):

<u>Company</u>	<u>% Owned</u>
Wasatch Advisors	8.6%
BlackRock	5.9%
Vanguard Group	4.9%
T. Rowe Price	3.6%
Dimensional Fund Adv	2.6%

**Short Interest** (as of 4/15/15):

Shares Short/Float	9.5%
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**KNX PRICE HISTORY**



**THE BOTTOM LINE**

Though not a big fan of its industry in general, Francois Rochon thinks the company is an "oasis in the desert," benefiting from a sector-best cost structure and growing rapidly in less-cyclical areas such as logistics services. Assuming no change in valuation, he expects 15% annual EPS growth to result in a doubling of the share price in five years.

Sources: Company reports, other publicly available information

**Ametek [AME] is one of the bigger market-cap companies – more than \$12.5 billion – we’ve heard almost nothing about. Is that part of its appeal?**

**FR:** When we find companies we consider undervalued, it’s typically due to short-term worries we believe are temporary. Sometimes, though, it’s more because the business isn’t very exciting and the company isn’t very well followed. Ametek is an example of that.

The company sells a wide range of products, many of which are used to monitor, test, measure and power any number

of industrial processes. It has dozens of divisions, which often have leading positions in niches where there aren’t a large number of competitors and switching costs are high. The portfolio is well diversified by industry as well as geographically, with 55% of revenues coming from outside the U.S. In important ways it’s a bit like Danaher [DHR], though smaller and a bit more focused.

**Explain more the Danaher comparison.**

**FR:** One would be Ametek’s focus on operating effectiveness, evidenced by its

variety of Six-Sigma-type approaches to streamline manufacturing, speed up product development and generally increase margins. In 2014 the company says it realized \$100 million in cost savings from various “operational excellence” initiatives, particularly involving global sourcing and procurement. It expects to take out another \$110 million in costs from similar initiatives in 2015.

Ametek is also like Danaher in counting on a disciplined acquisition plan to help fuel growth. In 2014 it spent \$575 million to acquire five businesses that added \$285 million in new revenue. But it’s not just an acquisition machine. Last year it also invested more than \$200 million in R&D. Products launched within the previous three years accounted for 23% of total 2014 revenues.

Overall results have been quite impressive. The return on equity is close to 20%. Net margins have increased from 10% to nearly 15% over the past ten years, and we believe they could get as high as 20% over time. Management expects to double revenues and profits in the next five years, which we believe is plausible from organic growth, acquisitions and continued margin improvement.

**Doubling profits over the next five years would – surprise, surprise – reflect 15% annual EPS growth. Is the multiple at today’s \$52.40 share price at a level where you’d expect all that upside to translate to the stock?**

**FR:** The shares currently trade at less than 19x our \$2.80 estimate for earnings per share this year, which adds back some intangibles amortization. We believe a 19x multiple makes sense today for a company with this level of profitability and growth profile. We can’t be sure it will make sense in five years, but we believe it will. They can execute on this plan for many years to come.

**You dedicate a section of each of your annual letters to mistakes, often citing those of omission rather than commission. Why is that?**

**INVESTMENT SNAPSHOT**

**Ametek**  
(NYSE: AME)

**Business:** Global manufacturer of air-moving electromechanical motors as well as a wide range of electronic instruments for monitoring, testing, calibration and display.

**Share Information**  
(@4/29/15):

<b>Price</b>	<b>52.40</b>
52-Week Range	45.12 – 54.50
Dividend Yield	0.7%
Market Cap	\$12.65 billion

**Financials** (TTM):

Revenue	\$4.02 billion
Operating Profit Margin	22.3%
Net Profit Margin	14.5%

**Valuation Metrics**  
(@4/29/15):

	<b>AME</b>	<b>S&amp;P 500</b>
P/E (TTM)	22.1	21.0
Forward P/E (Est.)	20.1	18.0

**Largest Institutional Owners**  
(@12/31/14):

<b>Company</b>	<b>% Owned</b>
Vanguard Group	7.6%
T. Rowe Price	6.6%
Fidelity Mgmt & Research	5.8%
State Street	4.3%
Artisan Partners	4.3%

**Short Interest** (as of 4/15/15):

Shares Short/Float	2.7%
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**AME PRICE HISTORY**



**THE BOTTOM LINE**

Francois Rochon sees the company as a smaller and lower-profile version of Danaher, with a similar emphasis on operational effectiveness and disciplined acquisitions. Through organic growth, acquisitions and margin improvement he believes its earnings can double in five years – assuming no change in multiple, the stock would follow.

Sources: Company reports, other publicly available information

**FR:** Even though they don't show up on our statements, errors from not buying something are often much more costly than errors on something we bought. Maybe an error of commission results in a stock that's down 20-30%. Most of the errors of omission I cite are cases where I didn't pull the trigger and missed a 400-500% run or even more.

Give an example.

**FR:** I could have cited Stericycle [SRCL] as a mistake every year for the past 12. When I first heard about it in 2002 from a portfolio-manager friend of mine, it struck me as just my kind of thing. It collected medical waste, a messy and unexciting business that tended not to attract competition and wasn't overly affected by technological change. The problem was the stock traded at 29x forward earnings, which was higher than I wanted to pay, even though I thought it could grow at a very high rate for a very long time. So what happened? Earnings have grown at an annualized 18% rate since, the multiple today is still

29x, and the stock has gone from \$16 to \$134. I never did, but had I purchased it at just about any time in the last 12 years, I would have been happy.

Everyone has stories like that and you can't beat yourself up over them. I would

### ON OMISSION ERRORS:

**Errors from not buying something are often much more costly than errors on something we bought.**

say, though, that having had that happen a few too many times, I'm now probably willing to pay a bit higher price for a company I believe is exceptional and has a particularly promising future outlook. I don't at all throw caution to the wind, but a willingness to pay from time to time a slight premium to where the average company trades has helped me avoid some costly mistakes.

**On the subject of adversity, you have detailed a "Rule of Three" for your investors. What does that consist of?**

**FR:** We tell this to investors to help them maintain perspective, but it's good for us to keep in mind as well. The first rule is to expect markets to go down 10% at least once every three years. The second rule is to expect one stock out of three that we purchase not to work as well as expected. The third rule is to expect us, even if we're very good, to underperform the index at least once every three years. So far, those rules have proven to be pretty much right.

The point is to accept that things are not always going to go your way. So when they don't, you can more easily ignore the pressure to change your strategy toward whatever's working at the moment.

Another thing I took from Peter Lynch was the importance of being pragmatic and humble. When things didn't work out for him, it wasn't the end of the world. He wasn't obsessed with proving he was right and just sold and bought something else. There's a lot of wisdom in that. VII

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