

Repetitive Advantage

Identifying high-quality, growing companies is far easier than not paying up to own them. The managers of Broad Run Investment have excelled at both.

After five years together as the analytical team supporting Chuck Akre's market-trouncing FBR Focus Fund, Brian Macauley, David Rainey and Ira Rothberg were given a straightforward mandate in taking over the fund's management upon Akre's departure in mid-2009. "Basically, don't screw it up," says Rainey.

They certainly haven't. Their firm, Broad Run Investment Management, which manages separate accounts and the since-re-named mutual fund, has earned a net annualized 19.8% in its Focus Equity Composite since September 2009, vs. 16.9% for the Russell 3000.

Targeting compounding machines over proverbial cigar butts, the trio today sees opportunity in aftermarket car parts, insurance brokerage, cellphone towers and investment management.

INVESTOR INSIGHT



Broad Run Investment Management
(l to r) Ira Rothberg, David Rainey, Brian Macauley

Investment Focus: Seek to buy companies when their ability to grow is underestimated and then hold them patiently while they compound value over time.



www.broadrunllc.com

Broad Run is an independent, employee owned firm providing discretionary investment management services to institutional and high net worth clients through separate accounts and a sub-advised mutual fund.

We apply a fundamental, research-intensive investment approach to identify companies that we believe will create significant long-term value. We concentrate capital in our highest conviction ideas, and try to prevent the permanent loss of capital by owning fundamentally sound businesses at discount valuations.

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Investor Insight: Broad Run

Brian Macauley, David Rainey and Ira Rothberg of Broad Run Investment Management describe the quality standards that narrow their opportunity set, why they hold their average position for nearly seven years, how they try to limit “unforced errors,” and why they believe Aon, O’Reilly Automotive, American Tower and Diamond Hill are mispriced.

You’re at the high-quality “compounder” end of the value investor’s target spectrum. Explain what high quality means to you.

Brian Macauley: In many ways it’s the standard definition: We’re looking for businesses that have sustainable competitive advantages that enable them to earn outsized economic profits for a long time. The advantage can come from many sources, including scale, proprietary know-how, unique patents or licenses, high customer switching costs, high barriers to entry and low costs. We focus on companies with leading positions in their industries and on industries with secular growth drivers and a rational competitive dynamic.

Ira Rothberg: Where we believe we put more emphasis than most is on risk avoidance. If you read Charles Ellis’s classic investment book, *Winning the Loser’s Game*, he likens investing to amateur tennis, where the victor prevails because he makes fewer unforced errors than his rival. The key to winning isn’t going for the corners, but to consistently hit the ball back over the net.

Our strategy is to own high-quality, modestly valued businesses over many years, to take advantage of the power of compounding as earnings grow. To do that successfully only works if we avoid mistakes – unforced errors – that interrupt the power of compounding. That means being acutely sensitive to rising competitive threats, technological obsolescence, faddish levels of demand, excess financial leverage and unsustainable valuation levels. The power of compounding is so great that our first job as investors is to avoid anything that might short-circuit it.

BM: We apply a simple test to every business: can we reasonably predict what it will look like in ten years? The reality is that for most businesses the answer is no.

That’s a key way we narrow our universe and it goes a long way toward reducing our risk of permanent capital loss.

What recent examples didn’t pass the test?

BM: One would be Dun & Bradstreet [DNB]. D&B’s credit reporting is a strong franchise with scale advantages and high margins. But it’s facing new competitive threats from established firms like Experian and Equifax, as well as upstarts such as Cortera. Our concern is that these new entrants can combine sophisticated analytics with Internet and alternatively sourced data to produce comparable information at a fraction of what D&B charges. A step-function decrease in rivals’ cost to compete would have big consequences for the high-margin incumbent.

Another example is II-VI Inc. [IIVI], the laser component maker. We were attracted by the secular growth in the laser industry and the company’s leading share and low-cost position in CO₂-laser components. What kept us away was the improved functionality and declining costs of competing fiber-laser technology. We’re confident the laser industry will have a larger role in manufacturing 10 years from now, but it’s just too hard to handicap how much of that market will be addressed by the CO₂ lasers that II-VI relies upon.

How did a technology company like Google [GOOG] pass the ten-year test when you bought it in early 2011?

IR: When we purchased the stock it was trading for only 11x earnings, net of cash. Our view then and now is that Google, through the quality of its search function and by extending its tentacles through things like Gmail, the Chrome browser, Google Maps and Android, has created a customer habit that is unlikely to change.



I. Rothberg, D. Rainey, B. Macauley

First-Hand Knowledge

There was no need for big strategic or process changes when Brian Macauley, David Rainey and Ira Rothberg took over in 2009 for Chuck Akre [VII, December 28, 2011] in managing what was then called the FBR Focus Fund. Says Rothberg: “Charlie Munger in a recent interview with *Fortune* said, ‘I have a habit in life, I observe what works and what doesn’t work and why.’ So having observed Chuck and other value investors like Buffett and Munger with strong track records, we’re happy to copy what they do and make some of our own innovations. When you see something work first-hand, it obviously encourages you to keep doing it.”

There have been some changes at the margin. While concentrating on a small number of names as Akre did, the new team generally won’t let one position exceed 10% of the portfolio and makes only one bet per industry, rather than two or three. They’ve also embraced a “player/manger” organizational strategy, in which the three portfolio managers are the entire analyst team. “In such a concentrated portfolio, each name needs to be right, or at least not significantly wrong,” says Macauley. “We think it makes sense to have three sets of eyes thinking very critically about how things could go wrong.”

It invests so much in R&D to maintain search leadership that it's hard to foresee a breakthrough it couldn't replicate before losing any material market share. It has 70% search market share in the U.S. and even higher overseas, shares that have been stable or growing for many years. Contrast that with the share and profitability shifts in markets like mobile phones. The one technology change that might have been a threat to Google has been the transition to mobile, but it has managed that transition very well and may be even more competitively strong there.

What level of growth are you typically looking for?

BM: We try to find companies that can grow intrinsic value per share three- to five-fold over 10 years, which implies a mid-teens level of annual growth. There are typically secular drivers or clear company-specific advantages behind this growth. In the case of American Tower [AMT], increasing penetration of smartphones is driving the need for more wireless capacity, both here and abroad. For Encore Capital [VII, May 31, 2013], credit-card debt collection isn't a growth industry, but changes in the industry's regulation and structure since the crisis are working to the company's advantage and have helped it sharply increase market share and earnings.

To be clear, we very much consider ourselves value investors. But rather than the typical model of paying 50 cents for \$1 of value, we're willing to pay 80 cents for what we believe will be \$3 to \$5 of value down the road. I'd add that we're not looking for hyper growth, which usually brings higher uncertainty and valuation along with it. We'll do well – without incurring undue risk – if we can pay a modest multiple for a business compounding at a mid-teens rate for five or ten years.

Describe the traits you look for in top management.

BM: We look for people who think like long-term owners and have skin in the

game. We're often investing where the founder or founding family is still active and/or the people in charge have spent the majority of their careers at the business. Because management's capital-allocation decisions have such an important impact on the value created over our expected five- to ten-year holding period, we pay careful attention to their historical record and want to hear that they have a rational framework for making such decisions.

To give an example of what appeals to us, prior to the financial crisis O'Reilly

ON LEVERAGE:

We favor conservatism borne out of thinking about the long-term health of the business, not just profits today.

Automotive [ORLY] was getting pressure to improve near-term earnings per share by leveraging up to repurchase stock. The gentlemen at the helm had spent their entire careers at the company and had a longer-term vision, which included buying out a large competitor on the West Coast, CSK Auto. By preserving the company's balance sheet, they were able to buy CSK at a bargain price when it was in distress in 2008. O'Reilly did eventually start to aggressively repurchase shares, but only after it had digested the acquisition.

Our businesses tend to have better-than-average balance sheets, in part because the people running them don't feel the need to max out leverage at all times. That's a conservatism borne out of thinking about the long-term health of the business, not just maximizing profits today.

Is your opportunity set fairly narrow?

BM: The 10-year test alone tends to limit where we look. We avoid natural resources, where the economic value is driven more by a commodity price than what the business itself is doing. We avoid businesses with rapid technological change, so

are unlikely to invest in biotech, medical devices, semiconductors and much of information technology. We're cautious as well in industries with big risks of customer concentration, such as healthcare, and in those with high governmental influence.

David Rainey: We are active in consumer-oriented businesses, business services, specialty financials and less-cyclical industrials. These are businesses that often require less labor and capital and therefore generate outsized profits and return on investment. There are roughly two dozen stocks in the portfolio today, but we also keep a watch list of about 75 names that meet our quality criteria but where the stocks are too expensive. In any given year three or four or five of those watch-list names get cheap enough for what we consider transitory reasons. Given our typical holding period, that's all we need.

Do you have any market-cap restrictions?

IR: We're market-cap agnostic, but it's easier to find businesses that can be three to five times larger over the next 10 years among small- and mid-caps, which make up about three-quarters of our assets. We also like that these smaller names tend to have easier-to-understand businesses, less-complicated balance sheets and more-accessible management. We're more likely to develop competitive insight around a smaller company than a big one.

What we don't do is put any artificial constraints on the size company we'll own. We think it's a mistake to have to sell something after it reaches a certain size. These are often the investments you know the best and that have compounded the most for you over time. To have to sell them for no other reason than size doesn't make sense to us.

As an illustration of how something goes from idea to portfolio holding, describe one of your most recent purchases, of Micros Systems [MCRS].

DR: We got to know Micros over the years from investments we've made in the

hotel/casino industry, one vertical market in which it sells point-of-sale and enterprise-management software and systems. It had many traits we like – leading market shares, high switching costs, high returns on capital, high margins – but the stock never got off our watch list because it historically traded at a full valuation.

The shares came under pressure in the middle of last year after a couple weak quarters, primarily due to a poor European hotel market and slow U.S.-restaurant capital spending. With growth grinding to a halt, people started to worry that a couple guys in a garage might develop an iPad app that makes Micros' workstations and servers obsolete. At the end of the year, the long-time CEO announced he was stepping down, adding to the uncertainty. From the mid-\$50s earlier in the year, the stock fell as low as \$40.

Our judgment was that the industry challenges were temporary, that technology threats were not material, that the new CEO brought a lot to the table, and that the company had an opportunity to resume growth by following its anchor clients into fast-expanding emerging markets. We bought a small position – about 1% of assets – in the fourth quarter of 2012, and then roughly tripled our stake in this year's second quarter. [Note: Micros shares currently trade at \$53.50.]

How do you think about valuation?

IR: We're essentially trying to pay a low-teens multiple of what Warren Buffett defined in his 1986 Berkshire Hathaway shareholder letter as owner earnings – free cash flow before growth-related capital spending – for businesses we believe can compound our capital at a mid-teens rate or better. If we're buying a quality business at a discount multiple, we expect our return to at least mimic the company's growth in intrinsic value per share. We'll do even better if we get a little multiple expansion along the way.

We're cognizant of private-market multiples and where the business has traded relative to its own history and peer group, but we'd argue there's a lot of false

precision in our business and that the best investments don't require a financial model that goes out five significant digits. The key is recognizing a fat pitch and swinging. When a business like Google trades at 11x earnings, your DCF model isn't going to be your competitive differentiator.

ON CONCENTRATION:

In a given industry we won't scatter our capital around, instead selecting the one idea we think is best.

As with Micros, do you tend to take start-up positions first?

DR: Yes. The reality is that it can take years to know a business thoroughly. Every time you visit with management, talk to a competitor or just read about what's going on in an industry, you gain a deeper understanding of the business and the company. That either supports your long-term thesis or it doesn't. As we gain confidence in the thesis and get various pricing opportunities, we're comfortable with positions that are 7-8% of the portfolio.

In a portfolio with two dozen names, how do you manage diversification?

BM: We try to strike a balance between concentration and diversification with 20 to 30 stocks spread across a wide range of industries. Of our 23 holdings today we have exposure, depending on your definition, to 21 or 22 industries. Also, in any given industry we won't scatter our capital around, instead selecting the one idea we think is best.

Describe the thesis behind one of your largest current holdings, Aon [AON].

BM: Aon's main business is insurance brokerage, helping corporate customers identify, remediate and insure against the risks in their businesses. Its secondary business,

scaled up through the purchase of Hewitt Associates in mid-2010, is focused on human-resources consulting and business-process outsourcing.

There are several aspects of the business we like. Customers have a recurring annual need for Aon's services and once on board they tend to stick around for many years. Both businesses are "asset-light," requiring little cash investment to support growth. The insurance-brokerage industry has consolidated over the last two decades, and Aon is now the biggest of only three competitors capable of servicing *Fortune* 1000 customers on a global basis. Finally, we think CEO Greg Case is a very thoughtful capital allocator.

We first got involved here in early 2010. Our thesis at that point was that this was an excellent business undergoing temporary pain from depressed insurance pricing, depressed insurance exposure units coming out of the recession, and depressed float income because of low interest rates. We considered buying into that at 9-10x owner earnings to be an attractive proposition.

Since then the company has made steady progress in taking costs out of both the Aon and Hewitt businesses. The soft insurance market is now stable to slightly positive. The economic environment has gotten a little better, which helps insurance exposure units and also on the HR side. The stock has done well and now [at \$82] trades at about 14.5x our \$5.60 per share estimate of 2014 owner earnings.

Is that still cheap given Aon's prospects?

BM: The elements of our original thesis are still playing out. The economy continues to slowly improve. Interest rates appear to have bottomed. As for the insurance-pricing cycle, while there's still too much capital in the industry across the board, we expect that as companies run out of reserve releases they're going to have to be more focused on underwriting profits to drive future earnings. We don't expect the big rebound in pricing we've seen in previous cycles, but a more gradual and persistent improvement.

With 4% annual revenue growth and improvements targeted in operating margins, we think EBIT can grow over the medium-term at 6-8% per year. Tax savings from redomiciling the company from the U.S. to U.K. should add another point to net earnings growth. They have about a 5% free-cash-flow yield which is used to pay a small dividend and aggressively buy back stock. Add that all up and you get a business compounding its value at 12-14% per year. Paying a 14.5x multiple for that is still an attractive proposition.

What could make it much more attractive is if Aon has the success we believe

it can in private healthcare exchanges. These are exchanges set up for corporate customers that allow their employees and retirees to buy healthcare. Aon earns revenue as an operator primarily from commissions on policies placed.

This is an early step on the road toward insurance becoming a defined-contribution benefit in much the same way pension plans gave way to defined-contribution 401(k)s in the 1980s. It offers a tremendous value proposition to the corporate customer and Aon is well positioned to leverage its existing capabilities to provide a compelling solution.

Is this a real business yet?

BM: The target markets are the 45 million current employees and the 12 million retirees in the U.S. under large-corporation insurance plans. Right now Towers Watson has the leading retiree exchange, while Aon is #2 with around 100,000 participants. Aon has the #1 employee exchange, with over 600,000 lives covered. It's still very early, but penetration rates are growing rapidly.

When we run the numbers, the retiree-exchange market alone is a roughly \$3 billion annual revenue opportunity, while the active-employee market is three to four times larger. That assumes this evolves as 401(k) plans did, which is obviously uncertain, but there are plenty of reasons to believe it will. We don't need any of this to find the stock attractive today, but it's certainly a compelling option on the upside.

O'Reilly Automotive has had a great run since the crisis. Why are you still a big fan?

IR: The company is the second-largest distributor and retailer of aftermarket auto parts in the U.S. It serves both the retail do-it-yourselfer as well as the professional do-it-for-me markets, selling a wide range of products, from spark plugs and windshield wipers to transmissions and cylinder heads.

We first got involved in 2005, attracted by a market that was ripe for consolidation and by the company's superior distribution model. O'Reilly has always invested heavily in its distribution infrastructure in order to offer better parts availability and faster delivery times, critical advantages in serving particularly the professional market. Given its sustainable advantages and single-digit market share in a huge industry, we thought it had ample room to grow. And as it grew, scale advantages in securing and distributing inventory would make the company more profitable and an even more-formidable competitor.

DR: I should return briefly to our conversation about predicting what the business might look like in ten years. Miles driven

INVESTMENT SNAPSHOT

Aon

(NYSE: AON)

Business: Provider of insurance, risk-management and human-resources consulting and services, primarily to large enterprise clients, in more than 120 countries.

Share Information

(@11/26/13):

Price	81.87
52-Week Range	54.65 - 82.55
Dividend Yield	0.8%
Market Cap	\$24.65 billion

Financials (TTM):

Revenue	\$11.69 billion
Operating Profit Margin	13.6%
Net Profit Margin	9.1%

Valuation Metrics

(@11/26/13):

	AON	S&P 500
P/E (TTM)	24.6	18.8
Forward P/E (Est.)	15.5	16.0
EV/EBITDA (TTM)	12.9	

Largest Institutional Owners

(@9/30/13):

Company	% Owned
Eagle Capital Mgmt	5.0%
Southeastern Asset Mgmt	4.8%
State Street	4.7%
Artisan Partners	4.7%
Vanguard	4.3%

Short Interest (as of 10/31/13):

Shares Short/Float	0.9%
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AON PRICE HISTORY



THE BOTTOM LINE

Through organic revenue growth, targeted improvements in operating margins, tax savings from a domicile shift, dividends and share buybacks, Brian Macauley believes the company can compound shareholders' capital at 12-14% per year. If a fledgling healthcare-exchange business takes off, he says, that adds a compelling option on the upside.

Sources: Company reports, other publicly available information

in the U.S. is quite stable, even during recessions, and as long as people drive, auto parts will wear out and need to be replaced. This is true whether people are driving gasoline-powered, hybrid or electric cars. The independent Internet provider poses little threat because of the immediacy of the customer need. Our view is that the auto-parts business ten years from today will look pretty much the same.

What's driving company growth today?

IR: O'Reilly's current U.S. store count is around 4,100, but we think it ultimately can be closer to 6,000. That will come from expanding in new markets where the company is virtually absent, such as the Northeast and southern Florida, as well as from increasing penetration in existing markets, particularly those opened up with the CSK acquisition. Mom and pops, still about 50% of the overall U.S. store base, continue to be run out of business by consolidators like O'Reilly and AutoZone which have buying power. Overall, we're expecting the company's annual square footage growth to be about 5%.

Another key benefit should be continued improvement at the outlets acquired from CSK. At the time of the purchase, those stores were earning 3% operating margins and generating about \$1.3 million in annual sales per store. Today their margins are in line with O'Reilly's 16.5% overall level, and we estimate they're generating more like \$1.6 million in sales per store. As the distribution model continues to attract professional customers, we think that could improve to at least \$2 million per store.

We're also counting on margin improvement, both from operating leverage as the company grows and from a culture of expense control that is deeply ingrained. Just to give an example, when we've made trips into the field with management, the CEO and CFO will share a hotel room and stay in a much cheaper place than those of us in the investment community. We estimate that operating margins by 2015 can hit 18%, 150 basis points over today's level.

Are there secular market trends working for or against O'Reilly?

IR: The average vehicle age in the U.S. has been increasing as people can hold onto cars longer because they're better engineered. As cars get older they go through more frequent maintenance, which is good for the auto-parts industry overall.

Another positive trend is the increased sophistication of today's cars, causing a gradual market shift from do-it-yourself to do-it-for-me. At the same time, the number of makes and models are increasing, driving higher parts counts. Both trends

favor O'Reilly – its distribution intensity can better deal with both professional demand and a proliferation in parts.

People worry that the rise in new-car sales will impact aftermarket-parts demand, but that hasn't really happened. Part of that is because the number of vehicles scrapped remains near historic lows even as new-car sales have increased.

How are you looking at valuation with the shares recently trading at \$124?

IR: Assuming 5% annual square-footage growth, 4% growth in comp-store sales,

INVESTMENT SNAPSHOT

O'Reilly Automotive
(Nasdaq: ORLY)

Business: Supplier of automotive aftermarket parts, tools, supplies, equipment and accessories to both professional and do-it-yourself customers in the United States.

Share Information
(@11/26/13):

Price	124.51
52-Week Range	87.06 – 135.62
Dividend Yield	0.0%
Market Cap	\$13.36 billion

Financials (TTM):

Revenue	\$6.52 billion
Operating Profit Margin	16.4%
Net Profit Margin	10.0%

Valuation Metrics
(@11/26/13):

	ORLY	S&P 500
P/E (TTM)	21.6	18.8
Forward P/E (Est.)	18.5	16.0
EV/EBITDA (TTM)	11.6	

Largest Institutional Owners
(@9/30/13):

Company	% Owned
T. Rowe Price	7.4%
Vanguard	7.0%
State Street	4.4%
Ruane, Cunniff & Goldfarb	3.4%
BlackRock	2.7%

Short Interest (as of 10/31/13):

Shares Short/Float	4.4%
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ORLY PRICE HISTORY



THE BOTTOM LINE

Ira Rothberg considers the company the best player in a still-consolidating industry that rewards scale. He expects increases in square footage, comp-store sales, margins and share buybacks to result in mid-teens annual EPS growth over several years. Given today's valuation, he believes shareholders' return should match the growth in EPS.

Sources: Company reports, other publicly available information

margin improvement and stock buybacks, we expect EPS to grow at a high-teens rate over the next three years and at a mid-teens rate longer term. With the likely acquisition of another regional chain, that compounding would be even higher.

For that we're paying 17.5x our \$7.15 per share estimate of 2014 owner earnings. That's not a modest valuation, but fair and in line with what the market has paid historically for the stock. Given that, we're comfortable that our shareholder return can match the growth in earnings per share, providing more than satisfactory upside from today's price.

American Tower has attracted some naysayers of late. Why do you think the bull case is fully intact?

DR: The company operates more than 60,000 cell sites in the U.S. and abroad, leasing space to wireless carriers such as AT&T and Verizon in the U.S. and Telefonica and American Movil overseas. These are relatively scarce assets with excellent long-term economics. Once a tower is sited, zoned and built, there is little economic reason for someone to put a tower right next to it. There's space for multiple tenants, and each incremental tenant provides a very high profit contribution. In the U.S., the first tenant generates a high-single-digit cash-on-cash rate of return on a tower, while by the fourth tenant it starts to look like an oil well. Once tenants are in place, it's expensive and disruptive for them to leave.

The U.S. tower industry has gone through a long period of consolidation, starting 10 to 15 years ago when the wireless carriers concluded their capital would be better deployed building out their networks and acquiring new customers than in owning underutilized tower assets. U.S. towers are now primarily in the hands of three independent players, American Tower, Crown Castle [CCI] and SBA Communications [SBAC].

A central element of our investment case is that the U.S. tower business is in a golden age that should last at least for the next five to ten years. All of the major

national carriers have reloaded their balance sheets and are building out their 4G networks on top of their existing 3G networks. 4G services new spectrum and requires completely different equipment on towers. Whether it's Verizon and AT&T just now beginning to add density to their coast-to-coast 4G networks or Sprint and T-Mobile just beginning 4G builds, they will all require using incremental cell-tower space on which the tower operators are currently earning little to no revenue. On top of that you have the government's proposed national 4G network, called FirstNet, the first site for which will probably

get turned on next fall. If Charlie Ergen is successful in building out Dish Network's planned 4G network, the land rush will be even more intense.

Is the story similar internationally?

DR: American Tower for some time has been taking its excess U.S. capital and deploying it in developing markets like Mexico, Brazil, India and South Africa. We consider management very sophisticated in capital allocation, targeting markets with a rapidly growing middle class, heavy competition among a number of

INVESTMENT SNAPSHOT

American Tower
(NYSE: AMT)

Business: Develops, owns and operates more than 60,000 wireless and broadcast communications towers located in the United States and 12 foreign countries.

Share Information
(@11/26/13):

Price	78.03
52-Week Range	67.89 – 85.26
Dividend Yield	1.4%
Market Cap	\$30.79 billion

Financials (TTM):

Revenue	\$3.19 billion
Operating Profit Margin	39.7%
Net Profit Margin	18.4%

Valuation Metrics
(@11/26/13):

	AMT	S&P 500
P/E (TTM)	53.1	18.8
Forward P/E (Est.)	35.0	16.0
EV/EBITDA (TTM)	19.5	

Largest Institutional Owners
(@9/30/13):

Company	% Owned
T. Rowe Price	8.7%
Fidelity Mgmt & Research	5.0%
Vanguard	4.8%
State Street	4.3%
BlackRock	4.3%

Short Interest (as of 10/31/13):

Shares Short/Float	1.8%
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AMT PRICE HISTORY



THE BOTTOM LINE

As relentless demand for global wireless capacity continues and it leases space on its communications towers at ever-higher incremental margins, the company can generate low-20% annual growth in "owner earnings," says David Rainey. Without valuation compression from today's "fair" level, he says, shareholders would earn a comparable return.

Sources: Company reports, other publicly available information

wireless carriers, and where the U.S.-type outsourcing model is taking hold.

They've taken criticism because certain markets, like India, haven't developed as quickly as expected. People also seem worried that profitability outside the U.S. hasn't been uniformly high. If you look at the entire portfolio, however, we consider the international business to be doing quite well. We also believe the critics don't always see the forest from the trees. It is true when you buy a tower portfolio with a single tenant and pay a full price because of location, the initial returns can be modest. But once you add additional tenants, the rates of return move up like a hockey stick. We've seen this play out in the U.S., and as long-term investors it's a proposition we like overseas. Many of these markets are five to ten years behind the U.S. in terms of voice and data coverage.

How do you see all this translating into revenue and profit growth?

DR: Overall we're looking for 12-13% top-line growth – mid-teens or better internationally and high single digits in the U.S. Given the high incremental margins, particularly in the U.S., we believe total-company EBITDA should grow at a high-teens rate and that adjusted funds from operations [AFFO] – a good proxy for owner earnings – can grow at a low-20s rate for the next three to five years.

At a recent price of \$78, can you expect earnings growth to translate into a comparable shareholder return here?

DR: Basically, yes. The company should earn somewhere between \$4.30 and \$4.50 in AFFO in 2014, so the multiple isn't cheap at more than 17.5x. But we believe it's a fair multiple given the revenue visibility, international growth prospects and the likelihood that management will continue to intelligently allocate capital.

Are there technology-related risks of note?

DR: There are other technologies, including Wi-Fi and small transponders that

can be attached to buildings in densely populated areas, that will help augment network coverage. But the coming data demand should swamp excess capacity, so we don't see any slowing of demand for highly cost-effective tower space.

Describe why Diamond Hill Investment Group [VII, May 31, 2012] meets your quality standards.

IR: When we look at an investment manager we concern ourselves with three things, philosophy, process and people. We think Diamond Hill scores very well

on all three. Its strategies are rooted in the teachings of Graham and Buffett, emphasizing fundamental research, margin of safety and a long-term investment horizon. That long-term view is reinforced by compensation, which is largely based on rolling five-year performance results.

The company is run by investment people, not marketing people, and interests are well aligned with both clients – who management emphasizes always come first – and shareholders. Employees can only have equity exposure through Diamond Hill mutual funds, in which they've invested more than \$60 million, or in Dia-

INVESTMENT SNAPSHOT

Diamond Hill Investment Group
(Nasdaq: DHIL)

Business: Value-based investment manager serving individual and institutional investors in the U.S. Assets under management as of the end of September: \$11 billion.

Share Information
(@11/26/13):

Price	123.01
52-Week Range	66.30 – 123.50
Dividend Yield	0.0%
Market Cap	\$401.5 million

Financials (TTM):

Revenue	\$76.0 million
Operating Profit Margin	36.6%
Net Profit Margin	26.6%

Valuation Metrics
(@11/26/13):

	DHIL	Russell 2000
P/E (TTM)	19.3	75.5
Forward P/E (Est.)	n/a	26.9
EV/EBITDA (TTM)	13.3	

Largest Institutional Owners
(@9/30/13):

Company	% Owned
Royce & Assoc	6.2%
BlackRock	5.7%
Wells Fargo	4.8%
Akre Capital	4.5%
Epoch Inv Partners	3.9%

Short Interest (as of 10/31/13):

Shares Short/Float	1.5%
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DHIL PRICE HISTORY



THE BOTTOM LINE

The company has the potential to be “a little T. Rowe Price,” says Ira Rothberg, where a sound process, philosophy and culture translates into superior investment performance. Given the economics of the business, he expects shareholders to fare extremely well if assets under management, as he expects, double or triple within the next five years.

Sources: Company reports, other publicly available information

mond Hill common, in which they own 30% of the shares outstanding. Employee turnover has been very low.

The results have been excellent. Seven of the company's eight strategies have since inception outperformed their benchmarks, while the management team, led by CEO Ric Dillon, has taken assets from \$50 million in 2000 to \$11.5 billion today. In keeping with a high-quality business, operating margins are over 35%.

Why would a company like this not be lavishly valued by the market?

IR: Performance over the last five years has only been average, primarily due to an overweight in energy. That has hurt net asset flows, which went flat in 2011, fell 3% in 2012, and were off 8% through September this year. From 2007 to 2010, net inflows averaged around 25% per year.

We're counting on the philosophy, process and people here turning relative performance back up over time, and for net flows to again go strongly positive. Their relative investment performance has improved dramatically in the last 18 months, and flows are starting to turn positive. Just in the eight current strategies we think the asset capacity is around \$30 billion. They're also laying the groundwork to launch global and international strategies, which would expand capacity further.

How are you thinking about upside with the shares at a recent \$123?

IR: If you back out net cash and investments, the stock currently trades at 16.4x our \$6.40 estimate of run-rate EPS. Here we don't go off forward earnings because they're so dependent on the level of equity markets in any given year.

We think 16.4x is a fair price if the company's performance and flows are in line with industry averages. But we actually expect them to be much better than that and that assets under management could be two to three times their current level within five years. Given the economics of the business, that makes the profit and share-price upside very interesting.

These guys have the potential to be a little T. Rowe Price, where the process, philosophy and culture translates into superior performance, which makes for an excellent asset-management business.

Do you worry that a continuing rise in passive investing could crowd out fundamental stock-pickers like Diamond Hill?

BM: These aren't benchmark huggers – they have high active share and a bottom-up fundamental value discipline. If the

ON MISTAKES:

I guess if you had to choose, errors of omission would probably be preferable to those of commission.

marketplace is more machine driven and there are fewer fundamental investors, I'd expect that to create more opportunity for investors like Diamond Hill. It's the benchmark-hugging, low-active-share managers that will be in trouble – the equivalent of Sears, say, squeezed between Wal-Mart and Nordstrom.

As long-term owners, what generally prompts you to sell?

IR: We expect most of our return to come from the compounding of intrinsic value rather than a return to intrinsic value. So we're not quick to sell if something goes from 12x earnings to 16x earnings if we still believe there's a long runway for mid-teens type of compounding. That multiple difference isn't going to have a big impact on our total return. That said, if valuations get really extended, we sell. Our rough rule of thumb is that if we don't think we're going to earn at least a 10% IRR on a name, we'd rather hold cash.

Frequently the reason we sell has more to do with concern that a company's moat is deteriorating or management has made bad decisions that haven't yet hit the stock.

What's a recent example of that?

BM: We owned Lamar Advertising [LAMR] for several years and over that time downgraded our assessment of management due to sub-optimal capital-allocation decisions. We also became concerned that things like voice search and turn-by-turn GPS navigation on smartphones would help make mobile advertising a more significant competitor to Lamar's outdoor advertising. That hasn't yet impacted the business, but it's a secular risk we're fearful will hit it in time. When the market got excited about the potential that Lamar would become a REIT, we decided there were better growth opportunities without the secular risks elsewhere. In fact, we used the proceeds to invest in Micro Systems, as well as in sporting-goods retailer Dick's Sporting Goods [DKS].

Can you generalize about your mistakes?

IR: Given the importance we place on not interrupting the power of compounding, we want our mistakes to be time-value-of-money mistakes and not permanent-loss-of-capital ones. That has basically been the case – our mistakes have almost always been those that didn't compound at our desired rate, not that lost money. Lamar would be an example, more or less a round-trip while it was in the portfolio.

BM: We also think a lot about names we could have bought and just didn't due to risk aversion. In hindsight, many of those decisions have been costly. Visa and MasterCard are examples. We weren't able to get comfortable with the potential impact of regulatory changes swirling around the duopoly. Another is LKQ Corp., an auto-parts company that we stayed away from because of its potential legal liability in replicating design patents on vehicle parts. The stock is probably up 10-fold since we took a real hard look at it.

I guess if you had to choose your mistakes, errors of omission would probably be preferable to those of commission. We've been able to find other things to own that worked out fairly well. **vii**

Disclaimer

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Past performance is no guarantee of future results. All investments involve risk and may decrease in value.

Broad Run Investment Management, LLC

Focus Equity Composite Disclosure Presentation



GIPS Composite Information

Composite Name	Focus Equity Composite
Reference Index	Russell 3000 Index
Reporting Date	December 31, 2016
Composite Inception	September 1, 2009

GIPS Compliance and Verification Status. Broad Run Investment Management, LLC (Broad Run) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Broad Run has been independently verified for the periods October 27, 2012 through December 31, 2016. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

Policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request. A list of composite descriptions is available upon request.

Firm Information. Broad Run is an investment advisor registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940, as amended. Broad Run is defined as an independent investment advisor that is not affiliated with any parent organization.

Composite Description. The Focus Equity Composite contains all fee-paying, discretionary accounts that are managed according to Broad Run's Focus Equity Strategy. The Focus Equity Strategy invests primarily in U.S equity securities—regardless of capitalization—and seeks long-term capital appreciation while incurring a low risk of permanent capital loss. The strategy uses a concentrated and low turnover investment approach, and generally seeks to invest in what the firm believes are high-quality growth-oriented companies trading at discounts to Broad Run's assessment of their intrinsic value. Broad Run has determined that no appropriate benchmark for the composite exists because the Focus Equity Strategy has minimal exposure to a number of sectors and invests across the market capitalization spectrum.

The Focus Equity Composite was created in October 2012; its inception date is September 1, 2009. From September 1, 2009 to October 26, 2012, the composite is composed solely of an equity mutual fund. Broad Run's managing members served as portfolio managers for this equity mutual fund while employed at the fund's advisor. From October 27, 2012 to February 28, 2013, the composite is composed solely of the successor equity mutual fund to the aforementioned equity mutual fund. Broad Run is engaged as the sole sub-advisor of the successor equity mutual fund (managing 100% of its assets) by its new advisor, and the firm's managing members serve as portfolio managers for the successor equity mutual fund. Broad Run has met the GIPS portability requirements to link the returns of the equity mutual fund and the successor equity mutual fund. For the time period after February 28, 2013, the composite is composed of the successor equity mutual fund and separate accounts. Currently, the assets in the mutual fund comprise a significant majority of the composite's assets.

Fee Schedule. Broad Run's standard annual asset-based management fee schedule is 1% of the account's total assets on the first \$5 million and 0.85% thereafter. Gross performance results do not reflect the deduction of Broad Run's investment advisory fee, which will affect a client's total return.

Gross of fees returns are calculated gross of management and custodial fees and net of transaction costs. Net of fees returns are calculated by deducting the monthly-equivalent amount of Broad Run's highest applicable annual management fee of 1.00% ("Model Net Fee"), as described in the firm's Form ADV, Part 2A (without the benefit of breakpoints) from the monthly composite gross return.

Reference Index Disclosure. The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The index is market-value weighted. Index figures reflect the reinvestment of dividends and capital gains. Index figures do not reflect deductions for any fees, expenses, or taxes. Investors cannot invest directly in an index. The index data below is supplemental information. The index's performance returns are included to illustrate the general trend of the U.S. equity market and are not intended as a benchmark for the composite.

Other. All returns presented in the table below (including the reference index) include the reinvestment of dividends, interest income, and capital gains. Valuations are computed and performance is reported in U.S. dollars.

	Calendar									Annualized (12/31/16)			
	2016	2015	2014	2013	2012	2011	2010	Sep-Dec 2009 ¹	1 YR	3 YR	5 YR	7 YR	Since Inception
Focus Equity Composite Gross Return (%)	8.83	4.40	11.76	37.18	18.27	5.13	26.40	8.64	8.83	8.29	15.55	15.47	16.01
Focus Equity Composite Net Return (%)	7.76	3.37	10.66	35.85	17.11	4.08	25.16	8.29	7.76	7.22	14.42	14.34	14.87
Russell 3000 Return (%)	12.74	0.48	12.56	33.55	16.24	1.03	16.93	10.34	12.74	8.43	14.67	12.92	13.81
Composite Standard Deviation ²	12.06	11.30	9.44	12.52	16.80	- ³	- ³	- ³	n.m. ⁴	12.06	10.78	13.93	13.87
Russell 3000 Standard Deviation ²	10.88	10.58	9.30	12.54	15.74	- ³	- ³	- ³	n.m. ⁴	10.88	10.56	13.07	13.02
Number of Portfolios	101	52	41	30	1	1	1	1					
Internal Dispersion ⁵	0.31	0.13	0.10	n.m.	n.m.	n.m.	n.m.	n.m.					
Composite Assets (USD millions)	2,671.8	2,266.5	1,618.5	1,454.0	781.2	672.2	772.8	812.5					
Firm Assets (USD millions)	2,794.1	2,268.6	1,619.5	1,459.8	781.2	N/A	N/A	N/A					

Past performance is not indicative of future results.

1: Annual Performance Results reflect partial period performance. The returns are calculated from September 1, 2009 to December 31, 2009 for the Focus Equity Composite. 2: Standard deviation measures the variability of the gross returns of the composite and the reference index. All standard deviation figures are calculated using monthly gross performance numbers. Figures presented for calendar year and YTD periods are three-year annualized standard deviations. 3: The three-year annualized standard deviation is not shown due to having less than 36 months of composite returns. 4: n.m. - Not statistically meaningful for periods less than 3 years. 5: The annual composite dispersion presented is a dollar-weighted standard deviation of the gross returns for all accounts in the composite for the entire year, using beginning of period values; not statistically meaningful (n.m.) for periods less than one year, or when there are five or fewer accounts in the composite for the entire year.

Additional Composite Details. The Focus Equity Composite includes a mutual fund for which we charge a sub-advisory fee that is lower than the model net fee. However, the mutual fund's total operating expenses, which are not applicable to you, are in excess of the model net fee. Therefore, the actual performance of the mutual fund in the composite on a net-fee basis will be different, and will normally be lower, than the model net fee performance. However, the model net fee performance is intended to provide the most appropriate example of the impact management fees would have by applying management fees relevant to you to the gross performance of the composite. Actual fees and expenses in client accounts may differ from those reflected in this composite presentation and would cause actual performance to differ. The performance figures do not reflect the deduction of any taxes an investor might pay on distributions or redemptions.

Investing Involves Risk. Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results and client accounts may not achieve the Focus Equity Strategy's investment objective. There may be market, economic, or other conditions that affect client account performance, or the performance of the referenced market index. Therefore, it should not be assumed that the future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended and/or undertaken by Broad Run) will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. The Strategy invests in small- and medium-size companies. Investments in these companies, especially smaller companies, carry greater risk than is customarily associated with larger companies for various reasons such as increased volatility of earnings and business prospects, narrower markets, limited financial resources and less liquid stock. A client account invested in the Focus Equity Strategy will hold fewer securities and have less diversification across industries and sectors than a diversified portfolio, such as a portfolio based on an index. Consequently a client account and/or the composite performance may diverge significantly from the referenced market index, positively or negatively.

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