

ELEVATION CAPITAL MANAGEMENT LIMITED: DIAGEO PLC [DGE:LN]



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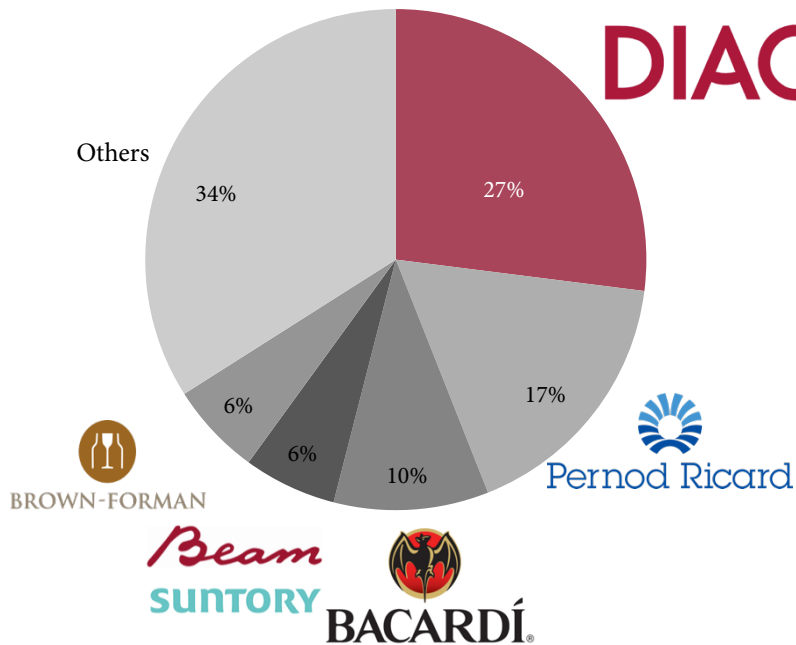
DIAGEO PLC: GLOBAL LEADER IN THE ALCOHOLIC BEVERAGE INDUSTRY

Diageo is a global leader in the alcoholic beverage industry with an expansive collection of brands across the spirits, beer and wine categories. These brands include Johnnie Walker, Crown Royal, J&B, Buchanan's, Windsor and Bushmills whiskies (recently divested), Smirnoff, Cîroc and Ketel One vodkas, Captain Morgan, Baileys, Don Julio, Tanqueray and Guinness. Diageo's products are sold in over 180 countries around the world.



DIAGEO PLC: THE LARGEST PLAYER IN PREMIUM SPIRITS

Global Volume Share of Premium Spirits



DIAGEO PLC: HISTORY

1759 Arthur Guinness signs 9,000 year lease on St. James's Gate brewery in Dublin

1934 MRMA Ltd is incorporated as a public company

- 1961 – MRMA Ltd shares first listed on the Stock Exchange
- 1962 – Name change to Grand Metropolitan Hotels Ltd

- 1971 – Grand Metropolitan Hotels Ltd enters the brewing industry by acquiring Truman, Hanbury & Buxton Ltd
- 1973 – Acquires Watney Mann Ltd, of which International Distillers & Vintners Ltd is a subsidiary
- Name change to Grand Metropolitan plc

1986 Guinness acquires the Distillers Company Ltd (DCL)

1987 United Distillers (UD) is formed from combining DCL and Arthur Bell & Sons, both owned by Guinness

- 1997 – Diageo created
- Guinness & Grand Metropolitan merge
- United Distillers & Vintners (UDV) created from integration of UD and Grand Metropolitan International Distillers & Vintners businesses

2000 Diageo sells its food assets (the Burger King and Pillsbury companies) to focus business on premium drinks

2001 Diageo acquires the Seagrams spirits and wine business



DIAGEO



Seagram's

DIAGEO PLC: SOME OF THE WORLD'S MOST ENDURING LIQUOR BRANDS



Johnnie Walker is the most popular whisky brand in the world



Crown Royal is the world's most popular Canadian whisky



Justerini and Brooks is the 5th most popular scotch whisky in the world



Buchanan's is the 3rd most popular premium scotch whisky in Latin America and the Carribean



Windsor is the 2nd most popular super premium scotch whisky in the Asia Pacific region



Bushmills Irish whisky is the 3rd most popular Irish whisky in the world (recently divested)

DIAGEO PLC: SOME OF THE WORLD'S MOST ENDURING LIQUOR BRANDS



Captain Morgan is the 2nd most popular rum in the world



Smirnoff is the most popular premium vodka in the world



Ciroc is the second most popular ultra-premium vodka in the world



Ketel One is the second most popular super premium vodka brand in the United States



Bailey's is the most popular liqueur in the world



Don Julio is the most popular premium tequila brand in the world (recently acquired control)

DIAGEO PLC: SOME OF THE WORLD'S MOST ENDURING LIQUOR BRANDS



Tanqueray is the most popular imported gin in the United States



Guinness is the number one stout brand in the world and one of the best known beer brands



Bulleit Bourbon is a popular bourbon whiskey in the super premium category



VAT 69 is a popular scotch whisky in the value category



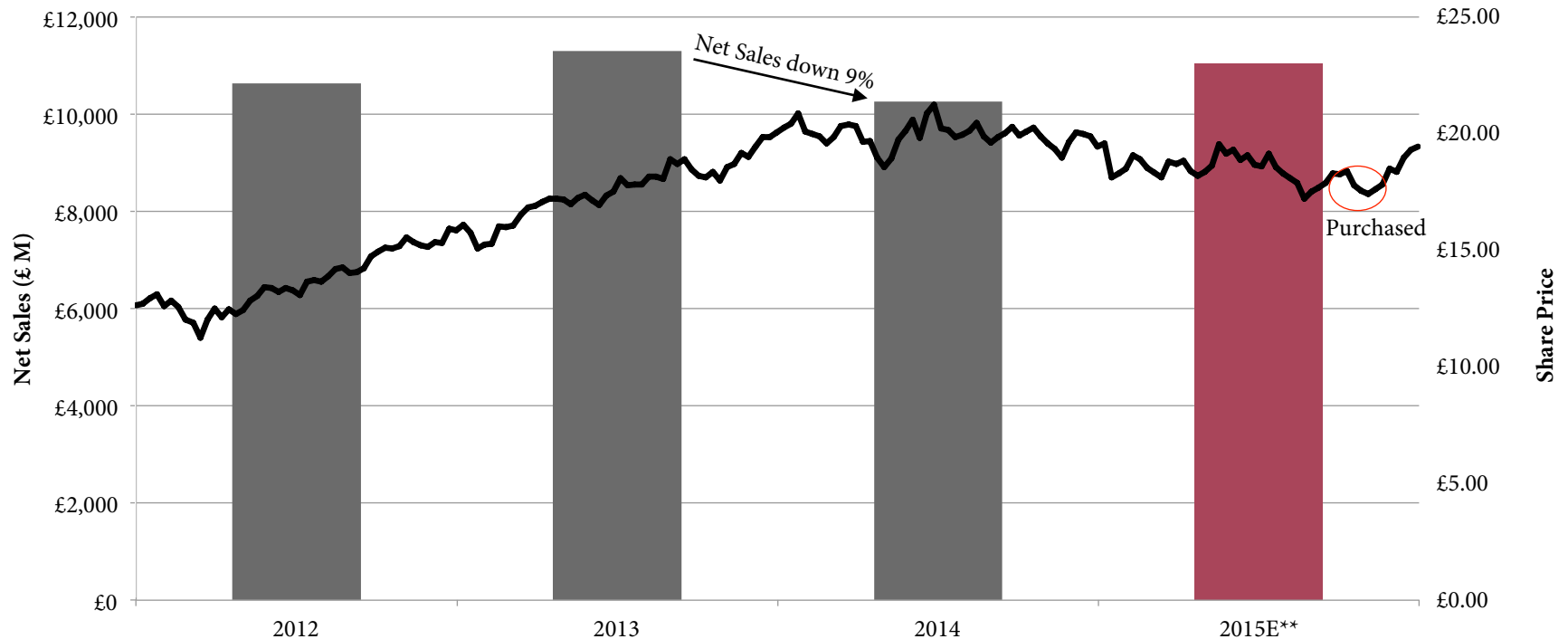
Grand Marnier is a popular orange flavoured liqueur



Gordon's gin is a popular gin in the value category

DIAGEO PLC: WEAKER FY2014 RESULTS PRESENTED AN OPPORTUNITY

- Declining share price over the past twelve months has largely been associated with declining revenue and earnings, stemming from the Company's exposure to emerging markets which have lagged the developed world recently
- We started to build our position in September 2014, at an average cost of £17.77 (to date)
- Current share price* = £18.27 (Market Capitalisation = £45.8B)



* AS AT 7 NOVEMBER 2014

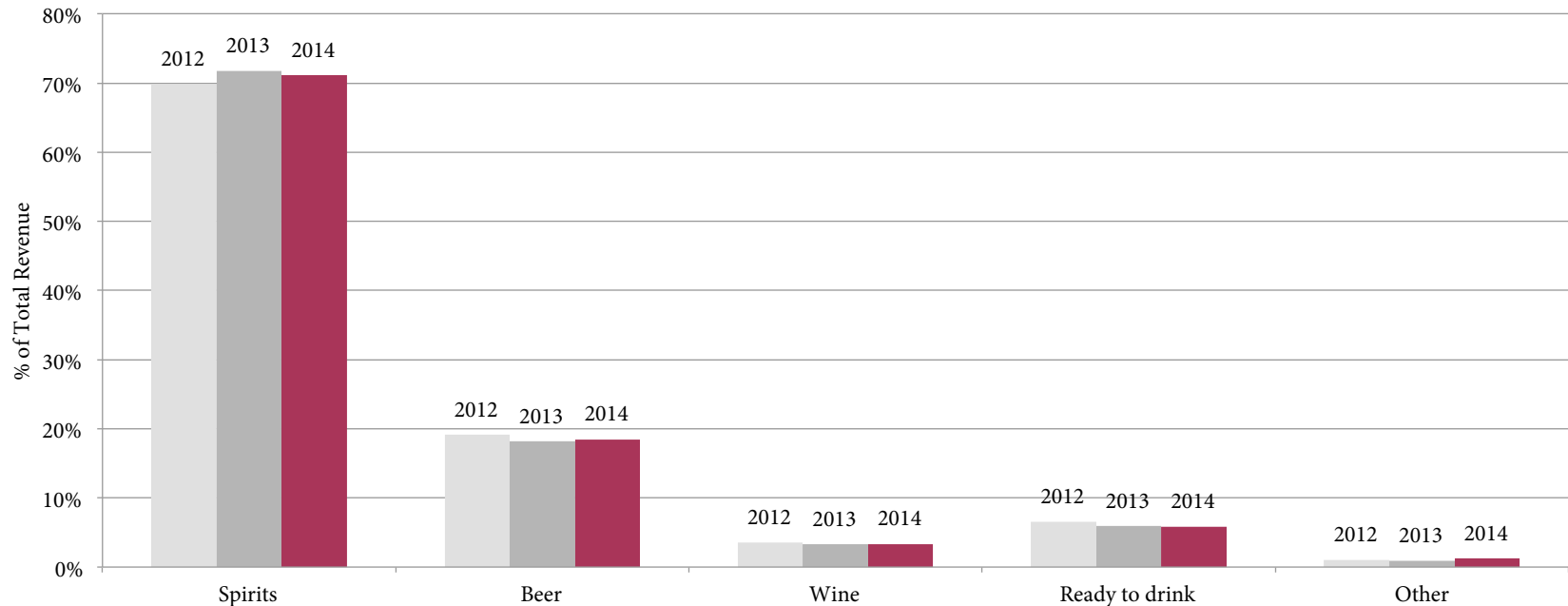
** SOURCE: THOMSON REUTERS STARMINE ESTIMATE AS AT 28 NOVEMBER 2014

DIAGEO PLC: PRODUCT CATEGORIES

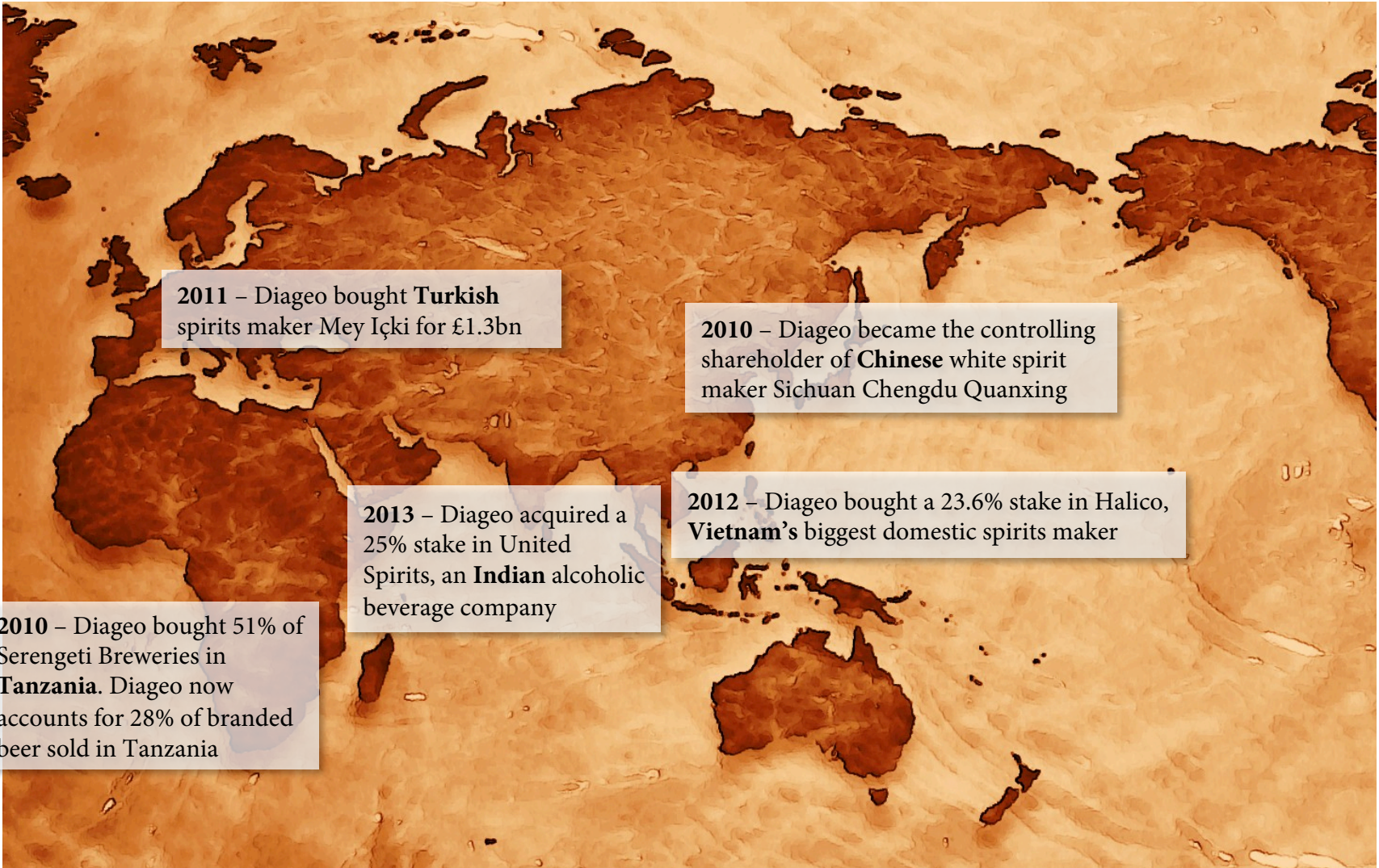
The Company offers products in the following five product categories:

- **Spirits** – 71% of FY2014 Total Sales, which includes Whiskey, Vodka, Rum, Liqueurs, Tequila and Gin
- **Beer** – 18% of FY2014 Total Sales
- **Wine** – 3% of FY2014 Total Sales
- **Ready to Drink** – 6% of FY2014 Total Sales
- **Other** – 1% of FY2014 Total Sales

Sales by Category



DIAGEO PLC: RECENT EXPANSION INTO EMERGING MARKETS



2011 – Diageo bought **Turkish** spirits maker Mey İçki for £1.3bn

2010 – Diageo became the controlling shareholder of **Chinese** white spirit maker Sichuan Chengdu Quanxing

2013 – Diageo acquired a 25% stake in United Spirits, an **Indian** alcoholic beverage company

2012 – Diageo bought a 23.6% stake in Halico, **Vietnam's** biggest domestic spirits maker

2010 – Diageo bought 51% of Serengeti Breweries in **Tanzania**. Diageo now accounts for 28% of branded beer sold in Tanzania

DIAGEO PLC: ASIA PACIFIC MARKETS

Diageo is operating in the following Asia Pacific markets:

- **South East Asia** – Vietnam, Thailand, Philippines, Indonesia, Malaysia, Singapore, Cambodia, Laos, Myanmar and Sri Lanka
- **Greater China** – China, Taiwan, Hong Kong and Macau
- **India**
- **Global Travel Asia**
- **Middle East**
- **Australia & New Zealand**
- **North Asia** – Korea and Japan

Diageo is accessing Asia Pacific through...

- Malaysia – 25.5% equity stake in Guinness Anchor Bhd
- China – 39.7% equity stake in Sichuan Shuijingfang Co., Ltd
- Vietnam – 45.6% equity stake in Hanoi Liquor Joint Stock Company
- India – Wholly-owned subsidiaries, and 54.8% equity interest in United Spirits Ltd (USL)
- Philippines, Vietnam, Korea and Australia – Wholly-owned subsidiaries
- Singapore – Diageo manages a key accounts business
- Thailand, Malaysia, Singapore and Greater China – JV arrangements with Moët Hennessy
- Japan – JV arrangements with Moët Hennessy and Kirin
- Indonesia, New Zealand and Middle East – Third party arrangements

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March 28, 2014 12:05 pm

Diageo targets China and India in management shake-up

By Scheherazade Daneshkhu, Consumer Industries Editor



Diageo, the London-based owner of Johnnie Walker scotch and Smirnoff vodka, has shaken up its management team in a move that underscores its ambitions in emerging markets and lays down a marker by chief executive Ivan Menezes.

Mr Menezes, who has been in the post for less than a year, said on Friday that China and India were "key growth engines" for the group and entrusted their development to a dedicated manager.

DIAGEO PLC: STRONG POSITION IN AFRICA

Diageo is operating in the following African markets:

- **Nigeria**
- **East Africa** - Kenya, Tanzania, Uganda, Burundi, Rwanda, South Sudan
- **Africa Regional Markets** - Ghana, Cameroon, Ethiopia, Angola, Mozambique
- **South Africa**

Diageo's subsidiaries in Africa:

- Guinness Nigeria Plc (listed, 54.3%)
- Diageo Brands Nigeria Ltd (100%)
- East African Breweries Ltd (listed, 50.03%)
- Serengeti Breweries Ltd (51%)
- United National Breweries (50%)
- Other wholly-owned subsidiaries in Cameroon, Ethiopia, Mozambique, South Africa
- Other majority-owned subsidiaries in Ghana, Seychelles

Diageo's joint venture in Africa:

- DHN Ltd (42.25%, JV with Heineken and Namibia Breweries Ltd)

Diageo has:

- 14 breweries in Africa
- 6 manufacturing facilities including glass, blending, malting and cider plants



DIAGEO PLC: POTENTIAL DIVESTMENT – BEER ASSETS?

While we like Diageo's beer assets (particularly the exposure to Africa), we consider the beer assets (~22% of net sales), including the world famous Guinness (~45% of beer sold by Diageo), to be candidates for divestment which would realise significant value for shareholders. We believe these assets may hold appeal to AB InBev, one of the most prominent acquirers in the beer industry currently. We value the beer assets at £7.95B (£3.17 per share), equating to a 3.1x revenue multiple*.

Brand	Some Facts	Top Markets
Guinness	The number one black beer is brewed in over 50 countries and enjoyed in around 150 worldwide	Great Britain, Ireland, Nigeria, United States, Cameroon
Guinness Foreign Extra Stout	Nigeria is the second largest market for Guinness Foreign Extra Stout in the world. It is one of the most loved brands in the country	Nigeria, Kenya, Ghana, Cameroon
Harp Lager	Harp is the largest growing lager in Nigeria	Nigeria, Ireland, Australia, Canada, Africa, United States
Kilkenny	Kilkenny is craft brewed in the oldest operating brewery in Ireland	Canada, Australia, Ireland
Smithwick's Ale	Smithwick's was originally brewed in St. Francis Abbey Brewery in Kilkenny, situated on the site of a Franciscan abbey where monks had brewed ale since the 14th century	Ireland, Australia, Canada, US
Tusker Lager	Kenya's national beer brand Tusker lager has been brewed in East Africa since 1922 and claims the special heritage of being the first beer in East Africa	Kenya, Uganda, Tanzania
Red Stripe Lager	The famous Jamaican lager Red Stripe was the official beer of the 2005 Ashes cricket series	Jamaica, Great Britain, United States, Antigua
Senator Keg	Senator Keg is a high quality, low priced beer providing an affordable alternative to illicit brews	Kenya
Windhoek Lager	Windhoek Lager is a premium, golden lager beer brewed according to the Reinheitsgebot, the German Purity Law of 1516	South Africa, Namibia, Botswana, Angola
Bell	The oldest beer brand in Uganda. Bell lager is Uganda Breweries Ltd flagship brand and is the number one premium lager in Uganda	Uganda
Serengeti Premium Lager	An international award winning brand, having won several gold medals from DLG and Monde Selection, and a Super Brand award as one of East Africa's fastest growing and most popular brands	Tanzania
Meta		Ethiopia



* THE 3.1X REVENUE MULTIPLE IS DERIVED FROM TWO RECENT TRANSACTIONS/SPECULATED TRANSACTIONS INVOLVING AB INBEV. THE FIRST IS THE 2013 ACQUISITION OF GRUPO MODELO AT 2.6X ITS TTM REVENUE, AND THE SECOND IS THE POTENTIAL ACQUISITION OF SABMILLER WHICH IS SPECULATED TO BE AS MUCH AS 3.6X ITS TTM SALES

DIAGEO PLC: POTENTIAL DIVESTMENT – MOËT HENNESSY?

Diageo owns 34% of Moët Hennessy, the wines & spirits subsidiary of the French luxury goods producer LVMH. Moët Hennessy owns some of the most prestigious and celebrated brands in the wines & spirits markets, such as Moët & Chandon, Dom Pérignon, Veuve Clicquot, Glenmorangie and Hennessy. It also has a controlling interest in the pre-eminent New Zealand wine brand Cloudy Bay

In our view, there is potential for Diageo to increase its ownership stake in Moët Hennessy to a controlling stake and the Company have made no secret of their intention to do so. For now the owner of LVMH, Bernard Arnault, has been unwilling to sell what has been the cash generator for the LVMH business.

We also see a possible divestment opportunity of the 34% stake in Moët Hennessy if Diageo cannot gain full control, and/or is to consider acquisitions such as Remy Cointreau or Gruppo Campari.

Conservative valuation puts the 34% stake in Moët Hennessy at £4.2B – £4.9B* (£1.67 – £1.95 per share)

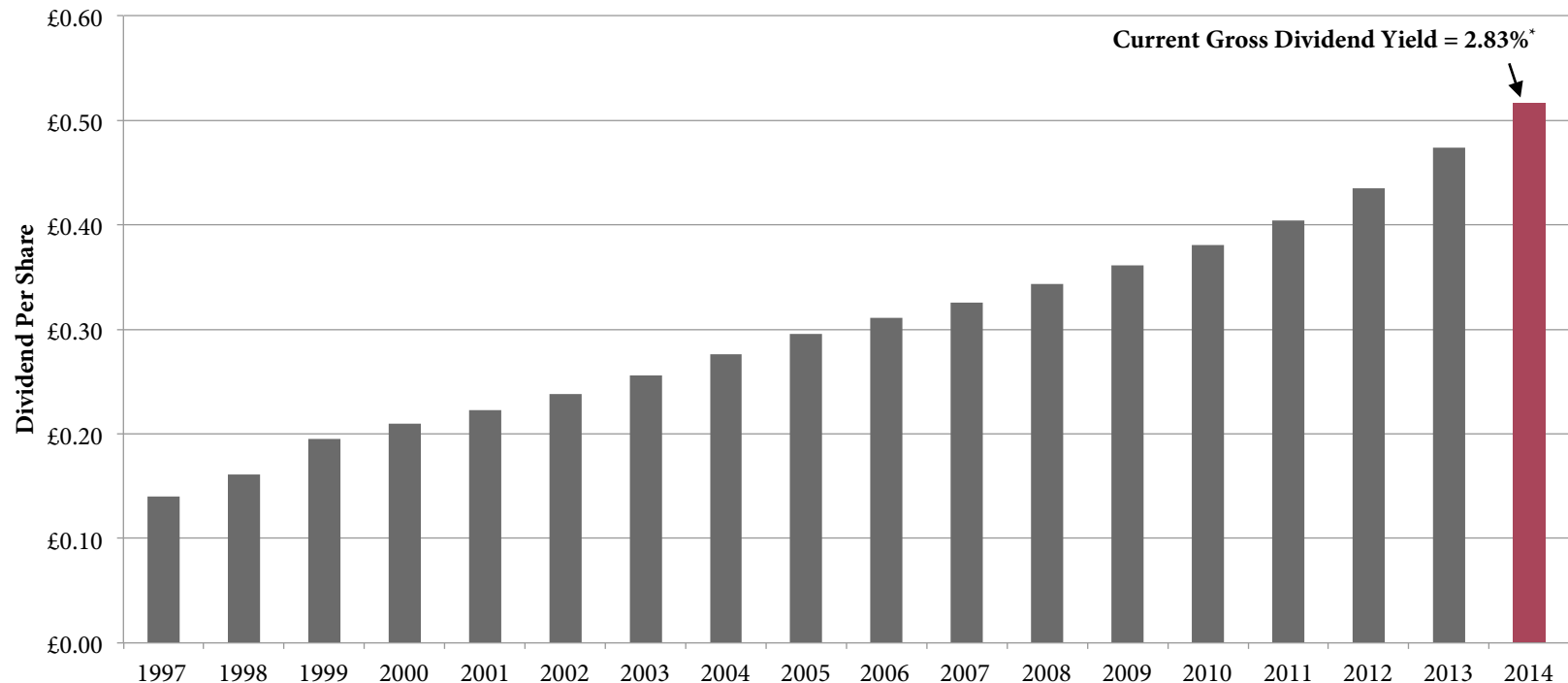


* BASED ON MOËT HENNESSY'S 2014 COMPREHENSIVE INCOME AS REPORTED IN DIAGEO 2014 ANNUAL REPORT. BASE-CASE VALUATION IS 19.5X DIAGEO'S 34% OF MOËT HENNESSY'S 2014 COMPREHENSIVE INCOME, AND OPTIMISTIC-CASE VALUATION IS 22.5X DIAGEO'S 34% OF MOËT HENNESSY'S 2014 COMPREHENSIVE INCOME

DIAGEO PLC: DIVIDEND HISTORY

- Dividends per share of common stock on issue have increased consistently since 1997, when Diageo was created (Compound growth of 7.5% per annum)
- The FY2014 dividend amounts to a 57.6% payout ratio
- Diageo currently has a Gross Dividend Yield of 2.83%*

Dividend History



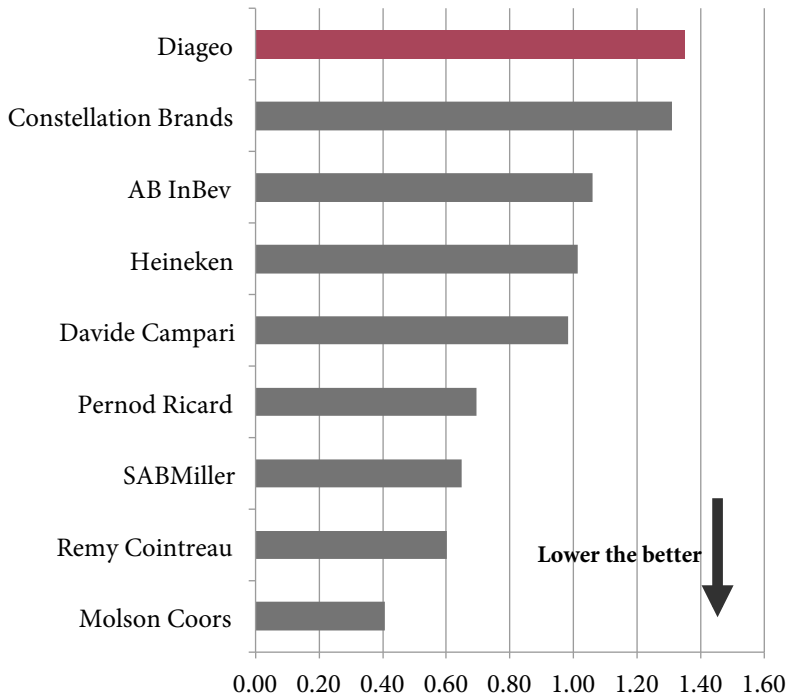
* AS AT 7 NOVEMBER 2014

DATA SOURCE: THOMSON REUTERS WORLDSCOPE

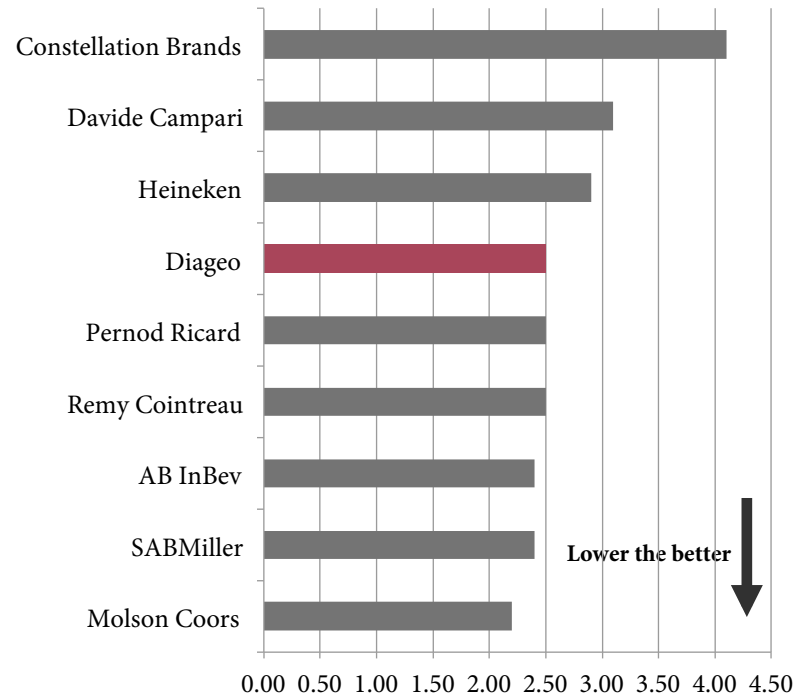
DIAGEO PLC: LEVERAGE

- Diageo's debt levels of 135% Debt / Equity are higher than the industry average of 90%*
- However, due to its high and steady Free Cash Flow, its Net Debt / EBITDA of 2.5x is below the peer group average of 2.7x*

Total Debt/Equity



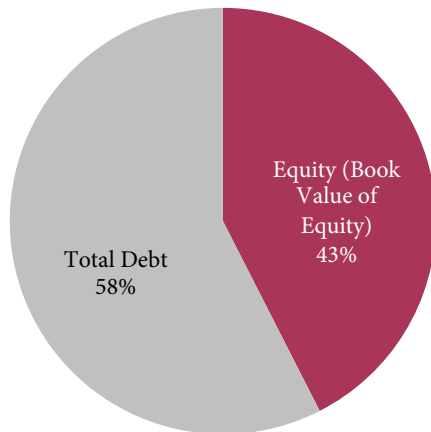
Net Debt/EBITDA



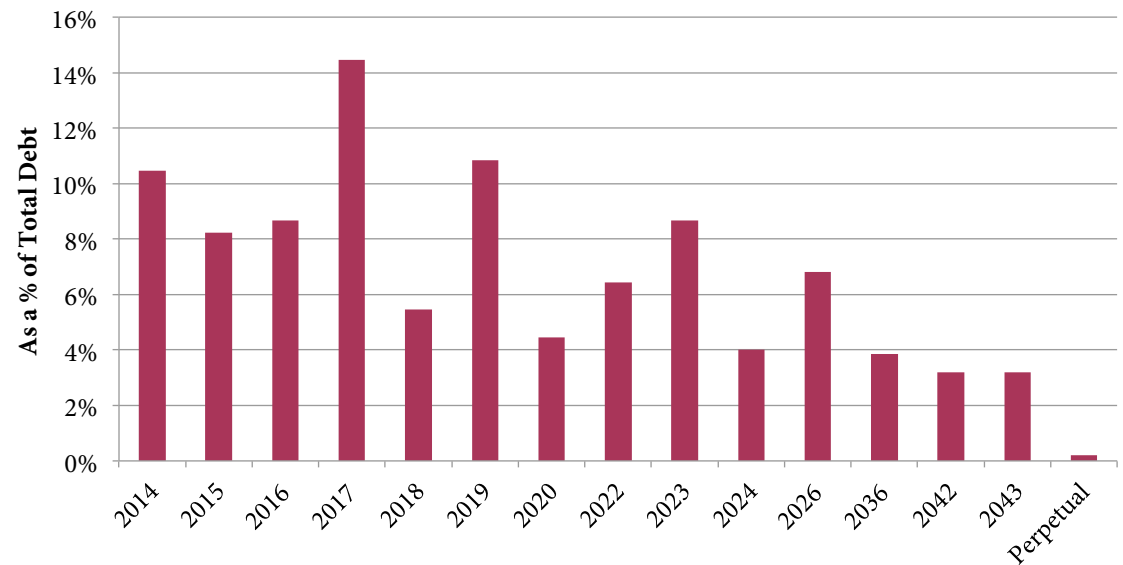
DIAGEO PLC: CAPITAL STRUCTURE

- **Equity** – Diageo has 2.51 billion shares outstanding. Current market capitalisation is ~£45.8B based on share price of £18.27*
- **Debt** – Diageo currently has £9.2B in total debt, down from £10.1B as at the end of FY2013. However, the stock still has a relatively high Debt/Equity ratio of 135% and Debt/Assets of 58%. The borrowing in recent years has been drawn down to fund new acquisitions and expansion into new markets
- **Debt Maturity Structure** – Diageo’s bonds and interest bearing obligations are spread over a long period of time. The majority of the bonds are issued in the US and are denominated in USD

Capital Structure



Debt Maturity Profile



DIAGEO PLC: COMPARABLE COMPANIES

- Diageo trades at a discount to its peer group average on a P/E basis, trailing 12 months and forward 12 months
- It trades at a premium to its peers based on EV/EBITDA multiple reflecting the fact that Diageo has higher leverage than its peers
- Diageo has the highest dividend yield at 2.83% versus the peer average of 1.8%

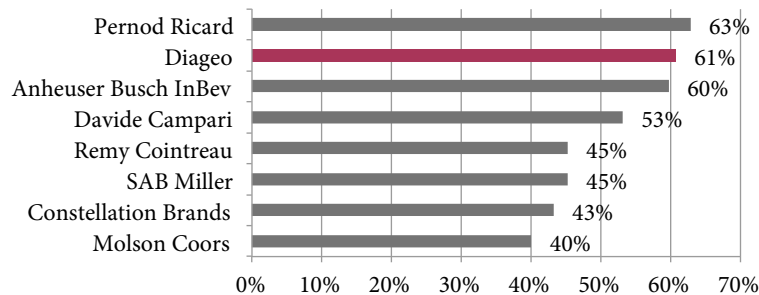
Peer Group

	Trailing P/E	Forward P/E	Price/Sales	EV/EBITDA	Price/Book	Dividend Yield
AB InBev	21.2x	19.3x	3.6x	10.6x	3.2x	2.1%
Constellation Brands	22.9x	19.7x	2.8x	12.9x	2.6x	0.0%
Davide Campari	21.5x	19.2x	2.0x	10.9x	2.0x	1.4%
Heineken	19.9x	17.8x	1.7x	9.1x	2.5x	1.5%
Molson Coors	17.2x	17.3x	2.9x	10.1x	1.4x	2.0%
Pernod Ricard	21.1x	17.6x	2.8x	12.9x	1.9x	1.8%
Remy Cointreau	33.3x	29.2x	2.8x	17.8x	2.5x	2.2%
SABMiller	22.4x	20.7x	5.1x	14.2x	3.0x	1.8%
Peer Group Median	21.4x	19.3x	2.8x	11.9x	2.5x	1.8%
Diageo	18.9x	18.3x	4.1x	14.3x	5.6x	2.8%

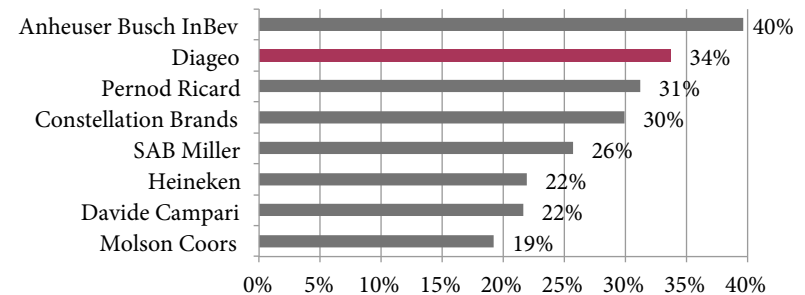
DIAGEO PLC: COMPARABLE COMPANIES – MARGIN ANALYSIS

- Diageo, Anheuser Busch and Pernod Ricard are consistently among those with the largest margins, particularly so in the gross margin category. This is due to the advantages of economies of scale as they are the largest alcoholic beverage producers
- We note that Diageo's margins have trended up since 2010, however the EBITDA and operating (EBIT) margins have been largely flat. One driver of increasing margins going forward is likely to be shareholder pressure on management in the industry in general as a result of cost reduction precedents set by the likes of 3G Capital. 3G has a reputation for improving the margins of its takeover targets by significantly reducing Selling, General and Administrative Expenses

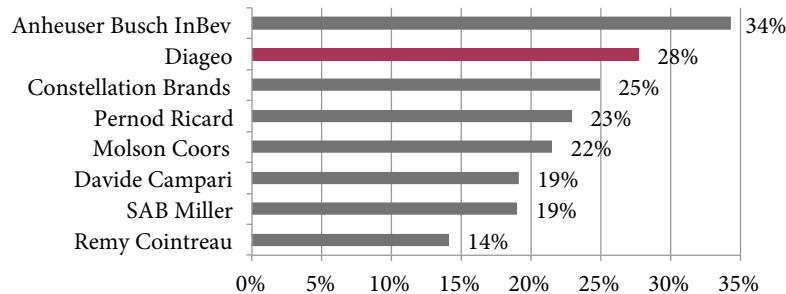
Gross Margin



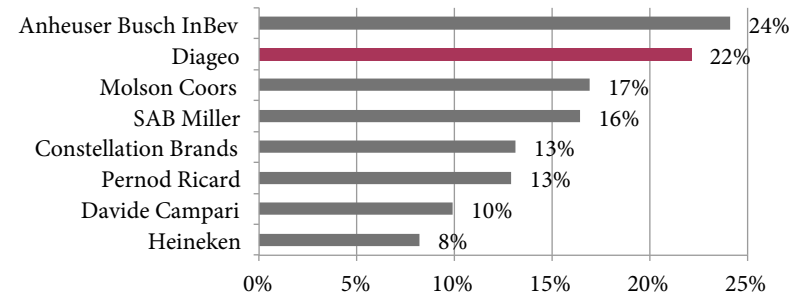
EBITDA Margin



Operating Margin



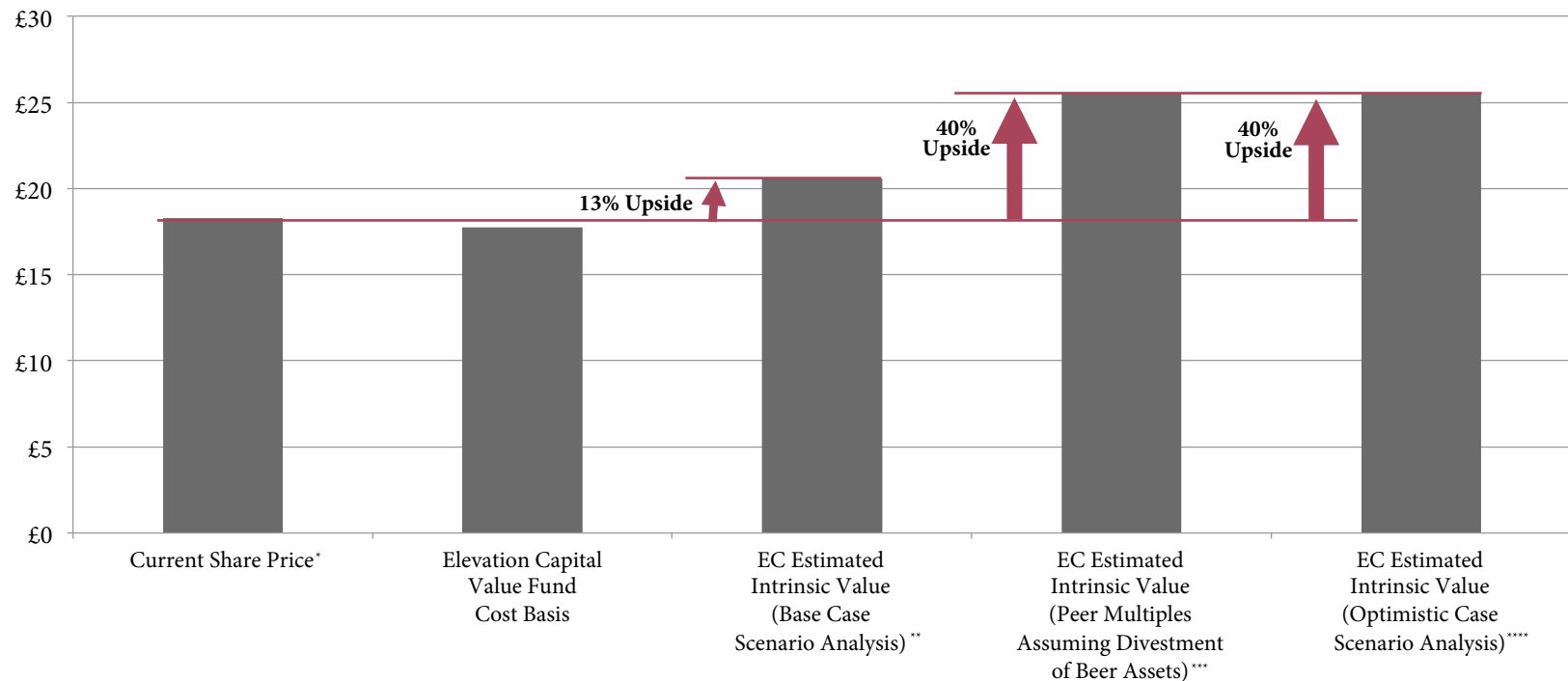
Net Margin



DIAGEO PLC: ELEVATION CAPITAL'S VALUATION

- We believe that Diageo is undervalued by the market on both a cross sectional (comparison with other companies) and a time series (compared with its own historical trading multiples) basis
- We believe Diageo is currently trading at a 29% discount (40% upside potential) to our Estimated Intrinsic Value of £25.55 per share

Valuation Summary



* DIAGEO SHARE PRICE AS AT 7 NOVEMBER 2014

** BASE CASE SCENARIO VALUATION IS BASED ON 19.5X 2016 ESTIMATED BASE CASE EPS OF £1.20, DISCOUNTED TO PRESENT VALUE (DISCOUNT RATE = 6.5%)

*** PEER MULTIPLES VALUATION IS BASED ON 20.1X EC ESTIMATED 2014 NET INCOME (EXCLUDING BEER SEGMENT) + 3.1X BEER SEGMENT 2014 TOTAL SALES

**** OPTIMISTIC CASE SCENARIO VALUATION IS BASED ON 22.5X 2016 ESTIMATED OPTIMISTIC CASE EPS OF £1.28, DISCOUNTED TO PRESENT VALUE (DISCOUNT RATE = 6.5%)

DIAGEO PLC: KEY OPPORTUNITIES

Exposure to Emerging Markets (“EM”)

Diageo remains one of the best means of increasing exposure to emerging market growth without the enhanced risks of directly investing in EM stocks. Diageo has increased its exposure to Africa over the past decade, a fact we like. According to the African Development Bank, there will be 65 million more legal drinkers in Africa by 2023. This is a significant opportunity and Diageo is targeting the continent via the beer segment, as this is the drink Africans tend to prefer. Guinness and Tusker, both popular drinks in Africa, are the key Diageo products in this market.

Scale

One of Diageo’s biggest advantages is its scale. Its size allows it to exploit economies of scale not available to its competitors in the spirits industry. This has allowed the Company to consistently produce gross, operating and net margins which are significantly above the peer group average. Similarly, it is able to generate the highest ROE and ROA among its peers.

Brands

Diageo has two primary sources of competitive moat, its scale and the popularity of its brands. Johnnie Walker, Smirnoff, Tanqueray, Baileys, Guinness, Captain Morgan, Hennessy and Moët & Chandon are some of the most enduring brands in the alcohol industry, giving Diageo a significant presence in virtually all product categories. Equally important, Diageo has popular brands in numerous price categories, from ultra-premium to value.



DIAGEO PLC: KEY OPPORTUNITIES (CONTINUED)

M&A Opportunities

On 3 November 2014, Diageo announced that it would acquire full control of the Don Julio brand of tequila (of which it had previously owned 50%) in a deal which would see Diageo swap Bushmills whisky for the high growth tequila brand (along with a payment of \$408 M to be received by Diageo). This shows that Diageo is thinking about its brand portfolio and is willing to undertake both divestments as well as acquisitions in order to add value for shareholders. In the long run, some key brands may be divested or full control may be acquired. We see the 34% stake in Moët Hennessy as a possible divestment opportunity if Diageo cannot gain full control (which it is seeking to do). Guinness could also be a high value spin-off/sale for shareholders.

We also consider Diageo's beer assets, including Guinness and East African Breweries, to be candidates for divestments which would add value for shareholders. We believe these assets hold appeal to ABInBev, one of the most prominent acquirers in the beer industry currently.

Localising the Product Range

Globally, the alcoholic beverage market is extremely diverse. Diageo has recognised this and openly addresses its intention to expand its product portfolio to further localise its offerings. This strategy has led it to Asia, where it has acquired the Chinese white spirit maker Sichuan Chengdu Quanxing (including its popular brand Shui Jing Fang), Turkey, where it has acquired Mey Ickim another local distiller and Africa, where it has acquired Serengeti Breweries among other assets.



DIAGEO PLC: KEY RISKS

Regulatory Risks

Governments globally have become more inclined to legislate against alcohol, whether through increasing taxes or by restricting the ability of retailers to sell alcoholic beverages. This is being countered by the alcohol industry through campaigns to reduce problem drinking, etc. Diageo is a leader in this field, however, increased levels of regulation represent a risk to the industry as a whole.

Exchange Rate Risks

Diageo has a high level of exposure to emerging markets which have recently experienced sizeable capital outflows. The translational effects of the associated depreciation of EM currencies has contributed to a fall in revenue and earnings. Similarly, sharp movements of the USD against the GBP could have a detrimental impact on Diageo's financials as North America accounts for 34% of net sales, and 45% of operating profit.



ABSOLUT TAXES.

On Tuesday, September 1st, the Illinois liquor tax will go up **90%**. Stock up.

www.illinoispolicyinstitute.org

DIAGEO PLC: KEY RISKS (CONTINUED)

Political Risks

Diageo operates in a number of regions around the world, some of which are less politically stable than others. These regions/countries tend to represent strong growth opportunities. However, they also increase the level of political risk to which Diageo is exposed. This can be realised in the form of unfavourable legislation, nationalisation or the effects of macroeconomic mismanagement.

High Level of Debt

Diageo's debt level is higher than its peers, at 135% Debt/Equity. However, Net Debt/EBITDA is 2.50x, in line with peers. Because of its lower Net Debt/EBITDA metric, we see Diageo's debt as a low level risk, but feel its high overall debt levels to be an issue worth highlighting.

Failure to Deliver Expected Value from Acquisitions

Diageo is a natural acquirer in the industry because of its size and growth strategy. If it fails to deliver value from acquisitions and/or integrate them effectively, including failure to embed Diageo's standards of compliance with laws, internal policies and controls, this will effect profitability.

US top court won't touch Havana Club

By CB Online Staff

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Bacardi has scored a technical knockout in its trademark fight with Pernod Ricard over the right to sell its Havana Club rum in the United States.

The U.S. Supreme Court on Monday refused to hear Pernod's appeal of a lower court ruling that its claim to the Havana Club brand was not valid in the United States because it concerns a trademark used by a business that was nationalized by the Cuban government.

The refusal by the top court to take up the case, which has no effect on the Havana Club trademark in other countries, adds to a cocktail of court opinions stretching from the U.S. to Spain in the Havana Club legal spat.

DIAGEO PLC: ELEVATION CAPITAL VIEW

Weak Share Price Presented a Longer Term Opportunity

Recent share price weakness has led to what we believe is an opportunity to acquire Diageo shares at a discount to our estimate of intrinsic value. This decline has been largely associated with decreasing revenue and earnings, stemming from the Company's exposure to emerging markets which have lagged the developed world recently. In connection with this, currency worries have also taken their toll on Diageo's revenue and earnings.

Margin-of-Safety – Brand Strength

Diageo owns some of the most recognisable alcohol brands in the world. Johnnie Walker, Guinness, Baileys and Smirnoff (to name a few) are enduring brands with reputations for quality. This dominance in the number and type of brands relative to other alcoholic beverage producers forms part of Diageo's competitive moat.

Margin-of-Safety – Scale

Diageo's scale allows it to have the highest gross and net margins amongst its peers. The synergies between its brands and business segments and the economies of scale it can leverage present the Company with a meaningful advantage over its competitors.

Margin-of-Safety – Valuation

We value Diageo using two methods; a peer multiples approach which accounts for a potential divestment opportunity which we perceive for the Company's beer assets; and a scenario analysis approach which yields a conservative and an optimistic estimate of intrinsic value. We believe the stock is trading at a discount to our Intrinsic Value Estimates (11% - 29%), with upside potential of 13% - 40% (not including dividends)

DIAGEO PLC: ELEVATION CAPITAL VIEW (CONTINUED)

Opportunities for Value Creation – Many Ways for Shareholders to Win

A number of opportunities for value creation are available to Diageo. Africa provides it with a dynamic and growing market and, in turn, investors gain a unique exposure to the fast growing African economy without the inherent risks of direct investments. Diageo's beer segment, intrinsically linked to the company's African operations, also presents a potential M&A opportunity. Consolidation in the beer market has been notable recently and the largest players in the industry have sought to increase their operations in Africa. Similarly, the localisation of Diageo's product line, particularly in Asia, also provide it with the opportunity to tap new markets. The 34% stake in Moët Hennessy could also present a divestment/value realisation opportunity for the Diageo shareholders.



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'INDEPENDENT THINKING – DISCIPLINED INVESTING'

INDEPENDENT THINKING

[In-de-pend-ent Think-ing] **inde'pendənt THiNkiNG** *verb*

Is essential to long-term investment success. We are often contrarian and do not pay attention to index compositions when making investment decisions. We believe that when you're several thousand miles away from Wall Street in a different nation, it's easier to be independent and buy the things that other people are selling, and sell the things that other people are buying. We also believe that cash is sometimes the most attractive investment.

DISCIPLINED INVESTING

[Dis-ci-plined In-vest-ing] **disciplinəd inves'ting** *verb*

The market presents opportunities every day, but disciplined investing is as much about the opportunities you do not take. Our investments are premised on the concept of "Margin of Safety" which we believe reduces risk.