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MONEY MANAGER INTERVIEW

CHRISTOPHER TSAI

Tsai Capital Corporation

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Preserving and Growing Capital with High-Quality Growth Companies

CHRISTOPHER TSAI, TSAI CAPITAL CORPORATION



CHRISTOPHER TSAI is President and Chief Investment Officer of Tsai Capital Corporation, a global equity manager headquartered in New York City. He founded the company in 1997 and serves as Chairperson of the firm's advisory committee. Tsai Capital is an SEC-registered investment adviser. Mr. Tsai seeks long-term investments in businesses Tsai Capital believes are high-quality, growth companies that offer significant upside potential and a margin of safety at the time of purchase. His research-intensive, fundamental and long-term approach

to investing has created significant wealth for his investors. Through Tsai Ventures, the seed and early-stage venture capital arm of Tsai Capital Corporation, Mr. Tsai invests in private companies and helps to build relationships for entrepreneurs. Mr. Tsai is a member of the board of directors of untapt inc. and is a member of the National Association of Corporate Directors and the New York Society of Security Analysts. Mr. Tsai was retained by Paul Hastings LLP, a leading international law firm, to provide expert assistance with the analysis of publicly traded equity securities. Mr. Tsai has been profiled in numerous financial publications, including *Barron's*, *Bloomberg*, *Business Insider*, *Financial Planning*, *Investment Advisor* magazine, *Private Asset Management* and *The Wall Street Transcript*. He has also been interviewed on Bloomberg Radio, China Money Network, Fox Business Network, TheStreet.com TV and Yahoo Finance Live. Mr. Tsai has contributed to *Investment & Pensions Europe* about investing in art as an alternative asset class. He is also the author of *Back Door to China*, a *Worth* magazine article about investing in contemporary Chinese art, a *Fundweb* article about the importance of maintaining portfolio exposure to Asia's growing middle class and a *Wealth Management* magazine article about investing in durable, long-term trends. Prior to forming Tsai Capital, Mr. Tsai was an equity research analyst at Bear, Stearns & Co. Inc.; John A. Levin & Co., Inc.; and Gabelli Asset Management. He began his career in finance at a young age, working for his late father, distinguished financier, fund manager and philanthropist, Gerald Tsai Jr., analyzing investment opportunities for the Tsai family and family foundation. Mr. Tsai has been a benefactor of numerous museums and cultural institutions, both nationally and internationally, including the Hirshhorn Museum and Sculpture Garden, The Jewish Museum, The Metropolitan Museum of Art, the Serpentine Gallery Pavilion, the Solomon R. Guggenheim Museum and the World Monuments Fund. Mr. Tsai received a Bachelor of Arts degree in philosophy and international politics from Middlebury College, where he is a member of the Middlebury College Arts Council and previously served as a Young Alumni Advisor.

SECTOR — GENERAL INVESTING

(AHK503) **TWST:** Could you tell me a little bit about the history of the company?

Mr. Tsai: Sure. I founded Tsai Capital back in 1997. We are a registered investment adviser based in New York City. And since our founding 20 years ago, our investment philosophy has been a consistent one. Our goal is to find high-quality growth companies that have significant upside potential and margin of safety at the time of purchase. We look for discounts to intrinsic value. And there just aren't a lot of investments that meet all of the fundamental and qualitative characteristics that we look for in an investment. So we do a significant amount of research upfront, we are very patient, and we wait for the opportunity to buy at a discount.

TWST: And who and what are some of the target groups that you sell to?

Mr. Tsai: Our client base is primarily comprised of high net worth individuals, corporations, trusts. Our clients also range in age. We have clients who are in their teens, and we have clients who are around 80 years old.

TWST: Did you want to maybe discuss a holding that you find interesting now?

Mr. Tsai: We like a company called **Yum China** (NYSE:YUMC). And part of our investment strategy is to position portfolios so that they benefit from a durable tailwind. It's something that I learned many years ago having worked for my late father, Gerald Tsai Jr., who had a long and successful history on Wall Street. And he once said to me, "You've got to position yourself with the wind at your back," so that's how we think about portfolios, and we think thematically.

And there's a broad trend occurring in the world today, and it's occurring in Asia. The middle-class population in Asia is booming. From 2009 to 2030, the middle class is expected to increase from 525 million people to 3.3 billion. And what's interesting about that is the spending power of that group is expected to increase from \$5 trillion to \$33 trillion. It's a huge increase in wallet power by this segment of the population.

And as people get wealthier, the natural inclination for investors is to think about luxuries, but we don't think about who might be able to buy a new car, because not everybody can. We think about simple luxuries like dining out, and **Yum China** fits very much into this long-term durable tailwind. **Yum China** is the exclusive licensee of **Pizza Hut**, **Taco Bell** and **Kentucky Fried Chicken** in mainland China. They have a couple of nascent brands as well, like **Little Sheep** and **East Dawning**. **Little Sheep** is a

hotpot concept that's quite popular.

But the core brands, **KFC** and **Pizza Hut**, have been around for a long time, and we like businesses with long operating histories. And today, **KFC** is China's number-one quick-service restaurant brand. They've got over 5,000 restaurants, so they're about twice as large as **McDonald's** (NYSE:MCD), and they're also the first quick-service restaurant brand to enter China in 1987. And **Pizza Hut**, it's the number-one Western casual-dining restaurant with about 1,600 restaurants in mainland China. And they're not just pizza; it's about dining out. They sell steak. They sell pasta. This is a company that will benefit as people spend more on little luxuries.

TWST: Now, in terms of its efficiency, I know with some of the fast food restaurants here in the United States, there's going to be more automation and maybe the labor

force is going to be trimmed a bit. Do you think that that might happen too in some of these restaurants in Asia?

Mr. Tsai: It's a great question, and it is happening already. The company is experimenting with facial recognition software for customers who enter the restaurant. It's a technologically savvy company. And one of the reasons it's technologically savvy is because **Ant Financial**, which runs **Alibaba's** (NYSE:BABA) Alipay mobile payments platform, is one of their partners. They actually invested \$50 million during the recent spinoff of the company from the parent **Yum! Brands** (NYSE:YUM) in the States.

They also have an investor, Fred Hu, who runs a company called **Primavera Capital**, and he is extremely well-connected across Asia. He was the former Chairman of

Greater China at **Goldman Sachs** (NYSE:GS), and **Primavera** put in \$410 million. Some of that money is being used to not only drive expansion but also to drive the technology behind the business.

And today, **Yum China**, they're the undisputed leader in digital engagement. They've got over 100 million fans on social media, and they process about \$1 billion in cashless payments every year. So this is a business that is focused on becoming more efficient, and technology is a large part of that.

TWST: Did you want to mention a second company?

Mr. Tsai: If we think about the States, there's a business called **McKesson** (NYSE:MCK). And we like **McKesson** long term because it's also benefiting from a long-term trend, just this trend is very much focused on the States. And that trend is the graying of the American population. The number of Americans

Highlights

Christopher Tsai discusses Tsai Capital Corporation. Mr. Tsai's goal is to invest in high-quality growth companies. He looks for companies that have significant upside potential and margin of safety. He focuses as much on capital preservation as on the potential growth of capital. Based on advice from his father to position himself with the wind at his back, Mr. Tsai aims to position portfolios with a durable tailwind. One of the broad trends he is following today, especially in Asia, is the growth of the middle class. Another trend is the graying of the American population.

Companies discussed: Yum China Holdings (NYSE:YUMC); McDonald's Corporation (NYSE:MCD); Alibaba Group Holding Ltd. (NYSE:BABA); Yum! Brands (NYSE:YUM); Goldman Sachs Group (NYSE:GS); McKesson Corporation (NYSE:MCK); CVS Health Corp. (NYSE:CVS); Wal-Mart Stores (NYSE:WMT); AmerisourceBergen Corp. (NYSE:ABC); Cardinal Health (NYSE:CAH) and Ecolab (NYSE:ECL).

aged 65 and older is going to double from about 46 million today to over 98 million by 2060, and the senior segment of the population, or those aged 65 and older, will rise to about a quarter of America's population from 15% today.

“And pharmaceutical manufacturers are what many investors gravitate toward when they think about the graying of the American population, but we think that it often makes more sense to focus on the distributors. Why, for example, get involved with manufacturing risks and patent expiration risks that manufacturers typically face when you can buy into the entire supply stream?”

What's interesting about that is that seniors take about three times as many prescription drugs as the younger population does. And pharmaceutical manufacturers are what many investors gravitate toward when they think about the graying of the American population, but we think that it often makes more sense to focus on the distributors. Why, for example, get involved with manufacturing risks and patent expiration risks that manufacturers typically face when you can buy into the entire supply stream?

So **McKesson** is the largest wholesaler of prescription drugs by revenue. They sell drugs and stock them for the pharmacies: **CVS** (NYSE:CVS), for example; **Wal-Mart** (NYSE:WMT). They do about \$200 billion in annual revenue. They're also the second-largest specialty pharmaceutical distributor in the States. They have an enormous scale. They operate essentially as an oligopoly, with **Amerisource** (NYSE:ABC) and with **Cardinal** (NYSE:CAH) being the other two major players.

And **McKesson** has — because of its scale — a tremendous competitive advantage. They also produce a healthy amount of cash flow, and the stock is trading in at about \$154 a share, which is significantly down from its highs. So at \$154, it's about \$33 billion market cap, and we think that over the next 12 months, they'll do about \$207 billion of revenue, and they'll earn about \$12.25 in earnings per share on a fully diluted basis, so that comes out to about 12.6 p/e multiple, which is a slight discount from its average historical multiple of about 13.6 times.

Management may also unlock some value, we think, by spinning off **Change Healthcare**. **Change Healthcare** is a 70% owned business. It was formed by the combination of substantially all of **Change Healthcare Holdings** and the majority of **McKesson Technology Solutions**. So **Change** provides financial, operational and clinical benefits to providers and consumers. There's a lot of value there, and again, we think that **McKesson** may wind up spinning that business off.

TWST: And what's on the horizon for them? I mean, technology seems to be improving the way distribution is done in a lot of different sectors, so I'm thinking more machine-to-machine communication or robotics?

Mr. Tsai: It's certainly possible, and it's certainly an area that the three major players will have to get more and more involved with. Margins are already very slim, and because margins are slim,

they need to look for areas in which to drive profitability. Technology is a constant focus for them. But on the other hand, because margins are thin, competitors are kept at bay.

TWST: I understand they also provide services for the health care industry.

Mr. Tsai: They do, and they're the 1,000-pound gorilla. So with \$200 billion-plus in annual revenue — and not just wholesaling prescription drugs, but through **Change Healthcare** and other subsidiaries that provide operational and clinical benefits to providers and consumers — they touch many lives.

TWST: Did you want to talk about a third company?

Mr. Tsai: The world is becoming more polluted. It's unfortunate, but it's a fact, and 90% of the world's population lives in places where the World Health Organization air quality guideline levels are not met. And this leads to millions of premature deaths. Another sad point is that according to the United Nations, water scarcity effects 40% of the world's population. So how do we think about investing here?

Ecolab (NYSE:ECL) was founded in 1923. Its CEO is Doug Baker Jr. He's done a wonderful job in allocating shareholder capital and creating shareholder value. This is a business that is at the center of dealing with the world's problems. It's also positioned well to make money for itself. We like businesses that can help the world and make money for themselves. **Ecolab** is the world leader in water hygiene, energy technologies and services, and they service the food, energy, health care and industrial markets.

1-Year Daily Chart of Yum China Holdings



Chart provided by www.BigCharts.com

So think about hospitals and supermarkets and schools and municipalities — they're all over the place, and an aspect of **Ecolab** that we like is its diversification and consistency. It's a consistent business, and **Ecolab** has a very strong balance sheet. We would consider them in the category of best of the best. We're looking for high-quality companies, and **Ecolab** certainly fits within this area. And we're also looking for businesses that have a long runway of growth ahead of them, that is a large total addressable market. And because the world is getting more polluted — China and India, for example, are very polluted and increasingly stressed — there's just a huge market opportunity for **Ecolab**.

TWST: What's on the horizon for them that

investors might be interested in? Any kind of new direction or just more of the same?

Mr. Tsai: Well, I think over time, they will continue to build out their operations in mainland China and in India. They recently purchased a company in mainland China, but the mainland China business is still a small part of the total pie. But over time, that piece of the pie is going to grow. From a valuation standpoint, the company does not appear cheap, but there's a reason for that.

“And we really don't look at the market as a whole when making investment decisions, because over the long run, if the company's earnings grow and you've paid a reasonable valuation for that business, the stock price will follow. Too many people are short-term-oriented. And that's why so many investors fail.”

So if we look at the math, there are 290 million basic shares outstanding. There are 11.9 million stock options, so together about 301.9 million diluted shares. Stock trades at \$131. It's a \$39.5 billion market cap. And over the next 12 months — we like to look in terms of forward 12 months in revenue and earnings forecasts — so over the next 12 months, we think they'll do about \$14 billion of revenue and earn about \$5.12 per diluted earnings per share. So it trades at about a 25.5 multiple. On the surface, that appears expensive, but historically, the stock has traded at a roughly similar multiple.

And one of the reasons it trades at a seemingly high multiple is because they produce a high level of free cash flow and owner earnings relative to net income. In fact, free cash flow conversion is far above 100% of net income. And if you think about what a p/e multiple really should be, you need to look at the discounted cash flows. After all, the value of a business is the present value of the cash that can be taken out of the company during its remaining life. In **Ecolab's** case, the present value of that cash is very high. Therefore, when you look at it in terms of next year's earnings, the p/e multiple will correspondingly be higher than it would be for a business with less cash flow conversion.

TWST: And you mentioned that some of the clients that you have are high net worth individuals. What do you think is foremost on their mind now as they look at the rest of this year and into next year?

Mr. Tsai: Capital preservation has always been a focus for our clients and for Tsai Capital. When we invest, we focus as much on capital preservation as we do on the potential growth of capital. And one of the ways in which we are able to be effective in terms of capital preservation is by buying businesses at discounts to intrinsic value. We do a lot of research upfront, and we wait for the right opportunity to buy the companies that we want at a big discount. And that discount not only provides a margin of safety, but it can also enhance the potential rate of return. We also stay within our circle of competence. We try not to make mistakes, and one of the ways in which we try not to make mistakes is by staying within our circle of competence.

TWST: And do you think that some of the high net worth individuals are also concerned that the S&P is so high? What might happen to it? Is that an issue for them too?

Mr. Tsai: I think many investors are concerned about the stock market, particularly since we've had a strong increase from 666 on the S&P when it bottomed during the financial crisis. But we think that there's still value in certain companies. And we don't buy the market anyway. We buy individual businesses. We're very selective. We're fundamentally oriented; we're bottom-up investors.

And we really don't look at the market as a whole when making investment decisions, because over the long run, if the company's earnings grow and you've paid a reasonable valuation for that business, the stock price will follow. Too many people are short-term-oriented. And that's why so many investors fail. The only way you get a real edge is by thinking long term and not worrying what the market is going to do over the next days or months. You've got to focus on the fundamentals.

TWST: And you mentioned that you have some younger investors too. Do they have strategies that are different than maybe the Baby Boomers in terms of how they see investments in the market?

Mr. Tsai: Absolutely not. Our approach for the young and for the old is the same: to preserve capital and to capture above rates of return. And we do that primarily within the high-quality space. We do that in businesses that we understand. And again, we're patient. We wait for discounts. We don't swing at every pitch. Great opportunities don't come around often, but when they do, we invest with size. There's no reason to take outsized risks just because one is younger in order to generate a potentially higher rate of return. The way you generate a potentially higher rate of return is actually by taking less risk. We want to buy growth businesses at a discount and over time get the benefit of that discount closing. We like to have our cake and eat it too.

1-Year Daily Chart of McKesson Corporation



Chart provided by www.BigCharts.com

TWST: And do you see more of the Millennial generation getting involved in the market now that the job situation is cleared up a bit and they might have things like student loans under control and those sorts of issues?

Mr. Tsai: We have a lot of contact with Millennials. And

Millennials are still, in general, risk-averse and concerned about the market. And one of the reasons that I think they're risk-averse is because the recent financial crisis happened during a period when many were graduating from school. It's still very fresh in their minds.

What we stress with Millennials is that nobody knows what happens over the next day, month or year. But time is an important element to building wealth. Compounding is a powerful model. In other words, the earlier you start investing, the more time works in your advantage. You have the ability to compound wealth over a longer period of time. That's powerful. So Millennials should invest as early as possible, like anyone.

TWST: And on the other side of that, a lot of Baby Boomers have either retired or are thinking about retirement. Do you think they still should have investments in stocks now rather than relying on things that might pay lower interest?

Mr. Tsai: It really depends on one's overall profile, but stocks should generally be a component of that overall strategy and likely a large part of that strategy, even for Baby Boomers.

TWST: With corporations that might have retirement funds, what are some of their concerns so that

they make sure that they have enough money for what they need to be spending their money on?

Mr. Tsai: Well, they're not sleeping very well right now. And the reason is because pension fund return assumptions are unrealistic. With the overall stock market at these levels and with interest rates near historic lows, they realize that it's going to be very hard to meet their return assumptions, and meeting those assumptions, incidentally, are super important to satisfying their obligations. That's why they are constantly thinking about where they can get alpha.

TWST: Thank you. (ES)

CHRISTOPHER TSAI

President & Chief Investment Officer

Tsai Capital Corporation

590 Madison Ave.

21st Floor

New York, NY 10022

(917) 979-4821

(917) 979-4849 — FAX

www.tsaicapital.com
