

Holland Views – Brembo SpA – Price: €6.90; MCap: €2.2bn – BUY

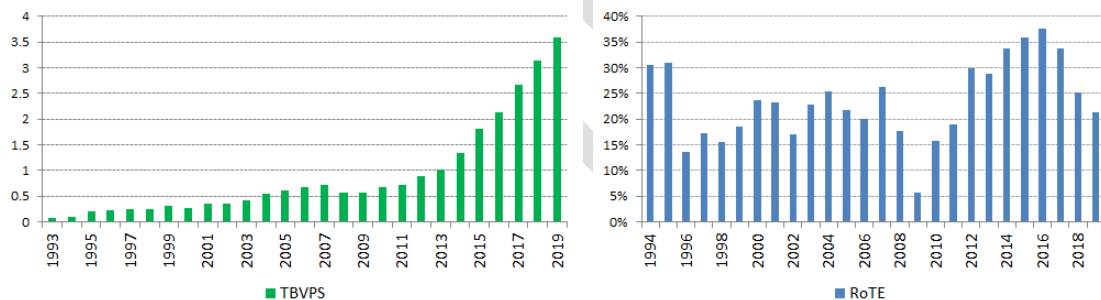
Braking Bad

Much of this analysis was done in the weeks pre Covid-19. At that time, we believed that we had found another great compounder with a long track record. Today its shares are -25% lower.

We have long held that one can find great businesses even in seemingly unappealing industries. Today, we discuss a very high-quality business in the auto supply chain.

Italy based **Brembo** has a 50 year history selling high performance brake discs and calipers. It has a longstanding monopoly supplying both Formula 1 track and Porsche road cars. This high-end dominance is derived from the company's exceptional innovation. Such innovation trickles down and Brembo is starting to penetrate the premium mass market. Have you ever noticed the *coloured* brake calipers on a sports car? Those are Brembo brakes. Brembo pioneered the use of coloured brakes as a branding feature making it one of the rare third-party parts brands that are visually promoted by car manufacturers (including Tesla). Brembo looks really good on our Franchise checklist, and on 6.2x owner earnings, offers close to a 20% IRR from today's price.

Fig.1: Long Track Record of High returns and reinvestment



Source: Holland Advisors

- **Owner Manager:** This is a family owned business. Alberto Bombassie, Chairman and son of the founder still owns 54% of the business.
- **Innovation:** The business has a long track record of high-end innovation and has established itself as the world-leader in braking materials and braking technology. We see it as a strong beneficiary of Electric Vehicles (EVs).
- **Resilient:** Braking is one of the few areas of car design that has not been up ended by EV; in fact it looks likely to benefit. EVs are heavier (thus needing better brakes), don't have a gearbox (hence don't have a 'Park' gear) and are ripe for innovation via 'brake-by-wire'. Elon Musk's adoption of Brembo brakes across the disruptive Tesla range is a huge endorsement of Brembo's product and brand strength in the EV world.
- **Returns and Growth:** Brembo has clean accounts. A median 10-year ROE of 21% + ROTE of 23% over the last 26 years. A 29% dividend pay-out leads to a 'textbook' 16% cagr in tangible book value between 1993-2009. Its growth is organically derived.
- **Compounder:** Brembo looks to us like a classic compounder. Despite reinvesting heavily in R&D and new capacity in the last decade, it has sustained/increased its ROE cycle-to-cycle as shown in Fig.1. Management have a track record as counter cyclical investors in both vertically integrated manufacturing and R&D innovation.

Its bet to expand US manufacturing and sell into the US market a decade ago is paying off. We expect a repeat in China where it has been investing heavily in recent years.

- **Cheap Shares:** Buffett's 2019 investor letter reminds us that retained profits are a key part of intrinsic value yet are not reflected in P&L earnings. 'Owner Earnings' are thus an important and insightful short-cut metric to assess intrinsic value. Brembo's ongoing investment and prudent accounting means that today's 'owner earnings' are significantly higher than P&L earnings (depreciation being more than 2x maintenance capex). Our estimate is that the stock is currently trading on circa 6.2x Owner Earnings (vs. c.9x headline P/E). That's a double-digit earnings yield/IRR on its own – before any re-rating, dividend, buyback or growth! We look at IRR prospects later in this note.

In this note

We focus on three areas of interest:

1. **What you can measure:** aka the great track record of financial results
2. **What you can't measure:** intangible assets, brand power and a look at the future opportunity via EVs and Tesla et al.
3. Finally, we assess Brembo's **compounding prospects**, highlight some caveats and offer a conclusion.

Historical Track Record (aka what you can measure)

Brembo is the world leader in high performance brake discs and brakes calipers dating back to its first supply contract with Alfa Romeo in the 1960s and its later breakthrough partnership with Ferrari's Formula 1 team in the 1970s. Today, it has three primary revenue streams:

1. Brake *Discs* (or 'rotors'): sold across a range of leading-edge market segments from Formula 1 to Daytona and World Rally right down to premium mass market (including discs for all BMW and Mercedes manufactured in the USA).
2. Brake *Calipers*: also sold directly to high performance racing cars and motorbikes OEMs. As alluded-to above, Brembo calipers are shifting into mass market car segments evidenced by Tesla's decision to use Brembos on the front wheels of its lowest priced 'Model 3' car. All other Tesla models have Brembo brakes on all wheels.
3. *After-Market* sales: Discs and Calipers. Brake discs and pads, by their nature, degrade with use and coupled with upgrade sales, there is thus a decent after-market for Brembo.

The company has dallied with other areas of auto supply such as suspensions and seat belts in the past but this was before the transition to Electric Vehicles became the inevitable future.

Unfortunately, the company does not disclose granular detail on volumes nor unit pricing so financial metrics need to be assessed in aggregate at group level. We estimate that auto OEMs pay between €50 and €200 per wheel for Brembo calipers.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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