HollAnd Advisors

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

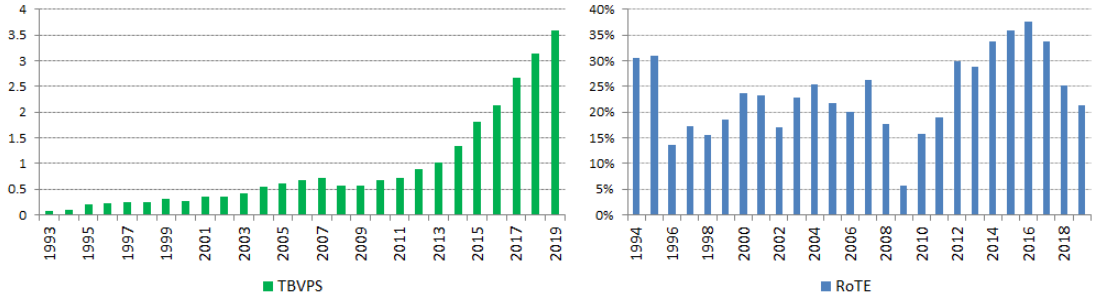
Braking Bad

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.

The company does however disclose sales by end market regionally with North America and Germany broadly 25% each of the business (the former realising an impressive doubling of sales vs. 2012 as per Fig.2 below). China (an increasingly important market), rest of Europe and Italy each make up another c.10% each. By broad end market, Brembo's revenues are 76% passenger cars, 10% commercial vehicles, 9% motorbike and 5% racing. A sample list of cars with factory fitted Brembo brakes can be seen at this link.[1]

[1] https://www.brembo.com/en/car/original-equipment/clients

Key Financial Metrics: Operate, Generate & Allocate

We summarise Brembo's group historical financials below in Fig.2. One can see it has been a phenomenal decade for the business in terms of growth, margin expansion and return on capital. Importantly, the growth has been realised with what remains a prudent balance sheet. We remind readers that, as per Fig. 1 and our spreadsheet the company's track record of strong returns goes back many decades. **We state again its median ROTE of 16% over 26 years!**

Our readings on the company show that, back in 2004, Brembo management realised that it needed to invest heavily in its manufacturing facilities. This was a bid to modernise operations, streamline its supply chain (discs are heavy and thus expensive to distribute) and not least, the company was very keen to penetrate the US market. Above all we think, Brembo was intent on getting closer (physically and otherwise) to its existing and prospective customers and their localised supply chains. Since 2012, Brembo has opened new manufacturing in Poland, Czech Republic, Mexico, China and the US.

This plan which began c.2005 has been ongoing and can be seen in the capex/sales ratio below. The plan looks to have borne much fruit – not least the company's aforementioned highly successful growth in the US as seen at the bottom of Fig.2. We try to assess the contribution from Tesla to this $645m run-rate later in the note.

Fig.2: Brembo Historical Financials

OPERATE	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Sales	826	1,075	1,255	1,389	1,566	1,803	2,073	2,279	2,464	2,640	2591
YoY	0%	30%	17%	11%	13%	15%	15%	10%	8%	7%	-2%
EBIT Margin	2.5%	5.5%	6.0%	6.4%	7.8%	9.7%	11.8%	13.8%	13.5%	12.4%	12%
Generate											
ROE	4%	10%	13%	21%	22%	27%	30%	31%	27%	21%	18%
RoNTA	3.7%	8.9%	11.1%	13.6%	15.7%	19.1%	24.0%	27.9%	25.1%	20.5%	19.5%
Allocate											
Goodwill as % of Total Assets	17%	15%	13%	12%	11%	9%	9%	14%	12%	11%	15%
Capex as % sales	6%	7%	13%	10%	8%	7%	8%	12%	15%	11%	10%
Capex/Depcretion	.5x	.9x	2.1x	1.6x	1.3x	1.1x	1.3x	2.0x	2.5x	1.6x	1.1x
Dividend as Payout of Net Inc	140%	46%	46%	25%	29%	25%	28%	22%	25%	30%	36%
Net Debt	253	247	325	330	330	280	162	197	219	136	149
Net Debt / EBITDA	2.8x	1.9x	2.3x	2.0x	1.6x	1.0x	.5x	.5x	.5x	.3x	.3x
Geographic											
NAFTA (North America, Mexico) Sales				312	373	463	602	637	621	645	648
YoY					19%	24%	30%	6%	-3%	4%	0%

Source: Holland Advisors

Historical growth drivers

Brembo's growth has been largely organic. The company acquired multiple small businesses over the decades, but these were mainly bolt-on technology business such as niche braking and metal foundries, a trend which increased post the company's IPO in 1995. Some of these were clearly strategic in terms of solidifying market share. Acquisitions included:

- UK-based AP Racing (2001) which fortified the F1 monopoly
- Rassini (2002) brought commercial vehicle braking technology
- The Simest China JV (2005) started the company's launch of production capacity in mainland China where there was clearly an increasing market for premium US and European cars and a localised supply chain.
- Meilian Braking Systems (2016) – cast iron brake discs for the Chinese market

An organic acquirer…so far

Importantly, despite these acquisitions, goodwill and intangibles together still only account for 15% of total assets today. We will discuss later in the Compounding section of this report whether future growth might include acquired growth (management have recently suggested it might) and the implications of that.

Braking is obviously a critical safety component of any car architecture but the majority of 'mainstream' braking suppliers are in effect selling highly standardised components. Whilst cars have moved from brake 'shoes' to disc systems in the last decade the bulk of these standard discs are not close to the quality of performance of the specialised products supplied by Brembo. Yet, performance versions of cars have increased significantly as a proportion of market mix – and this has brought Brembo out of the shadows. It is quite common nowadays to see a BMW M3, Audi RS4 with those coloured brake calipers (Brembo) prominent behind the front alloy wheels.

> Interviewer: *Ford CEO Mark Fields said in January at the Detroit auto show that performance car sales have grown 70 percent globally since 2012, and he predicted the trend will continue. Does Brembo agree?*
>
> Brembo exec: *We do. We think the OEs, in general, are doing a great job right now working on product rather than product cost. For years, they spent a lot of time focusing on, "What's this going to cost? What's that going to cost?" Now I think there is sort of a different attitude. In order to sell cars, you need to improve the driving experience. You need to make the car something that people want to get into and drive, make it more exciting.*
>
> *"We're not afraid to invest. We want our customers to commit to us. If they tell us they will give us a program for three years, I don't know if I'll invest. If they give it to us long-term, that's something we'll talk about."*

Margins: Cyclical or secular improvement?

Fig.2 shows the impressive margin expansion in Brembo's financial statements since 2009. Clearly the tripling in revenue to €2.6bn is a driving factor of margin improvement here and, notwithstanding the cyclical tailwinds, it seems unarguable that the company has gained market share. We should credit the investments that the company made in improving its own production facilities, increasing vertical integration (merging foundries and metal working facilities) and increased adjacency to customers. Some might suggest this operating leverage is an industry phenomenon. Indeed, a brief look at Spanish brake disc company Lingotes (not really a true competitor) shows a similar margin increase from c.3% op margin in 2009 to today's 12% and our work on GM and Fiat showed that the global automotive supply chain en masse has rationalised itself beyond recognition since 2009. Yes, the global auto supply chain has been revitalised massively but this should not retract from the savvy investment that Brembo has made in its own operations. Nor from the fact that unlike other suppliers it has been making premium returns and margins for many decades.

In the absence of a massive reversal of the mix of premium segment, we think Brembo's market share strength is defendable and can grow. No other company can offer the material innovation, the product strength and, not least, the branding that Brembo enjoys. On that latter point: **Brembo's are an important status signal on a premium car. We discuss this in detail later but we note the more than $5k retail upgrade cost to a Tesla Model 'P' is largely about buying upgraded Brembo brakes!**

Marginal returns on retaining earnings

We begin with a timely reminder from Buffett's 2019 letter:

> *"Well-managed industrial companies do not, as a rule, distribute to the shareholders the whole of their earned profits. In good years, if not in all years, they retain a part of their profits and put them back into the business. Thus,* ***there is an element of compound interest*** *(Keynes' emphasis) operating in favour of a sound industrial investment. Over a period of years, the real value of the property of a sound industrial is increasing at compound interest, quite apart from the dividends paid out to the shareholders."* **JM Keynes (via Berkshire 2019 letter to shareholders)**

From our perspective, we are looking for companies that have good returns and have the opportunity to retain earnings for reinvestment whilst maintaining such returns. We think Brembo fits that bill evidenced by the stability and duration of its Return on Equity. Although ROE has trended down in the last two years due to the sizable investment it is making, this presents the opportunity in front of us (i.e. profits and the share price are depressed). This has caused asset turns to decline (see Appendix). This is all representative of a company that that strong reinvestment opportunities from new market growth, but whose current returns are depressed ahead of that future growth arriving. Its resilient over-time ROE supports the notion of an innovative branded product with some resulting pricing power.

Prudent balance sheet (and capital allocation)

Looking at Brembo's balance sheet, this growth has been managed prudently. The company management have kept a very low level of financial gearing with Net Debt/EBITDA negligible at the end of 2019 of just 0.3x (0.7x including capitalised leases as per Appendix model). Whether the company might gear-up the balance sheet for an opportunistic acquisition is an unanswered question that is in the back of our minds – more on this later.

The intangibles (aka: What you can't measure)

The last section looked at the historical financial performance. In this section, we look at what is driving the company's strong returns and unmatched high-end market positioning – the qualitative stuff like innovation, culture and branding. This is a business where the intangibles, the attributes of the business that are not readily measured in a spreadsheet matter hugely.

Brembo's corporate culture is an unusual combination of German-like engineering prowess (remember it is the sole-source brake supplier to Porsche) with Italian design flair (who else would think to offer not only coloured brake calipers but bespoke colours – but an Italian?!!). This highly unusual combination reflects what seems a superb internal creative culture that pervades the business.

Here is one version of the 'Secrets of our success' according to Brembo's Chairman in 2014. For a longer form interview with the Chairman on innovation please see this link[2].

> *"There were three main ingredients for this achievement," continued the billionaire who took over the company founded by his father, solidified its unchallenged primacy in the performance-brake market, and also is a prominent politician in Italy. "*
>
> *No. 1, we've been a bit* ***contrarian*** *in the sense that we invested quite massively in the United States even with the big crisis in 2007 and 2008.*
>
> *No. 2 was the* ***evolution of the car sector*** *[in the U.S.] where vehicles are becoming more sophisticated and world-class, and in terms of brakes they've evolved quite significantly.*

[2] http://www.diminin.it/2014/02/alberto-bombassei-a-dialogue-on-innovation/

> *And the third factor is our **management**: I like the style and the team that we put together many years and I've trusted them since the beginning."* **– Chairman**

Innovation culture

One of Munger's mental models which we have quoted often is relevant to Brembo as it pertains to the technological disruption of EV in the car industry. We think Brembo can actually thrive in the unstoppable shift of the car industry to EV.

> *"The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you. And most people do not get this straight in their heads"* **- Charlie Munger**

Brembo's longstanding dominance as a supplier to Formula 1 is central to its past and future success in innovation. It is well known that the car manufacturers use F1 as a launch pad for promoting high end auto features which are intended to eventually cascade into their mass market cars. For example, one of Brembo's key F1 innovations was the development of aluminium brake calipers which traditionally had always been made of cast iron. Prompted by the need for lower weight in Formula 1, the innovation and advancement of Brembo's metallurgical know-how ultimately trickled down into consumer car markets. The same applied to discs where advanced carbon-ceramic discs (which cost c.$1000 or about six times more vs. $150 for a traditional steel version) offer phenomenal braking performance in road cars.

Well placed for an EV future

EV brings much need for innovation. In an era of cars getting heavier because of huge battery packs – a Tesla Model S battery pack alone weighs over half a ton (540kg) for example – performance brakes are now becoming not just about status but also a practical necessity. So too, individual caliper control (via drive by wire) can facilitate better traction control, i.e. driver safety.

It is also interesting that Musk sees braking as a key metric for Tesla Model 3.

> *"Tesla won't stop until Model 3 has better braking than any remotely comparable car."*[3] **– Elon Musk**

Similarly, EV cars tend to have narrower wheels (again to reduce weight) but this has a knock-on effect on the size of the calipers[4] that can be used. We should also mention Brembo's successful efforts to penetrate the van market[5] with its electronic brake system.

'Brake by Wire', as we see it, is a trend that can benefit Brembo although the transition to high volume production will likely be realised in stages.

- The first stage is electric hand brakes. These are already mainstream even in legacy ICE autos and Brembo is a beneficiary of this change in architecture especially for those cars which are designed to have a *separate*/dedicated caliper and disc for the handbrake function (cheaper alternatives use an existing rear wheel caliper).
- The next stage will be to replace the physical cable between the brake pedal and the caliper with an electrical cable. This is already happening in many premium models such as the Audi e-tron though notably, the hydraulic (oil) system needed to actuate the caliper remains in place. As an aside, note that EV cars which do not have a pressurised ICE, require a 'booster' to create the vacuum to power the caliper piston (and give

[3] To be fair, this quote from Musk was in the context of his response to an early braking problem (a software algorithm problem with ABS apparently) on the Model 3. Nevertheless, we think the quote is indicative of Musk's intention of using Brembo as a value-add feature on the car specification to enhance demand. Therefore, we think it representative of the 'pulling power' of the Brembo brand and product quality.

[4] https://www.designnews.com/automotive-0/brembo-continues-refining-disc-brake-technology/152602865962159

[5] https://www.whatvan.co.uk/test-drives/first-drive/2008/brembo-electronic-parking-brake

resistance to the pedal). Bosch and Continental seem strong in this new category – the former supplying Tesla, a reminder that Brembo faces competition in other brake areas.

- The final transition to Brake by Wire will be when the hydraulic system will be replaced entirely by an electro-mechanical system (no oil). The power available via an EV battery pack now makes this a viable option for car designs but considering the notoriously slow design cycle in the auto industry, the shift away from a longstanding safe system will likely be slow and above-all prudent.

The future of braking

For a look at the future of braking, this link from Brembo is interesting[6] and it shows that Brembo is moving with the trend. Furthermore this excerpt from the company's 2019 'Disclosure on non-financial information' is very interesting as it pertains to the commercial success of Brembo's engineering innovation.

> *"Regarding commercial vehicle applications, Brembo continued to develop, in collaboration with Daimler, a new light disc solution that reduces weight by up to 15%, thanks to the combination of two different materials. In particular, it is due to this solution that Brembo has been chosen as the brake disc supplier for all the new generation rear-drive cars produced by the German manufacturer. In addition, the new "light" disc has also been tested successfully by other leading manufacturers such as Jaguar, Land Rover and Tesla. In 2019 efforts were directed at finalising the completion of the application development phase of the new models set to make their debuts in 2020"* – **Source: Brembo 2019 'non-financial' report[7] (emphasis ours)**

Marketing and the Tesla effect

We have outlined the need for better brakes as cars get heavier and faster. But we should not overlook the attraction of Brembo brakes as a marketing feature.

> *"Land Rover, for example, had Range Rover logo on the caliper. They now have Brembo logo on the calipers. It's really a marketing decision*." **– Brembo CEO**

The prominent placement of a third-party brand on an already premium branded car is surely a huge endorsement of Brembo's brand cachet. Like Harman car speakers, Pininfarino styling, or Pirelli tyres (another great Italian brand), it seems to us that Brembo is highly attractive to car companies from Porsche to Land Rover to Tesla who are seeking to differentiate their cars with subtle 'cues' which mark their cars as being high performance.

> "*Model 3 is designed to have super good stopping distance…*" **– Elon Musk**

Fig.3 below shows a close-up of the two versions of Tesla Model 3, the base model (left) and the 'P' (performance, aka the $5k upgrade). Both versions use Brembos on the front wheels (a Korean supplier Mando supplies the rear on the base model – see footnote[8]). The base model (left) is a low-end Brembo, whilst the performance model (right) is a "flash" high-end Brembo caliper painted in red with a prominent Tesla logo! Perhaps not so subtle!

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[6] https://www.brembo.com/en/company/news/future-brake

[7] https://www.brembo.com/en/SustainabilityReport/2019/Relazione%20di%20Sostenibilita%202019%20UK.pdf

[8]

- The 'basic' model 3 has Brembos on the front wheels and 'Mando' (Korean) calipers on the rear
- The Model 3 'P' has upgraded Brembos on all 4 wheels
- All other Tesla models (X, Y, roadster) have Brembos on all wheels are standard.

Fig.3: $5,000 Model 3 upgrade? Performance or status symbol? A bit of both really!

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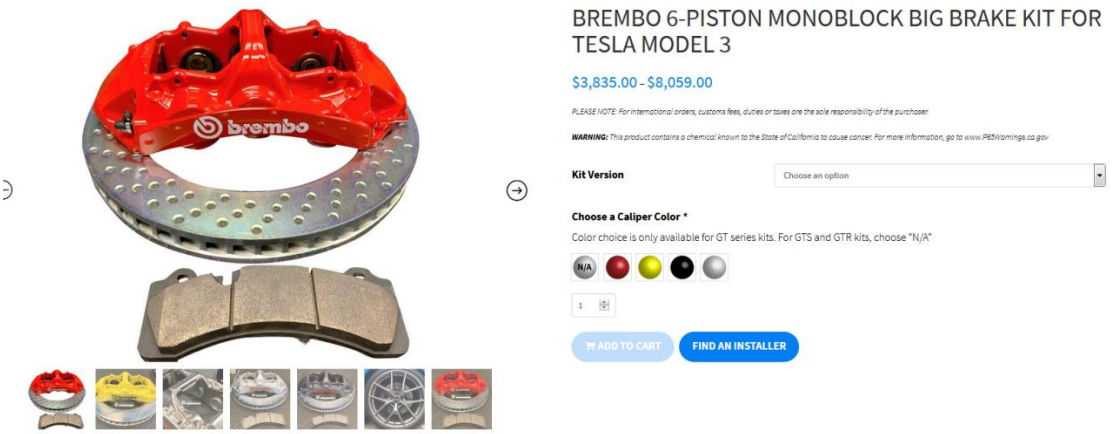
Source: Holland Advisors, Tesla

Thinking about Tesla volumes

Tesla is now producing c.500k cars per annum. In 2019, 367k Tesla's were sold, which is obviously reflected in Brembo's 2019 results. Based on Tesla's production growth plans (China and Germany) these volumes could possibly triple to c.1.5m in the next 5 years or so (i.e. 1m *incremental* Tesla units vs. 2019). It is extremely hard to assess the average wholesale $ value of the Brembo parts in an average Tesla. As per Fig.4, we do know an after-market Brembo upgrade parts set for a base level Model 3 might cost as much as $3,000 to $8,000!! Let's assume in high volume long-term contracts, Brembo derives just $1,000 in wholesale revenue *on average* per Tesla sold. That might equate to c.$350m in sales from Tesla in 2019, suggesting it represents 13% of Brembo 2019 sales. But such an assumption would imply Brembo sales to Tesla would rise to $1.5bn (i.e. $1.2bn incremental sales) in the next 5 years.

Fig.4: After-market cost of a Brembo upgrade



Source: https://unpluggedperformance.com/product/brembo-big-brake-kit-tesla-model-3/

Were other EV manufacturers to follow Tesla's lead, the opportunity could be very significant. Even, just the Tesla expansion alone suggests Brembo could have strong pathway of growth in front of it. Such an outlook (which the company is very coy about discussing) will see it make a good return on the significant capital currently being deployed. It will also likely see ROTE recover to previous highs.

Compounding, Caveats and Conclusion

In this section we combine our thoughts above on the company's long and impressive track record with the intangible attributes of the business with a view how the next phase of growth might play out in terms of operations and capital allocation. Our aim being to assess a potential level of per-share compounding that might be on offer to today's investors in Brembo's common equity.

Valuation: 15-20% IRRs on offer and Owner Earnings

We have applied our Holland Compounding Model to Brembo. It is true that, as it stands today, Brembo is not an especially complex business to model in terms of capital allocation or capital structure. The company paid-out circa 1/3 of earnings in dividends and had a falling level of financial gearing therefore the main variables to consider in a base case scenario are revenue growth, margins and P/E rating.

A variety of scenarios could be used to model the future likely IRR an equity investor might make by holding Brembo shares for say, the next 8 years or so.

Regular readers will by now be familiar with our efforts to assess an investment in this roll–forward way. Our intention is not to just think through the likely compounded growth of such an entity but also it most likely uses of cashflow. The *most likely* phase is we think important. As ever; we'd rather be approximately right than precisely wrong. By ignoring *some* detail and instead looking at likely sources of growth and deployment of capital we can produce a variety of outcomes. In summary each of these outcomes is very attractive for Brembo investors for the simple reason that its share today looks far too cheaply priced vs. their compounding ability.

The Appendix shows two scenarios. Both are intentionally simple. For the next 8 years this base case assumes Brembo will increase its sales, EBIT and Assets all by 5% pa from Dec 19 starting levels. It assumes its share re-rate back to a 14X PE at the end of that period (vs. 9x today) and will pay-out its normal 30% of Net income by way of dividends.

The outcomes could be as follows:

1. Base Case: (Sales, EBIT, Asset = 5% pa) ¦ 30% Payout ¦ end P/E at 14x = **15% IRR**

We add a second scenario whose main driver is to see RONTA recover to past levels (i.e. 25%) reflecting the recent higher capital investment period. This is achieved with lower assumed growth in future assets (2%pa) and higher assumed sales growth (7%pa).

2. RONTA recovers to 25% by yr5: (Sales & EBIT = 7%pa ¦ Assets+2%pa) = **17% IRR**

Interestingly the two scenarios both also produce a further outcome: without any assumed use of cash except for organic investment and for 30% Dividend payout, a significant excess cash is produced on the balance sheet (€1.2bn or €1.6bn respectively by year 8). In practice this is unlikely to occur as either a faster rate of organic growth or bigger dividends will be paid. Scenario 2 with 75% divi payout would give a 19% IRR (N.B. Brembo has not done buy-backs up to now).

The third use of excess cash is of course for acquired growth. Rather than model/guess each of factors (higher dividend vs buy-backs vs acquisitions) we think just reflecting on the IRR these

base assumptions throw off and the resulting excess cash is in itself very informative. Particularly as we will look at the one caveat, we have about Brembo: possible M&A.

Before looking at the company's comment on potential acquisitions, we outline our calculation of owner earnings. Readers we hope will realise that the scenarios we are outlining above use the group P/L for both growth and valuation assessment. The ending PE we model of 14x compares with a 10 year history for the company of 12-18x and today's headline multiple of 9x 2019 earnings. Not only do we think Brembo is a business good enough to justify its past higher multiples (18x) suggesting its valuation could double from today's level, we also think the 9x does not give the full story as to how cheap the share might be currently. By adjusting for maintenance capex which the company usefully discloses **we calculate a price/owner earnings vs. Dec 2019 of only 6.2x** as per Fig.5 below. Now where is that bucket!

Fig.5: a simple check on owner earnings based on 2019 financials

share price	€	6.90
# shares		326
Market Cap	€	2,249
EBITDA		515
interest		-10.8
tax		-68
m capex		-75
Owner Earnings		361
P/OE		6.2x

Source: Holland Advisors

Caveats – M&A and betting the company…?

We are aware that the auto supply chain is consolidating. ZF Friedrichshafen bought US competitor Wabco for $7bn last year. Brembo itself has acquired a small stake in Pirelli earlier this year which they descried as a 'strategic' investment. Considering its history, it is interesting (read unusual) that Brembo is seemingly interested in doing a large, opportunistic acquisition:

> *Tiraboschi said he wants to double revenue in the coming years. "It's hard to do it just with what we do today, as our market shares are already very high,' he said. "We must think of something different from braking systems."*

He goes on to say:

> *the family-owned company believes an acquisition is the answer so it can expand into digital devices and keep pace with changes in how cars are designed and used. Brembo is not alone. German auto parts maker ZF Friedrichshafen, for example, bought U.S. rival Wabco for over $7 billion this year to strengthen its expertise in autonomous-driving technologies. Tiraboschi said the brake maker, which supplies premium brands such as Ferrari, Tesla, BMW and Mercedes as well as several Formula 1 teams, was looking at the auto sector for acquisitions. "We must complete the range of products we offer but that must be consistent with what we do," he said, adding that Brembo's search was focused on businesses including electronics, autonomous driving and infotainment.*
>
> *Tiraboschi said in June the company, which has a market capitalisation of 3.1 billion euros ($3.5 billion), was eyeing a target of "significant size" - even as big as Brembo itself.* **– Brembo deputy Chairman Matteo Tiraboschi, Oct 2019[9] (emphasis ours)**

[9] https://www.cnbc.com/2019/10/24/reuters-america-challenged-by-electric-cars-brembo-aims-to-put-the-brakes-on-noise.html

The above quotation from the Tiraboschi is in truth a little unnerving to us. We like very much Brembo's innovation, market position and compounding power – acquired growth is much less appealing. We cannot dismiss the possibility that Brembo might like to diversify further nor the possibility that it in doing so, it might decide it appropriate to put a lot of capital at risk.

Here is where we could model a lot, or think a little. Theoretically we could model to gear up the company's balance sheet in a theoretical acquisition that we prudently assume to be value destructive let us say to the tune of €1bn over the next 8years. Or we could reflect on the starting price for the shares and the cash that it is set to generate and how little or no value will be ascribed to that cash (Ref our earlier scenarios). This M&A ambiguity confuses the outlook for the company, but we think to dismiss it for that reason alone at current prevailing valuations would be foolish.

We remain sceptical of 'bet the company' type deals and thus are very surprised to hear Brembo speak in these terms. This is where the alignment of an owner manager is key. As a c.50% shareholder we would assume our Tiraboschi will act rationally. As such we will watch this area closely and keep an open, but sceptical mind. It is worth the reader spending time modelling the company as we have done to see the cash being generated at perhaps a faster rate than can now always be deployed for future growth? Maybe this creates a conundrum for an industrial business manager used to always re-investing.

In Conclusion

Brembo looks to be a 'textbook' under-priced business that ticks practically all of the boxes that we seek in a compounder. It has an owner manager, a very long-term track record of good return and equally good past capital allocation. Seemingly it has a moat in its brand, market leadership of a niche and great product innovation. Whilst the M&A commentary is usual and needs to be considered the price we are being asked to pay for such a quality business we think is too good to resist. The most likely scenario of investors buying into the equity of the business today is we think 20% IRRs over an 8-year period.

We will not over-complicate things – this stock is a buy.

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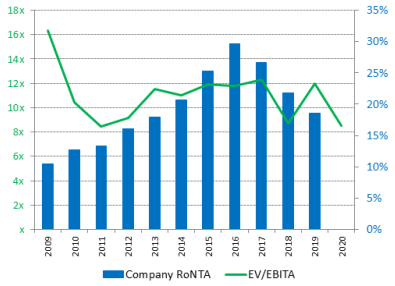
Appendix

Notes

HollAnd Advisors FRANCHISE Screen

BREMBO SPA	URL: www.www.brembo.it						
Share Price =7.55	updated: 07-May-2020	Mgmt stake 51%	**Reports in EUR**	**Priced in EUR**	Market Cap in EUR 2.48bn	Year-end: 31/12/2019	
		Largest Insider stake in EURm =			IPO Date 03/07/1995		
Top Five Holders	NUOVA FOUR B SR	CAPITAL GROUP C	BREMBO SPA	BNP PARIBAS	VANGUARD GROUP	CREDIT AGRICOLE	NORGES BANK

RETURNS

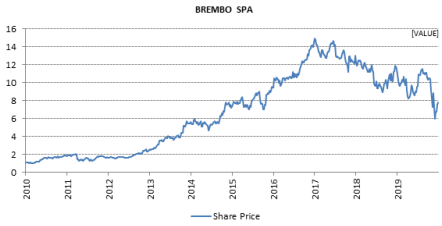


											most recent Fiscal Year-end	31/12/2019	Consensus	
GROWTH	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20e	FY21e
Book value per share	17%	0.9	1.0	1.0	1.2	1.3	1.6	2.1	2.6	3.2	3.7	4.2		
Sales per share		0.0	3.3	3.8	4.3	4.8	5.5	6.4	7.0	7.6	8.1	8.0		
Adjusted EPS	**36%**	**0.0**	**0.1**	**0.1**	**0.2**	**0.3**	**0.4**	**0.6**	**0.7**	**0.8**	**0.7**	**0.7**	**0.39**	**0.59**
Tangible Book per share	20%	0.6	0.7	0.7	0.9	1.0	1.3	1.8	2.1	2.6	3.0	3.5		

CAPITAL ALLOCATION	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Total Payout (Divi + SBB)		140%	61%	50%	33%	37%	40%	28%	27%	27%	30%	31%
Diluted Shares Outstanding	0%	329	327	326	326	326	326	325	325	325	325	325
(G'will+Intang)/Total Assets		17%	15%	13%	12%	11%	9%	9%	14%	12%	11%	11%
Capex/Depreciation		49%	87%	209%	156%	129%	113%	131%	202%	247%	165%	109%
Acquisitions		0	0	0	0	0	0	0	0	0	0	0

PRICE v VALUE

	07 May 2020
Market Cap	2,451
EV	2,798
EV/EBIT	9.2x
Headline P/E	10.8x
P/Tangible Book	2.2x
Divi Yield	3%
EUREUR Currncy	1.00



P/book	1.2x	1.6x	1.3x	1.7x	3.0x	3.4x	4.3x	4.4x	4.0x	2.4x	2.6x	
P/Tangible Book	1.9x	2.4x	1.9x	2.3x	3.9x	4.2x	5.0x	5.6x	4.9x	2.9x	3.2x	
P/E	32.4x	15.6x	10.0x	8.2x	14.3x	14.0x	15.8x	15.5x	15.6x	12.1x	15.5x	
EV/EBITA	16.3x	10.4x	8.4x	9.2x	11.6x	11.0x	11.9x	11.8x	12.3x	8.7x	12.0x	8.5x

PROFITS	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20e	FY21e
Sales	12%	826	1,075	1,255	1,389	1,566	1,803	2,073	2,279	2,464	2,640	2,592		
adj EBIT		21	60	75	89	122	175	245	315	332	328	304		
adj EBIT margin			**6%**	**6%**	**6%**	**8%**	**10%**	**12%**	**14%**	**13%**	**12%**	**12%**		
EBITA		36	72	90	105	139	189	258	334	353	349	328		
EBITDA		92	127	144	169	211	269	347	431	465	481	501	382	464
Effective P&L Tax Rate		11%	30%	21%	6%	15%	22%	24%	22%	20%	26%	22%		
Net Income	36%	11	32	43	78	89	129	184	241	263	238	231		
[Cash from ops]-Capex		**104**	**38**	**(26)**	**21**	**51**	**103**	**175**	**129**	**57**	**197**	**93**		
Share in issue	0%	329	327	326	326	326	326	325	325	325	325	325		
EPS	#DIV/0!	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		

ASSETS	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Total Fixed Assets	15%	312	323	407	475	503	540	590	747	934	1,041	1,259
Working Capital		0	159	176	172	168	218	209	212	217	183	261
Net Tangible Assets		**312**	**482**	**583**	**647**	**672**	**758**	**799**	**959**	**1,151**	**1,224**	**1,520**
Taxed RoNTA		10%	13%	13%	16%	18%	21%	25%	30%	27%	22%	19%
Asset Turns		2.6x	2.2x	2.2x	2.1x	2.3x	2.4x	2.6x	2.4x	2.1x	2.2x	1.7x
Total Assets	12%	854	967	1,133	1,220	1,299	1,502	1,585	1,965	2,299	2,531	2,742
Shareholder Equity	17%	291	326	334	394	429	536	688	882	1,064	1,229	1,388
Pension Liability		21.9	20.2	19.6	26.7	27.0	32.8	30.3	32.7	27.8	27.1	25.6

LIABILITIES	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Net Debt		253	247	325	330	330	280	162	197	219	136	347
Net Debt/EBIT		2.8x	1.9x	2.3x	2.0x	1.6x	1.0x	.5x	.5x	.5x	.3x	.7x
Interest Cover		3.0x	7.4x	7.2x	6.6x	9.1x	12.1x	18.4x	28.9x	31.8x	23.4x	20.4x

OTHER	10 year cagr	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19
Capex (PP&E)	20%	-34	-61	-147	-124	-115	-109	-138	-231	-327	-250	-214
Capex (intangibles)											-37	-38
Total Capex											**-287**	**-252**
Maintenance Capex											~75	~75
Depreciation	11%	69	71	70	80	90	97	105	115	132	152	197

Summary - Modelled 8-year forward IRR	15.5%	share price	€ 6.80	# shares	325.187	M Cap	€ 2,211

BREMBO SPA	FY Year	Growth YoY ↓↓		Dec-19 0	Dec-20 1	Dec-21 2	Dec-22 3	Dec-23 4	Dec-24 5	Dec-25 6	Dec-26 7	Dec-27 8	CAGR
		↓↓↓ this column to be manually updated/checked for each specific company/business model											
Revenue		5%		2591	2,721	2,857	2,999	3,149	3,307	3,472	3,646	3,828	5.0%
Clean EBIT		5%		319	334	351	369	387	407	427	448	471	5.0%
EBIT Margin				12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	
Fixed Assets		5%	5%	1064	1,117	1,173	1,232	1,293	1,358	1,426	1,497	1,572	5.0%
Working Capital		5%	5%	260	273	287	301	316	332	348	366	384	5.0%
% sales				10%	10%	10%	10%	10%	10%	10%	10%	10%	
Revenue/Net Tangible Assets				2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	
Interest				.11	2	12	22	32	43	55	67	80	
Other				0									
PBT				308	337	363	391	420	450	482	516	551	
Margin				12%	12%	13%	13%	13%	14%	14%	14%	14%	
Tax		20.0%		-68	-67	-73	-78	-84	-90	-96	-103	-110	
PAT				240	269	290	312	336	360	386	412	441	7.9%
PAT Margin				0	10%	10%	10%	11%	11%	11%	11%	12%	
NTA				1324	1,390	1,460	1,533	1,609	1,690	1,774	1,863	1,956	5.0%
Returns: PAT/NTA				18%	19%	20%	20%	21%	21%	22%	22%	23%	
Starting PE Multiple	9.2x					14x	14x	14x	14x	14x	14x	14x	
Ending PE Multiple	14.0x												
Company Equity Value				2211	2,485	4,065	4,374	4,699	5,040	5,398	5,774	6,169	13.7%
PAT				240	269	290	312	336	360	386	412	441	
					269	290	312	336	360	386	412	441	
Cost of growth - organic					66	70	73	77	80	84	89	93	
Excess Cash(allowed Negative)					203	221	239	259	280	301	324	348	-
Check: Implied potential Payout ratio					75%	76%	77%	77%	78%	78%	78%	79%	
Assumed Re-investment rate(ACQUIRED GROWTH)		0%											
Retained earnings					0	0	0	0	0	0	0	0	
Historical payout ratio		29%											
Dividend Paid (% of N.Income)		30%			81	87	94	101	108	116	124	132	
SBB Cash		0%			-	-	-	-	-	-	-	-	
Number of shares				325									
Number of shares bought					-	-	-	-	-	-	-	-	
Start of yr no. of shares					325	325	325	325	325	325	325	325	
End of year no. of shares				325	325	325	325	325	325	325	325	325	0.0%
Subsequent End of Year value per share				7	8	13	13	14	15	17	18	19	12.2
DPS					0.25	0.27	0.29	0.31	0.33	0.36	0.38	0.41	2.6
Divi yield					3.3%		2.1%						
				Year 1 P/E	8x								

Total return	
	14.8
% return	217.1%
Annualised return	15.5%

Summary - Modelled 8-year forward IRR	17.0%		share price	€ 6.80	# shares	325.187	M Cap	€ 2,211

BREMBO SPA	FY Year	Dec-19 0	Dec-20 1	Dec-21 2	Dec-22 3	Dec-23 4	Dec-24 5	Dec-25 6	Dec-26 7	Dec-27 8	CAGR
	Growth YoY ↓↓	↓↓↓ this column to be manually updated/checked for each specific company/business model									
Revenue	7%	2591	2,772	2,966	3,174	3,396	3,634	3,888	4,161	4,452	7.0%
Clean EBIT	7%	319	341	365	390	418	447	478	512	547	7.0%
EBIT Margin		12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	12.3%	
Fixed Assets	2%	7% 1064	1,085	1,107	1,129	1,152	1,232	1,319	1,411	1,510	4.5%
Working Capital	2%	7% 260	265	271	276	281	301	322	345	369	4.5%
% sales		10%	10%	9%	9%	8%	8%	8%	8%	8%	
Revenue/Net Tangible Assets		2.0x	2.1x	2.2x	2.3x	2.4x	2.4x	2.4x	2.4x	2.4x	
Interest		-11	2	12	22	32	43	55	67	80	
Other		0									
PBT		308	343	376	412	450	490	533	579	628	
Margin		12%	12%	13%	13%	13%	13%	14%	14%	14%	
Tax	20.0%	-68	-69	-75	-82	-90	-98	-107	-116	-126	
PAT		240	274	301	330	360	392	427	463	502	9.7%
PAT Margin		0	10%	10%	10%	11%	11%	11%	11%	11%	
NTA		1324	1,350	1,377	1,405	1,433	1,533	1,641	1,756	1,879	4.5%
Returns: PAT/NTA		18%	20%	22%	23%	25%	26%	26%	26%	27%	
Starting PE Multiple	9.2x			14x	14x	14x	14x	14x	14x	14x	
Ending PE Multiple	14.0x										
Company Equity Value		2211	2,532	4,217	4,615	5,039	5,490	5,971	6,483	7,028	15.6%
PAT		240	274	301	330	360	392	427	463	502	
			274	301	330	360	392	427	463	502	
Cost of growth - organic			26	27	28	28	100	107	115	123	
Excess Cash(allowed Negative)			248	274	302	332	292	319	348	379	-
Check: Implied potential Payout ratio			90%	91%	92%	92%	74%	75%	75%	76%	
Assumed Re-investment rate(ACQUIRED GROWTH)	0%										
Retained earnings			0	0	0	0	0	0	0	0	
Historical payout ratio	29%										
Dividend Paid	30%		74	82	91	100	88	96	104	114	
SBB Cash	0%		-	-	-	-	-	-	-	-	
Number of shares		325									
Number of shares bought			-	-	-	-	-	-	-	-	
Start of yr no. of shares			325	325	325	325	325	325	325	325	
End of year no. of shares		325	325	325	325	325	325	325	325	325	0.0%
Subsequent End of Year value per share		7	8	13	14	15	17	18	20	22	14.8
DPS			0.23	0.25	0.28	0.31	0.27	0.29	0.32	0.35	2.3
Divi yield			2.9%		2.0%						
		Year 1 P/E	8x								

Total return	17.1
% return	251.7%
Annualised return	17.0%

Disclaimer

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