Value Investor INSIGHT

The Leading Authority on Value Investing

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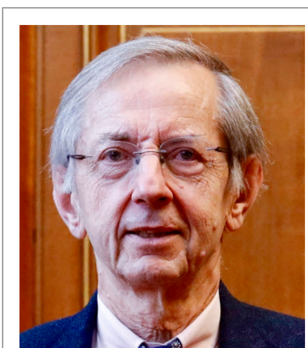
Au Courant

There's clearly an old-school element to William Higgons' value investing approach. He avoids basing decisions on forecasts. He will not "pay up" for quality. "If the stock of a normal company trades at 10x cash earnings and the market is at 15x, we buy it," he says. "Even if we don't know why it's so cheap."

His results since founding Paris-based Indépendance et Expansion AM have been anything but passé. Specializing first in France and now also in Europe, his flagship French small-cap strategy has earned a net annualized 14.0% since 1993, vs. 8.0% for the CAC Mid & Small Cap index. Today he's finding bargains in such diverse sectors as television, consumer-electronics retailing and sail boats. See page 2



William Higgons
Indépendance et Expansion

Value Judgement

The two essential questions in investing are "how good is a business and how much do you have to pay to own a piece of it," says Jennifer Wallace. "Success happens over time at the effective tradeoff between those two things."

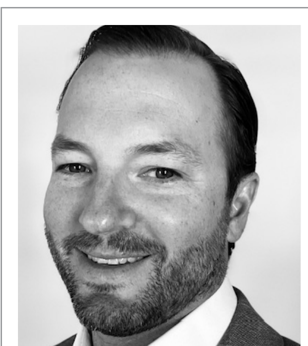
Wallace has been working at just that since co-founding Summit Street Capital during the financial crisis in 2009. Over a period in which business quality has often taken precedence over bargain prices, the partnership has just outpaced the Russell 2000 Value Index, earning a net annualized 14.6% despite having an average cash balance of 12%. Cautious as always, she sees opportunity today in media, managed healthcare and specialty chemicals. See page 7

Jennifer Wallace
Summit Street Capital

Anti-Competitive Behavior

Matthew Sweeney has a simple explanation for why he focuses on off-the-radar companies with what he thinks are misleading or no longer relevant historical financials. "I'm trying to reduce my competition," he says, "both from humans who aren't looking where I am and from computers who only look backwards."

Sweeney's anti-competitive behavior is so far paying big dividends, earning for his Laughing Water Capital investors a net annualized 31.1% since inception in early 2016, vs. 17.6% for the Russell Microcap Index. Still seeing "an unusual amount of unusual opportunities," he's finding overlooked value today in such areas as K-12 education, niche printers and plant-based sweeteners. See page 12



Matthew Sweeney
Laughing Water Capital

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Investor Insight: William Higgons

William Higgons and Victor Higgons of Paris-based Indépendance et Expansion AM describe how their unique value approach weeds out value traps, why they favor family-controlled businesses, how they took their strategy across borders, where they look first to sell, and why they see unrecognized value in Télévision Française 1, Unieuro and Catana Group.

Your strategy from the beginning has been mostly classic value, with a quality twist. Describe generally how you prospect for ideas.

William Higgons: We believe that it's very difficult to make good predictions, so the most reliable information to go on is what is available to us today. If that's true, in order to do better than the index, we want to buy companies that are relatively less expensive based on the information available to us today. Our portfolio companies at purchase normally trade at a discount on a price-to-cash-flow basis of at least 30% compared to the market.

We've also always believed that our chances of success with this approach increase considerably if we only invest in companies that have solid balance sheets, have five-year revenue growth at least matching GDP, and have high returns on capital employed, say of 10% or more. High returns signal a company's capacity to invest in a profitable and sustainable way in its own development. Excessive discounts in these types of companies should not persist over time.

The size of company we'll invest in has increased since the beginning, but the median market cap in our French portfolio is still €500 million. We don't have as much competition in analyzing such companies, which I like. We also find them more nimble and capable of taking advantage of non-saturated and growing niche markets.

You are probably going to ask why good-quality companies can at times trade at high discounts to the market. Sometimes the market overreacts to negative news. This happened sometimes last year with the pandemic. After its share price fell by 50%, we were able to buy the stock of the advertising firm Publicis [Paris: PUB] at around 8x cash earnings, which we define as net income plus depreciation and amortization. The market was expecting advertising spending to decrease by a huge amount in 2020, but we thought the nature of Publicis' businesses and its exposure to digital advertising that was less likely to be cut meant it wouldn't be as bad as expected. When the P/E on a company like this is below 10x, just buy it. [Note: In the low €40s pre-pandemic, Publicis' shares fell below €22 in March 2020. They recently closed at €57.75.]

Sometimes there are reasons a stock is cheap but they are not good ones. We own shares in Technip Energies [Paris: TE], an energy services firm that earlier this year was spun off from TechnipFMC. One given reason the stock was cheap was that TechnipFMC still owned a material stake that it planned to sell. If you believe a company's value represents its discounted future cash flows, the fact that there is a large seller like this in the market shouldn't really depress the share price. Technip Energies' stock has moved up somewhat since TechnipFMC sold its shares this month, but it still trades at 8x cash earnings. [Note: TE shares, spun off at €12.70, recently traded at €13.50.]

I'll give you one more example, which is one where I'm feeling rather alone in my position. We own shares in ALD [Paris: ALD], which provides vehicle leasing and fleet-management services to corporate customers. I can't understand why a solid company growing faster than the average company trades at a P/E of 7.5x when the market trades at more than 20x. There's always a reason. At one point there was concern they had too many diesel cars in the fleet. That turned out not to be such a problem, and then the concern was that used-car prices were too low. Now used-car prices are high, and the worry now is that ALD is looking to make an acquisition for which it will pay too much. Even if the market keeps getting it wrong, the valuation doesn't change. But if I can't find the problem, I can't sell shares that

William Higgons

Against Naive Consensus

Having spent much of the first 15 years of his career as an investment banker or a corporate mergers-and-acquisitions specialist, William Higgons came to the conclusion that he was much more interested in – and better at – analyzing companies than he was drumming up new M&A deals. He wanted to manage money full-time, but there was one key sticking point: "I needed a real underlying strategy," he says.

His inspiration for that strategy came in a 1993 article in *The Economist* titled "Cheap and cheerful," which cited a recent academic study by U.S.-based economists Josef Lakonishok, Andrei Shleifer and Robert Vishny that attributed value investing's long-term outperformance to its contrarian nature against the market's naive consensus, while also suggesting the best valuation approach was to focus on companies with low-price-to-cash-flow ratios. Higgons in 1993 started managing a small-cap fund owned by his then employer, Groupe Siparex, with just that strategy, and the die was cast. Quite successfully so: that original strategy, now under his own firm, Paris-based Indépendance et Expansion AM, has outperformed its benchmark over the past 28 years by 600 basis points per year.

have a P/E of 7.5x. I guess I will have to be patient in this case. [Note: Priced at the beginning of 2020 at around €12.50, ALD shares now trade at around €11.80.]

Is it somewhat lonely being a value investor in France?

WH: It is true that most investors here are growth investors. Of the 100 or so small-cap funds tracked by Morningstar in France, five are considered to be value. To us that's not at all something to worry about, and in fact makes it easier for us.

Growth investors want to invest in companies that are nicely growing their earnings per share. To do that, these companies have to increase their revenues or their margins or both. Most of those we invest in already have good margins and aren't necessarily focused on increasing them, which might hurt their potential to grow at the rate they believe they should. Growth investors don't want to hear that, and that lack of interest can result in still-good companies that can grow a bit faster than the market trading at big discounts. That gives us an opportunity to buy them.

Family-controlled businesses make up a majority of your portfolio. Explain that.

Victor Higgons: Part of that is a function of our markets. Nearly 50% of listed companies in France have at least 20% founding-family ownership, while the number in Europe overall is closer to 25%.

Beyond that, we generally appreciate the qualitative differences between professional managers with stock options and owner-managers with more or less permanent ownership stakes. Owner-managers care less about today's share price and more about the sustainable earnings power of the company's business. They're less likely to underestimate challenges ahead and are more likely to underpromise and overdeliver. That reticence to oversell may dampen enthusiasm for the stock in the short term – especially among growth investors – but family owners are willing to let the performance speak for itself over the long term. We generally prefer that.

After focusing on France for much of your firm's history, you started a European fund in 2018. Are you doing anything differently as you broaden your opportunity set?

WH: I probably shouldn't admit this, but one reason we took so long to start a Europe-wide strategy was that I used a lousy model at first to test if our low-price-to-cash-flow, high-return-on-capital discipline would work in Europe. Once Victor helped me correct that, our back testing found the strategy should work quite well.

ON INVESTING IN FRANCE:

Of the 100 small-cap funds tracked by Morningstar, five are considered to be value. That makes it easier for us.

VH: William also says another reason the firm just focused on France at the beginning was that when annual reports were delivered by mail, he had an advantage because he had access to financial data before people in other countries – an advantage he'd lose if he invested elsewhere. That wasn't a very good reason any more to stick only to France.

We've applied exactly the same criteria and methodology in Europe, and it's working quite well. I'd say one positive has been that there are more potential opportunities across all of Europe, so we have more good ideas to choose from and can be more selective. On the other hand, we don't have the same background knowledge of non-French companies that we have of those in France. I don't believe that's hurt us yet, and we're working every day to continue to narrow that gap.

Are you seeing any valuation differences today between France and other European companies?

VH: I would say no. Our funds and the market have done very well this year, but a lot of that has been driven by earnings growth more than multiple expansion. The average P/E of our portfolio companies in France is just over 13x, while in the European fund it's a bit below 12x. That's not worrisome relative to history – the highs, in 2007 and 2017, were closer to 15x – but it is something we pay attention to. We try to be fully invested, which has been a good policy over time, but if we're looking for discounts relative to the market we should know when the market overall seems particularly expensive. For now we don't consider that to be the case.

Describe your investment case for Télévision Française 1 [Paris: TFI].

WH: This is France's largest television company, with three main businesses. The broadcast division operates free-to-air, thematic and on-demand channels, including TF1, the most-watched channel in France. It also has a large production division that produces mostly TV content for itself and for others. Then there is a digital division that operates popular websites such as Aufeminin and Marmiton.

In May of last year when the pandemic was at a high level, everybody expected advertising in France to disappear, and TF1's share price fell from around €8 to around €4. The P/E on cash earnings was less than 4x. At that point you could make the argument that the broadcast-television business, with the leading market share in France, was essentially free. Given the assets, we thought there was very little downside so we bought a position.

TV advertising did not fall as much as expected, but there is still a general perception that television viewing will consistently decline as people spend more time in front of their computers and telephones. That's why TF1's cash P/E today is still only 6x. Our general belief on viewership is that if you consider viewing across platforms, it has been and will continue to be more stable than is generally believed. That would be a clear positive for TF1.

How are you handicapping the company's announcement in May to merge with top domestic competitor Groupe M6?

WH: From a business perspective, the combination of the two companies makes a great deal of sense. There would be tremendous cost savings – the companies estimate €250 to €350 million annually – and the combined company would be better positioned to compete in a streaming, digital world.

The big question is whether the competition authorities in France will allow the deal to go through. The post-merger company's share of the television-advertising market in France would be close to 70%, which normally would not be allowed. But if the regulators look more broadly at the competitive set, it is possible. Many in government would like to see a French-owned national champion in an important market, which I believe makes approval more likely than the market seems to expect. TF1's share price didn't move when the deal was announced.

It will take maybe until the end of next year, before we know if the deal is allowed. We think it would be wonderful for shareholders, but we find the shares attractive today without assuming it happens.

How are you looking at valuation today with the shares trading at €8.40?

WH: The P/E multiple on estimated reported earnings for this year is around 11x. Maybe that's justified if you expect the traditional broadcasting business to consistently decline and that that decline cannot be offset by the good growth of the television-production and digital divisions. We don't believe either of those will be the case. If we're right, we would expect a fair P/E valuation of the shares to be closer to 15x.

Then there is a free option on the merger with M6 going through. Earnings power of the combined company could increase something on the order of 30%. That should translate into additional upside for the shares.

Turning to an idea in Italy, describe your interest in consumer-electronics retailer Unieuro [Milan: UNIR]?

WH: We originally established our position in Unieuro in April of 2019 when the valuation on the shares seemed to indicate the market expected Amazon to completely take over the selling of consumer electronics and household appliances in Italy and that physical stores in that market were doomed. The P/E on reported earnings was close to 5x and on cash earnings was 3x.

When valuation is that low, in my experience you'd be better off not analyzing the company very deeply because you're likely to come up with reasons why you shouldn't buy it – and you'll turn out to be wrong. As long as you believe the company won't go bankrupt – in this case, Unieuro was earning 50% returns on equity with no debt – you shouldn't think too much about it and just buy. For the past 30 years I've had no problem investing that way.

What was particularly unusual about the pessimism built into the share price was that the company was actually performing well. The stores are well known in Italy – similar to the FNAC chain in France – and offer a wide variety of products, including smartphones, televisions, videogame players, refrigerators and vacuum cleaners. Over the past three fiscal years, the latest

INVESTMENT SNAPSHOT

Télévision Française 1
(Paris: TFI)

Business: Media/entertainment company based in France with operating divisions focused on television broadcasting, television content production and digital media.

Share Information
(@9/29/21, Exchange Rate: $1 = €0.86):

Price	**€8.42**
52-Week Range	€4.48 – €9.24
Dividend Yield	5.3%
Market Cap	€1.77 billion

Financials (TTM):

Revenue	€2.33 billion
Operating Profit Margin	12.6%
Net Profit Margin	5.4%

Valuation Metrics
(@9/29/21):

	TFI	S&P 500
P/E (TTM)	14.4	31.1
Forward P/E (Est.)	10.4	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
DNCA Finance	2.9%
Azimut Capital Mgmt	2.1%
Norges Bank Inv Mgmt	1.5%
BWM AG	1.4%
Vanguard Group	1.4%

Short Interest (as of 9/15/21):

Shares Short/Float	n/a

THE BOTTOM LINE
William Higgons believes the prospects for the company's traditional broadcasting business and its production and digital divisions are materially brighter than reflected in a stock trading at 11x estimated 2021 EPS. He says the shares deserve at least a 15x P/E, which leaves the completion of a pending strategic merger as a free option on the upside.

Sources: Company reports, other publicly available information

ending in February 2021 and including the pandemic, revenues have grown 12%, 16% and 10%, respectively. While the Italian market has not been the fastest to embrace Internet buying, Unieuro's online sales last year grew very rapidly and have more than compensated for physical store traffic being down.

At €19.30 the stock trades at less than 6x trailing earnings and is down nearly 40% from its high in June. Is it still a "just buy?"

WH: We still consider the shares quite inexpensive and we don't believe that the current valuation fairly reflects the company's performance, its leading market position, or its prospects going forward. Amazon may very well be a strong competitor in coming years in Italy, but as online sales overall grow in the country, Unieuro has the financial strength to invest in enhancing its position and there's no reason it will not get its fair share of that growth. If it does perform better than the market seems to be pricing in at less than 6x trailing earnings, the shares are very likely to re-rate higher. Even at 10x earnings, there's still plenty of upside in the stock.

French telecom firm Illiad bought 12% of Unieuro in April. What's behind that?

WH: Illiad has been aggressive and rather successful as a wireless-service provider in France and other countries. They sell subscriptions to their services in Italy through Unieuro, so we imagine this investment was meant in some way to protect that customer-acquisition source. We don't know if they have plans beyond that, but at this point we would not expect those plans to impact Unieuro in any fundamentally negative way.

Is your bet on sailing-boat manufacturer Catana Group [Paris: CATG] more of a pandemic recovery play?

WH: Catana is one of three French companies, along with Beneteau [Paris: BEN] and Fountaine Pajot [Paris: ALFPC], that are the market leaders in Europe in the sale of catamarans. We first got interested in it in the fall of 2019. Despite reporting an order book that had increased 20%, the market didn't react to that and was pricing the shares on our estimate of forward earnings – we believed the order-book numbers – at a P/E of around 8x. So we bought.

Of course that did not look very good when the pandemic came and people thought Catana's sales, particularly those to large leasing companies in the West Indies, would fall off a cliff. We had bought the shares at around €2.50 and in April 2020 they had fallen to as low as €1.75. Our belief was that the pandemic impact would last no more than three years, so if we looked beyond that to when the business returned to normal, we decided the shares were still very cheap and added to our share position. We don't often do that when shares we own go down, but we did in this case.

Revenues were hurt somewhat by the pandemic, but rather than falling sharply they ended up last year to be roughly flat. Catamarans in general have become more popular as a more comfortable and luxurious way to sail, and Catana's Bali catamarans have been in particularly high de-

INVESTMENT SNAPSHOT

Unieuro
(Milan: UNIR)

Business: Leading retailer of consumer electronics and household appliances in Italy, selling through some 470 owned or affiliated locations as well as online through unieuro.it.

Share Information
(@9/29/21, Exchange Rate: $1 = €0.86):

Price	**€19.30**
52-Week Range	€10.02 – €31.36
Dividend Yield	13.7%
Market Cap	€392.5 million

Financials (TTM):

Revenue	€2.84 billion
Operating Profit Margin	3.5%
Net Profit Margin	2.4%

Valuation Metrics
(@9/29/21):

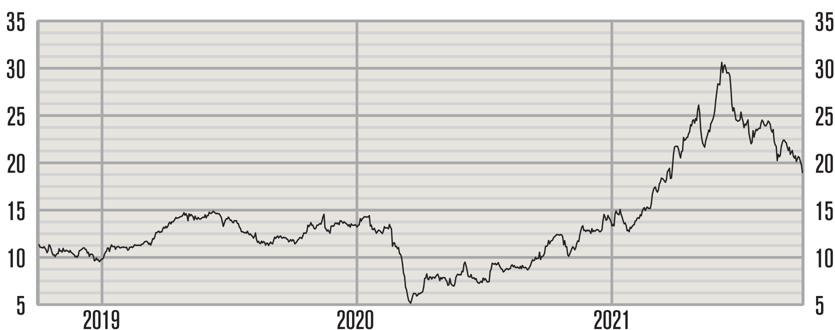
	UNIR	S&P 500
P/E (TTM)	5.6	31.1
Forward P/E (Est.)	n/a	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Amundi SGR	4.8%
Mediolanum Gestione Fondi	4.7%
JPMorgan Asset Mgmt	4.5%
Oddo BHF Asset Mgmt	2.2%
Canaccord Genuity Wealth	1.9%

Short Interest (as of 9/15/21):

Shares Short/Float	n/a



THE BOTTOM LINE

The current 6x trailing P/E ratio on the company's stock does not fairly reflect its ongoing performance, its leading market position or its prospects going forward, says William Higgons. If the company holds its own as he expects against increased online competition, he would expect the shares to re-rate to a higher, at least double-digit, valuation multiple.

Sources: Company reports, other publicly available information

mand in the market. The company's order book is still showing 20% year-over-year growth. So this is not just a pandemic-recovery play, but emphasizes maybe a bit more than is usually the case for us that the company can continue to grow nicely and profitably. Operating margins are in the 9-10% range and the return on equity has typically been close to 25%.

How inexpensive do you consider the shares at today's €6.20 price?

WH: The shares today trade at a forward P/E of 13.5x. That compares with the comparable market multiple of well over 20x. We don't believe that level of discount is correct for a company with this growth and profitability profile. If the shares traded at 18x estimated forward earnings of €0.46 per share, the stock would be 33% higher.

It's unusual for the market to be relatively uninterested in a company like this. French investors typically love businesses with luxurious and beautiful products. In this case it's not only an attractive business, but one with good secular growth potential. When P/Es are low for companies in such an industry, we should try to take advantage. We actually own shares in Fountaine Pajot as well.

Describe generally how you think about selling.

WH: We try not to be in a rush to sell, but if there's a material redemption or we want to buy something else we have to sell because we usually don't keep cash on hand. We don't set target prices, so the first place I look to sell is at the most-expensive stocks in the portfolio. Today we have some positions trading at 20x or so P/Es, so I will trim those first. As an example, I've been selling shares in Delta Plus [Paris: DLTA], which makes personal protective equipment, for probably the past seven years. It's been an excellent investment for us and I haven't wanted to rush to get out, but the P/E is now around 20x. If I'm looking to raise cash, this is one I will turn to today.

In recent years I've also at fairly regular intervals started to go through the worst-performing stocks in the portfolio and ask simply if I should still own them. If I buy a stock, it's not because I expect the price to decrease, so if it's decreasing by a significant amount, there is a good chance I have missed something and I'd be better off taking the loss and moving on. There's nothing automatic about it, but I've found this exercise to be quite helpful and has kept me from compounding some of my mistakes.

William, are you still enjoying what you're doing after all these years?

WH: I, like most professional investors, like to win. So if I'm beating the market I think this a wonderful job. When I'm lagging behind, I think it's a lousy job.

Honestly, I still enjoy how things change every day, how I have to constantly learn new things, and how I'm able to spend most of my time with interesting, intelligent people. I've had friends say I could retire and do something unpaid to fill my days. For now I prefer to do something I continue to enjoy and for which I am paid. VII

INVESTMENT SNAPSHOT

Catana Group
(Paris: CATG)

Business: Design, construction, sales and servicing of new and pre-owned catamarans and sailing yachts, made in France and sold under the Catana and Bali brand names.

Share Information
(@9/29/21, Exchange Rate: $1 = €0.86):

Price	**€6.22**
52-Week Range	€1.88 – €6.36
Dividend Yield	0.0%
Market Cap	€185.2 million

Financials (TTM):

Revenue	€89.3 million
Operating Profit Margin	10.9%
Net Profit Margin	9.4%

Valuation Metrics
(@9/29/21):

	CATG	S&P 500
P/E (TTM)	23.9	31.1
Forward P/E (Est.)	13.5	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Moneta Asset Mgmt	6.3%
Indépendence et Expansion	5.0%
Ostrum Asset Mgmt	2.8%
Tocqueville Finance	2.6%
La Française Asset Mgmt	1.6%

Short Interest (as of 9/15/21):

Shares Short/Float	n/a

THE BOTTOM LINE
While the company is more of a growth story than William Higgons would typically embrace, its shares even after a recent strong run are trading at a significant – and he believes unwarranted – valuation discount to the market. At a still-below-market but justified 18x forward P/E, he says, the stock would rise another 33% from today's level.

Sources: Company reports, other publicly available information

Investor Insight: Jennifer Wallace

Jennifer Wallace of Summit Street Capital describes why she's reticent to buy ostensibly cheap stocks in today's market, how her perspective on energy-related opportunities has evolved, why she's cautiously optimistic about the prospects for women in money management, and why she sees mispriced upside in Discovery, Molina Healthcare and Huntsman.

You describe your strategy as trying to buy shares of uncommonly good companies when they're available at bargain prices. Are you finding that a difficult combination to pull off today?

Jennifer Wallace: The best way in our view to compound our partners' capital safely is to target companies with strong cash returns on invested capital and good balance sheets that trade at inexpensive prices. That can happen when the market overall is hit. It can happen when there's a legitimate time-horizon question, about whether, when and to what extent a business improves over the current situation. And it happens because of human nature – investors love good news and smooth sailing and hate bad news and uncertainty. Bargains caused by real or perceived problems can be opportunities if you can be more rational in assessing what's going on.

Our last good opportunity for new ideas was around the start of the pandemic. When oil prices went negative and energy-company share prices collapsed, we bought shares in Texas Pacific Land [TPL], which owns perhaps the best property in the Permian Basin and has a capital-light business model. We could look beyond the temporary bad news and also saw potential for the company to expand its investor base through an upcoming conversion to a C corporation. [Editor's Note: As low as $350 in March 2020, TPL shares now trade at around $1,240.]

Medifast [MED] would be another example that also describes how we evaluate opportunities. It provides weight-loss programs and related meals, and it initially came to our attention in late 2019 when it missed earnings and lowered short-term financial guidance. We continued to work on it and when the market sold off with Covid the stock fell as low as $55, 35% below where it was when we started our research and 80% below its peak in 2018.

The company is different from the multi-level marketers to which it's often compared. The products are ordered by customers directly so no inventory is built by the "coaches" that manage their programs. Around 85% of revenue is recurring, gross margins have been high and stable, and the company had grown free cash flow by 37% annually during the previous five years. We were able to buy the stock of a capital-light business earning a more than 50% return on equity at just 9x earnings, with a 10% dividend yield. As it turns out, the business proved more resilient than even we expected. Last year was its best year in history and the stock has recovered accordingly. [Note: MED shares closed recently at around $199.]

To your question, most of the companies hitting our screens today for business quality and valuation – like homebuilders, recreational-vehicle companies, gun manufacturers – we think are cheap on recent earnings that may be difficult to sustain. We love what we own and have been able to selectively add to existing positions at times, but in the past year we've done much more trimming than buying. Our cash position today is close to 20%.

Are you finding areas of the market where you think a cycle turning up is creating opportunity?

JW: Let's talk about energy. By and large we don't own exploration and production companies, where the commodity price drives returns more than anything distinctive about an individual business. Today, especially as ESG increasingly drives capital flows, investors broad-brush anything associated with fossil fuels. The thinking is that the sector is in structural decline and you should avoid it at all costs. We believe it's far more nuanced than that.

We've owned Valero Energy [VLO] since 2017, buying more when its shares

Jennifer Wallace

Planting the Seed

First truly introduced to value investing while taking a class at Columbia Business School – where guest speakers included Warren Buffett, Seth Klarman, Michael Price and Mario Gabelli – Jennifer Wallace was working as a McKinsey consultant when she got a call in 1998 from renowned value investor Robert Bruce to see if she was interested in working with him. He was then running a large equity portfolio for the family office of Robert M. Bass and was more than willing to teach a novice investor the ropes. "It was one of those situations that exists far too rarely these days," Wallace says, "a genuine apprenticeship, sharing an office and working elbow-to-elbow day in and day out."

She stayed with the Bass organization until spinning fully out on her own in co-founding Summit Street Capital Management with partner Artie Williams in 2009. One of a relatively small but growing number of women portfolio managers, she credits Columbia's Bruce Greenwald for originally planting the seed for her future career path: "He always said he thought money management was a great business for women, because investors are judged on their results above all else. That always stuck with me."

fell during the pandemic. It's the world's largest independent refiner and the second-largest global producer of renewable diesel. Our basic view is that the market has an unrealistic expectation of how quickly electric drivetrains will replace internal-combustion engines. Modeling at even the highest estimates of EV growth, approximately 88% of the vehicles on the road in 2030 will still have internal-combustion engines. Given the continued underinvestment in refining capacity, we believe the supply/demand dynamics for refined fuel argue for a significant upcycle for Valero over the next few years.

That outlook can be obscured when the company gets lumped in with other energy producers like Exxon Mobil or Chevron. Energy ETFs, which often include Valero, move around based on oil-price prospects. When the outlook is bearish, money flows out, putting pressure on Valero's shares despite the fact that low oil prices are on balance a good thing for it because it reduces input costs and increases demand.

We also don't think the company from an ESG perspective is well understood. Its refineries are capable of taking the heaviest, dirtiest crude and creating clean fuels that can meet green fuel standards. It's expanding its renewable-diesel capacity. Add it all up and we don't believe the shares [at a price of $70.25] should trade at a 10% forward free-cash-flow yield and 7x consensus EV/EBITDA. Based on our sum-of-the-parts valuation, we think VLO is worth closer to $100.

The share price of United Therapeutics [UTHR] – recently around $185 – has nearly doubled since we talked about the company last year [VII, March 31, 2020]. Can you give us an update on it?

JW: My argument when we spoke was that this was a case of false pattern recognition. Other investors saw generic competition for the company's primary drug, Remodulin – used to treat pulmonary arterial hypertension – as a death knell, which we thought undersold the company's ability to innovate and extend the franchise's life and addressable market. We weren't valuing them in our base case, but we also saw free options from products in the pipeline.

The short update is that sales of Remodulin actually continue to grow, and inhaled and oral versions of it have extended intellectual-property protection, defended market share and opened new subsectors of the market. The free call options are still in place. We're seeing value grow along with the share price, so while we've trimmed, it's still a big position for us. Our discounted-cash-flow value for the shares is now around $310.

ON INVESTING IN ENERGY:

As ESG increasingly drives capital flows, investors tend to broad-brush anything associated with fossil fuels.

Describe why you're high on the prospects for media company Discovery [DISCA].

JW: We've had success investing in media companies and became interested in Discovery when it acquired Scripps Networks, which we owned at the time and have talked with you about before [VII, May 31, 2017]. We bought the stock in the aftermath of the pandemic at not far from where it trades today.

The company's main assets are its flagship networks – Discovery, HGTV, Food Network, TLC and Animal Planet – which produce relatively inexpensive content that is generally easy to repurpose for non-U.S. use. Revenues are split 65%/35% U.S. vs. international, and are evenly divided between distribution rights payments from pay-TV providers and advertising.

The primary concern about the company is its exposure to a traditional U.S. pay-TV market in decline. As viewers "cut the cord," rights payments to Discovery from cable and satellite companies will fall. We recognize that headwind, but believe the market is overreacting to the impact and underestimating the company's ability to compensate. There's much untapped growth potential outside the U.S., both in pay-TV penetration and advertising. The company's content is differentiated and popular, which will always find outlets willing to pay for it. The Discovery+ streaming service, launched at the beginning of this year, attracted 18 million subscribers within the first eight months and has beaten revenue projections with a hybrid subscription/ad-lite offering.

Were you surprised by the spike in Discovery's share price – to as high as $78 in March – following the Discovery+ launch?

JW: Unbeknownst to us, and to the market, the stock got caught up in what became the Archegos Capital debacle. As the stock price rose, we concluded other investors were seeing the value we did and giving the company credit for its streaming launch. When Archegos was forced to liquidate, the shares came right back down to the high-$20's. We bought back the shares we had trimmed on the way up and lowered our average cost. It was one of those weird, rare gifts the market offers up every once in a while.

Have you also been surprised by the market's indifference, at best, to Discovery's announcement in May that it was merging with WarnerMedia?

JW: We're already positive on the company's prospects and this makes us more so. Discovery's management did a brilliant job integrating Scripps and we expect the same to be the case this time. We think the combined company will be a content and streaming juggernaut in the same league as Disney and Netflix, but you wouldn't know that by the relative valuations of those stocks and Discovery's. As more information around what the company will look like post-merger comes out, we think the value-creation potential will become much more clear. The deal is targeted to close in the middle of next year.

With the stock trading at $25.40, what type of value-creating potential do you envision?

INVESTMENT SNAPSHOT

Discovery
(Nasdaq: DISCA)

Business: Global media production and distribution through networks including HGTV, Food Network and Discovery; announced merger with WarnerMedia in May 2021.

Share Information (@9/29/21):

Price	**25.42**
52-Week Range	19.07 – 78.14
Dividend Yield	0.0%
Market Cap	$12.80 billion

Financials (TTM):

Revenue	$11.30 billion
Operating Profit Margin	21.1%
Net Profit Margin	12.2%

Valuation Metrics
(@9//29/21):

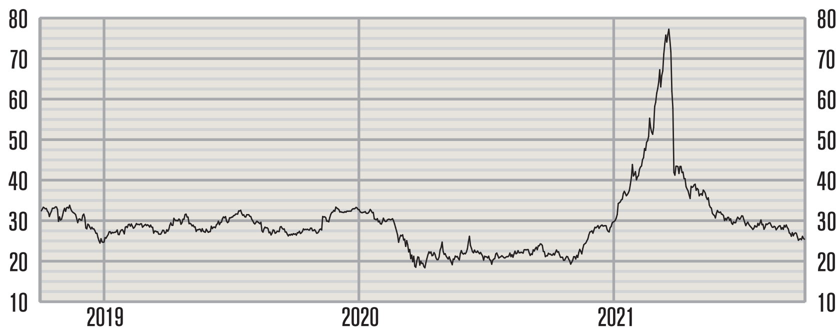
	DISCA	S&P 500
P/E (TTM)	12.3	31.1
Forward P/E (Est.)	8.3	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Vanguard Group	10.1%
BlackRock	5.4%
ClearBridge Inv	5.1%
State Street	4.6%
Mellon Inv	2.0%

Short Interest (as of 9/15/21):

Shares Short/Float	15.6%



THE BOTTOM LINE
The discrepancy in how the market treats the company's shares relative to those of other media/entertainment elites is "off the charts," says Jennifer Wallace. If its legacy network business remains even stable – versus the sharp decline she believes is priced into the stock – the shares at the low end of her estimated fair-value range would trade at $65.

Sources: Company reports, other publicly available information

JW: For our base case we don't yet factor in the merger because there is a paucity of data about it so far. Using what we consider reasonable expectations for Discovery's streaming business, we believe the market today is pricing the shares as if the legacy network business will decline by 10% per year. That's way overstated in our view – in our DCF we essentially assume the revenues and margins in the legacy business are stable. I think that's likely to be conservative, but with that assumption and using a 9% discount rate, we think the stock is worth between $65 and $80 per share. The difference between the high and low end is a function of how much the company spends in rolling out the streaming business. Even if that ends up at the top end of what we can imagine, the share upside is still quite significant.

Discovery has never been particularly well appreciated by either financial or Hollywood elites, but the discrepancy today versus it and companies like Netflix and Disney is off the charts. In the end it's the results that count, and we obviously expect Discovery to continue to deliver.

What do you think the market is missing in Molina Healthcare [MOH]?

JW: Molina was founded in 1980 to serve low-income families in Southern California and now provides managed healthcare plans in 15 states, primarily to people receiving government assistance. More than 75% of premium revenue comes from those on Medicaid, with the rest primarily covered by Medicare or through the Affordable Care Act Marketplace.

The company for much of its history was run by the Molina family, which could be fairly described as quite competent at developing effective healthcare plans, but less capable of managing operations and finances as the business grew and scale became more important. That led to the board bringing in Joseph Zubretsky as CEO in 2017, and he's done an excellent job in turning the company around. He's cleaned up the balance sheet, which was compromised with unnecessary obligations and burdened with restrictive covenants. He's added discipline to the request-for-proposal and renewal bidding processes. He's streamlined operations and taken out costs. He's also made and effectively integrated tuck-in acquisitions.

While we first perceived Zubretsky as a fixer who was going to clean up the company for sale, we now believe he's built an excellent platform and team that can grow it organically and through acquisition. There's opportunity to expand geographically and to take share in still-fragmented existing markets. It's always difficult to assess political winds, but while we believe government-run healthcare will remain a non-starter, we also find it hard to imagine a scenario in today's Washington in which people in Molina's target market don't receive increased access and funding to secure the types of healthcare plans it provides. The market may not yet see this, but we don't think it's a stretch to think the company can move from being a nice turnaround to more of a compounder.

Are you worried about the impact of a flood of claims as procedures postponed by the pandemic are rescheduled?

JW: That does appear to be a concern of the market's here, but we believe any

backlog will be worked through relatively quickly. Some procedures missed will never get done, and there are only so many hours in a day to make up the rest. We see this as a short-term risk that doesn't impact our assessment of the company's long-term value.

The shares have done very well during Mr. Zubretsky's tenure. What upside do you see from today's price of $280?

JW: We're assuming organic premium-revenue growth of 8-10% annually over the next couple of years, with an additional 5% per year from M&A, which is what they've guided to and have historically been able to deliver. If the medical cost ratio stays in the 87-88% range, we estimate the company can earn over $22 per share by 2023. At an 18x P/E – just under the trailing five-year average – the stock would trade at nearly $400.

Some people aren't willing to build prospective M&A into their models, but we think it's reasonable in this case. Molina has a great deal of white space geographically and in its existing states, and management has underpromised and overdelivered when it comes to deal-making in the past. They are committing publicly to upside from acquisitions and we think it's credible to incorporate it into our numbers.

From health insurance to specialty chemicals, explain your investment thesis today for Huntsman [HUN].

JW: We'd argue the market tends to lump chemical companies together as non-ESG-friendly businesses operating in cyclical commodity markets. That's hardly a recipe for popularity today.

Huntsman we believe doesn't deserve that characterization. Over the past decade it has been methodically shifting its product mix away from commodity chemicals toward more specialty ones in its four operating areas of focus, which it calls Polyurethanes, Performance Products, Advanced Materials and Textile Effects. The Polyurethanes division accounts for more than 60% of EBITDA and Performance Products for another nearly 20%. The company's five-year-average return on equity of 23% is not indicative of a commodity supplier.

We also don't consider a bad ESG rap appropriate here. Across the company's products you'll see a number of environmentally-friendly elements. For example, the biggest end use for its polyurethanes is insulation, which plays an important role in reducing energy consumption for heating and cooling. It makes ethylene carbonate, which is used in lithium-ion batteries. It has also recycled more than five billion plastic water bottles for use in insulation since 2015. These are not just image enhancers: Demand for products that play a role in reducing greenhouse gases should have a tailwind as energy conservation becomes more important and incentivized.

Management is another differentiator here in our view. The founding Huntsman family still owns around 15% of the shares and Peter Huntsman, the founder's son, is currently Chairman and CEO. The family operates the business as you would hope long-term owners would, with disciplined capital allocation focused on building shareholder wealth over time. They

INVESTMENT SNAPSHOT

Molina Healthcare
(NYSE: MOH)

Business: Provider of managed healthcare services in the United States focused primarily on Medicaid- and Medicare-related solutions for low-income families and individuals.

Share Information (@9/29/21):

Price	**280.13**
52-Week Range	171.40 – 289.59
Dividend Yield	0.0%
Market Cap	$16.11 billion

Financials (TTM):

Revenue	$22.60 billion
Operating Profit Margin	3.9%
Net Profit Margin	2.8%

Valuation Metrics
(@9//29/21):

	MOH	S&P 500
P/E (TTM)	26.1	31.1
Forward P/E (Est.)	16.7	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Capital Research & Mgmt	9.9%
Vanguard Group	9.2%
BlackRock	7.8%
T. Rowe Price	7.0%
Wellington Mgmt	4.9%

Short Interest (as of 9/15/21):

Shares Short/Float	2.2%

MOH PRICE HISTORY

THE BOTTOM LINE

Jennifer Wallace says the company has fairly quickly gone in her estimation from turnaround in preparation for sale to potential compounder. Assuming 13-15% annual premium growth and stable margins, she estimates it can earn over $22 in EPS by 2023. At an 18x P/E – below the trailing five-year average – the stock would trade at nearly $400.

Sources: Company reports, other publicly available information

require an organic-capital hurdle rate of at least 20% and a minimum mid-teens IRR for inorganic investments. They've also been nimble in acquiring businesses that were divisions of other companies or owned by private equity and then driving costs out. We expect them to continue to be opportunistic and disciplined.

What do you think Huntsman's shares, now trading at just under $30, are more reasonably worth?

JW: Generally assuming a gradual recovery out of the pandemic and normalized EBITDA margins, we value the shares on a sum-of-the-parts basis on our 2023 estimates. We assume 6x EV/EBITDA for Textile Effects, 7x for Polyurethanes and 8.5x for the rest, which results after adjusting for net debt in around $8.5 billion in equity value. That would translate into a $38 share price.

When we purchased our initial stake in late 2018, the shares traded at around 6x EV/EBITDA at a time when net debt to EBITDA was around 4x. Today the shares still trade close to 6x EV/EBITDA, but the balance sheet is now only about 1x levered. We think that's a good indication of the market's relative lack of interest in the stock today.

Activist investor Starboard Value just announced it has taken an 8% stake in the company. What do you make of that?

JW: Huntsman in recent years has made significant advances in strengthening the balance sheet and focusing on higher-margin businesses, but the market has not awarded it a multiple. It remains a very inexpensive stock, so it's not surprising an activist took notice.

There aren't as many women doing what you do for a living as there should be. Are you optimistic that can change?

JW: There appear to be three main issues. There's a pipeline problem – for whatever reason women don't perceive finance as an industry that's good for them. There's an allocation problem. In studies, in this case around venture capital, when people were presented with a resume and business plan from an actor who is a woman and the exact same resume and business plan from an actor who is a man, allocators overwhelmingly assumed the plan pitched by the male would be more successful and they were willing to invest twice as much with the entrepreneur played by a man. I would guess those who participated in that test don't view themselves as being prejudicial, but there are unconscious biases. I'd also say this issue is improving, with more institutions today actively seeking out women to invest with.

Finally, there's a role-model problem. Women in the business, including myself at times, may prefer to keep a low profile. At all levels of our firm we're active in our mentorship of women, but I think there is probably more we could do to demonstrate that this is actually a great career for a woman, where you're judged more on your results than anything else. There are increasingly more role models out there today. We'll see, but I think generally that we're hitting on the right three areas, which gives me some optimism that things can change. VII

INVESTMENT SNAPSHOT

Huntsman
(NYSE: HUN)

Business: Global manufacturer and marketer of specialty chemicals; four operating segments are Polyurethanes, Performance Products, Advanced Materials and Textile Effects.

Share Information (@9/29/21):

Price	**29.85**
52-Week Range	21.65 – 32.35
Dividend Yield	2.5%
Market Cap	$6.62 billion

Financials (TTM):

Revenue	$7.04 billion
Operating Profit Margin	8.4%
Net Profit Margin	8.9%

Valuation Metrics
(@9//29/21):

	HUN	S&P 500
P/E (TTM)	10.5	31.1
Forward P/E (Est.)	9.5	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Vanguard Group	9.4%
BlackRock	5.2%
Capital Research & Mgmt	4.6%
Fidelity Mgmt & Research	3.8%
LSV Asset Mgmt	3.6%

Short Interest (as of 9/15/21):

Shares Short/Float	1.5%

HUN PRICE HISTORY

THE BOTTOM LINE

The market tends to view chemical companies as "non-ESG-friendly businesses operating in cyclical commodity markets," but Jennifer Wallace argues that neither of those characterizations is entirely fair in the company's case. Based on a sum-of-the-parts valuation on her 2023 estimates, she believes the shares today are worth at least $38.

Sources: Company reports, other publicly available information

Investor Insight: Matthew Sweeney

Laughing Water Capital's Matthew Sweeney explains how he tries to create a "structural" investing edge, what he looks for that computers are more likely to miss, how he's trying to keep early success from going to his head, and what he thinks other investors are missing in Houghton Mifflin Harcourt, TransAct Technologies and Whole Earth Brands.

We imagine you're often asked as a relatively new fund manager what you think your edge is. How do you answer that?

Matthew Sweeney: There are really only four sources of edge. There's an informational edge, which is hard to come by in most cases and may get you into trouble depending on how you get it. There are analytical and behavioral edges, which are largely innate. Then there's what I call a structural edge, which is completely in your control. To me that includes being selective about your investor base and setting yourself up to reduce your competition. That's one way I'd like to believe I can have an advantage.

What does that mean? Part of it is running a very concentrated portfolio, with no more than 15 stocks, that looks nothing like an index. Part of it is focusing on small- and micro-cap stocks, where I'm not competing with those with the deepest pockets. With our investors, it's important they understand that we're deliberately trying to separate ourselves from the herd, which can be uncomfortable.

I also spend a lot of time thinking about what quantitative screeners cannot see. Anything that's quantitatively cheap, broadly speaking, is often cheap for a good reason. So I'd rather look for ideas that don't look quantitatively cheap, because the trailing financials are not meaningful or the GAAP numbers are misleading. If you can combine misleading financials with little to no sell-side research, then quant screeners are effectively blind. In trying to find ideas where the market is not efficient, I think these types of things provide a good place to start.

We spoke not long ago about Whole Earth Brands [VII, February 28, 2021]. This was a case where two business lines were being bought by a special-purpose-acquisition company set up by someone who had already built a multi-billion-dollar public company from scratch. The businesses were being sold by a billionaire, Ron Perelman, who was on the front page of the New York Post having to sell off assets in a fire sale because his business empire was presumably imploding. The original purchase price was $575 million, then the price got cut to $425 million, and then three weeks later because everybody's worried about SPACs the newly christened company's market cap was $250 million. There was a lot going on there, and it's exactly the type of thing I'll want to explore.

What types of things make GAAP numbers misleading?

MS: Very often it's simply a good company/bad company situation. Say a company has two segments. The good business earns $1 per share and the bad one loses 50 cents per share. To a computer, the company makes 50 cents per share, so may not look cheap. The exercise then is to try to understand what's going on with the bad business. Could it become a good business? Should it just be shut down? How you come out on that can result in your having a very different view of future earnings power than the market.

We're typically buying businesses that are dealing with some sort of operational or structural problem that we believe our management partners are capable of moving past in the not-too-distant future. That means the future can look very different from the past. If we're right and the problems are overcome, the stocks should benefit from both improved fundamentals and an improvement in what may be pretty lousy market sentiment.

Describe a relatively new purchase and what attracted you to it.

MS: Much of our past success has been tied to investing in businesses in transi-

Matthew Sweeney

Into Focus

Matthew Sweeney was not at all planning a career in finance when an acquaintance from his Long Island hometown called to ask for help. It was September 2001 and the young man worked for brokerage firm Cantor Fitzgerald, whose head office had just been destroyed and more than 650 of its employees killed in the terrorist attack on the World Trade Centers. The firm needed any able bodies it could find to help it try to put itself back together.

His first day on the job was September 17th and his initial task was assembling furniture for temporary office space. He quickly worked his way into an institutional equity-sales position where he was exposed to a wide range of portfolio managers. One at value investor Royce Funds introduced him to the writings of Benjamin Graham, Warren Buffett and Joel Greenblatt. "It was like I had found something I was looking for my whole life," he says, "but I just hadn't known yet that it existed." Sweeney stayed at Cantor, eventually becoming a partner, but spent much of his free time learning on his own about investing, with the goal to one day start his own firm. In 2015, at 36, he launched Laughing Water Capital and started managing outside money the following year.

tion, and today there are a lot of interesting opportunities out there where that's the case. Many companies that might otherwise have dragged their feet to address issues holding them back have been forced to become better versions of their prior selves over the past 18 months. As that's underway, valuations can be favorable because the business mix is changing and it's less clear how it will all play out. If management is capable and properly incentivized, I find these types of ideas, with patience, can work out pretty well.

We added a position earlier this year in Thryv Holdings [THRY], which believe it or not is one of the last remaining players in the Yellow Pages business. I had noticed that it came public via a direct listing, which is kind of unusual. It has a messy corporate history, with more than one bankruptcy filing. Who on earth wants to publish phone books? Then on one of the first conference calls John Paulsen, whose Paulsen & Co. is a big shareholder, talked about how he thought the company's software business serving small and midsized companies was worth far more than the total market cap. All of that made me want to take a closer look.

While phone books have clearly been in decline, the Yellow Pages' business still earns substantial cash flow which the company has invested in the software service. It serves companies that Thryv likely already has a relationship with, helping them automate key aspects of daily workflow like estimates, invoices, billing and payments through a cloud-based subscription. That business is now profitable, so cash flow will also be freed up to pay down debt and even buy up additional Yellow-Pages assets on the cheap, providing additional cash flow and a broader sales funnel to market the software. Once the market realizes the business model really works, we'd expect the stock [recently trading at $29.50] to re-rate higher.

We've in the past [VII, August 31, 2020] discussed with others small-cap holding company Aimia [Toronto: AIM]. Describe how it fits the profile of something you find interesting.

MS: I think of value investing as being on a spectrum. On one end you have undervalued asset plays and on the other you have underappreciated growth potential. One great thing about the early portion of my career as an institutional equity salesperson was that I was in regular contact with a large number of portfolio managers who came at things in a variety of different ways. I think that makes me a bit more comfortable with ideas all along the value-investing spectrum, which I'd argue has been additive to my performance.

ON STRATEGY:

I'm comfortable with ideas all along the value-investing spectrum. That has been additive to my performance.

Aimia fits on the asset-value side of the equation. The company had historically been mismanaged by a board with no skin in the game, but that's changed with the arrival of Chris and Phil Mittleman, who have spoken with you about this before. The bottom line is that we believe its primary asset, a stake in Aeroméxico's PLM loyalty program, is likely worth C$500-600 million at a time when Aimia's total market cap is only around C$415 million. It's complicated, in no small part because Aeroméxico is making its way through bankruptcy, but that would mean the other assets of the company – which include a holding in an outdoor advertising firm in China called ClearMedia [HK: 100] and a stake in Trade X, an innovative cross-border trading platform for used cars – are worth less than zero.

Trade X, in particular, I think has the potential to be a huge winner. It is a two-sided marketplace that greatly simplifies a very complex process and serves a total addressable market that I believe is more than $100 billion. This investment is in its early days, but I think it could ultimately be worth many multiples of what Aimia is valued at today. But no one even knows it is there. Sell-side analysts have literally not said a word about it. I like not having to pay anything for it.

Turning to another idea that likely qualifies as "in transition," describe your investment case for Houghton Mifflin Harcourt [HMHC].

MS: This is a relatively easy-to-understand business: the company provides instructional content, including textbooks and supplementary materials, for the core K-12 education market in the U.S. Houghton Mifflin, Pearson and McGraw Hill dominate the U.S. market and have for a long time. Pro-forma for the recently announced sale of its commercial books and media division, this is all the company now does.

The transition in the business is driven by an ongoing shift toward producing and delivering curriculum content digitally. That requires reorienting how the content is created and updated as well as how it's sold. Rather than big new-product launches or updates every five years or so, materials have to be continuously updated and are increasingly sold with a subscription model. All that accelerated considerably with the pandemic last year, as students in far greater numbers needed access to digitals tools and content, as well as the availability of computers and iPads to take advantage of it all. The future of digital K-12 education is here.

Does all that make the company's historical financials "misleading"?

MS: Very much so. You have to extract the commercial-book business going forward. The business model is shifting from up-front payments to ongoing subscriptions. The cost base has changed, as new management has reduced headcount by 25% and there's considerably less expense for things like printing, warehousing and shipping. Then, of course, there's been Covid, which dramatically impacted revenues last year and billings still haven't returned to what might be considered normal. The company's five-year trailing free cash flow

has been negative, so from our perspective the historical financials better prove to be misleading.

Is anything positive showing up yet in the numbers?

MS: The company last year, despite a drastic fall in billings, still was able to generate a very small amount of free cash flow. We consider that very much a positive when you consider that two or three years ago the business was materially cash-flow negative at a time when billings were 40% higher.

Is the movement in some states toward open-source curriculum a concern for the company?

MS: Some states have given teachers much more leeway to use whatever materials they want, which could theoretically impact demand for curriculum content from legacy players like Houghton Mifflin. The push back on that is, one, that there doesn't appear to have been much negative impact on the company from open-source policies to date. I'd also say that given what educational systems have been through in the last 18 months, the impetus to pursue cheaper curriculum options over what has proven to be tried and true is likely to be fairly limited for the foreseeable future.

The shares were pricing in disaster after the pandemic hit last year, falling below $1.50 per share. At a recent $13.50, what potential do you still see from here?

MS: With a cleaned-up balance sheet and streamlined cost structure, this is a different business than it was last year. To arrive at a normalized estimate of free cash flow, I start with the average of the last five years of the educational business' billings – including, for conservatism, last year's negative outlier. I take into consideration the recent operational changes, recent and prospective changes in the balance sheet, and take at face value management's estimate that any billings in excess of $850 million per year will translate into free cash flow at a rate of 65%. That results in my estimate of roughly $200 million in normal annual free cash flow.

For a valuation multiple, there aren't any great pure-play comps, but there are a number of somewhat similar businesses with positive free cash flow in down cycles and more subscription-type business models. There is obviously a range of valuations for those types of businesses, but I think something in the mid-teens on free cash flow would not at all be overly ambitious. At 15x my "normal" estimate, that would translate into a stock price of $21-22 per share.

I should mention that there is the potential over the next few years for results to be much better than normal. Typically education budgets are 90% state and locally funded. But the federal government in the wake of Covid has earmarked another $200 billion for education. The pie is going to be much bigger and that should significantly benefit Houghton Mifflin in the short term.

I'm also not building into my numbers the company doing anything intelligent with all the cash they should be generating. If 2021 results meet guidance and the next four years are collectively normal as

INVESTMENT SNAPSHOT

Houghton Mifflin Harcourt
(Nasdaq: HMHC)

Business: Provider of educational materials for the U.S. K-12 market, including print and digital textbooks, digital courseware, instructional aids and assessment solutions.

Share Information (@9/29/21):

Price	**13.45**
52-Week Range	1.68 – 14.44
Dividend Yield	0.0%
Market Cap	$1.70 billion

Financials (TTM):

Revenue	$1.12 billion
Operating Profit Margin	(-2.0%)
Net Profit Margin	6.3%

Valuation Metrics
(@9/29/21):

	HMHC	S&P 500
P/E (TTM)	n/a	31.1
Forward P/E (Est.)	n/a	22.0

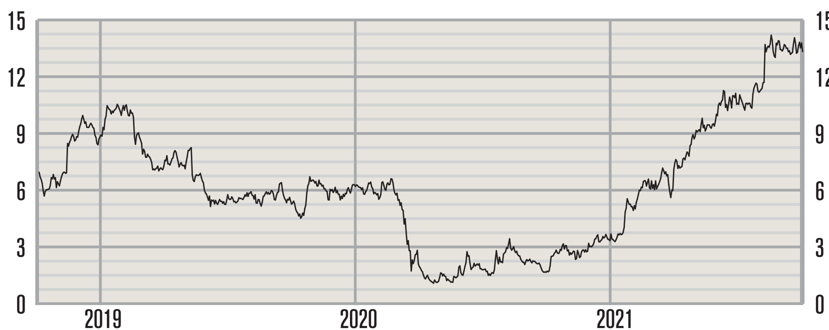
Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Wellington Mgmt	12.3%
Burgundy Asset Mgmt	8.3%
AllianceBernstein	6.8%
BlackRock	5.9%
Vanguard Group	5.0%

Short Interest (as of 9/15/21):

Shares Short/Float	3.5%

HMHC PRICE HISTORY



THE BOTTOM LINE

After years of dismal performance only made worse by the pandemic, the company is at a point from a strategic, operational and balance sheet perspective that it can it can finally prosper going forward, says Matthew Sweeney. At 15x his $200 million estimate of normalized free cash flow, the share price would increase by roughly 60% from today's level.

Sources: Company reports, other publicly available information

I've described it, the company will have generated around 60% of its current market cap in cash that it could put to use investing back into the business, on creative M&A, or to return money in some fashion to shareholders.

One distinguishing feature of your next idea, TransAct Technologies [TACT], is a 25-year stock chart that's pretty flat. Describe why you expect that to change.

MS: Just looking at the stock chart would cause most investors to take a quick pass. What that misses is a lot going on under the surface, including the company shuttering underperforming business lines to focus on a legacy franchise that primarily operates in a niche duopoly with high switching costs, and on a new software-based product that has tremendous growth potential. It is very unusual to see small companies deliberately shrink their historic footprint in order to focus on their best opportunities going forward.

The surviving legacy hardware business primarily makes specialized printers for slot machines. This is a regulated duopoly where OEM customers care a lot more about reliability and quality than cost, and where strict regulation makes it hard to be replaced by another supplier once you've been approved and built into a given machine line. We think gross margins are 50-60%, quite nice for a hardware business.

The newer software business is called BOHA – for back-of-house automation – and is gaining traction in a couple of areas. One is in providing systems to convenience stores that allow them to update fresh-food labels in real time from a centralized location as menu items and prices change. There are something like 150,000 convenience stores in the U.S. and the big trend in that business is to offer more "grab and go" fresh food – which under FDA regulations has to be labeled with full nutritional information – that can drive higher traffic and higher margins. TransAct has been an early mover in this space and already has long-term contracts with leading industry players, including 7-Eleven, which enhances its credibility in the market.

BOHA also sells software and labels into restaurants' back-of-house to automate tasks such as food preparation, time keeping and temperature monitoring. As restaurants struggle to find workers and keep up with rising wages, automating time-consuming, error-prone tasks is at a premium, which we think provides a favorable backdrop for continued adoption of TransAct's offering. The big news here is that the company has partnered with Apple to be included in its push to sell iPad-based systems to restaurants.

Management has been saying on the restaurant/convenience store side that they'll be in 10,000 stores by year end, but if you look at press releases on deals already won, we think that the path to 20,000 stores has already been blazed, even before considering the partnership with Apple. It's still small, but 20,000 stores at a roughly $1,200 annual revenue per user would result in a high-margin recurring revenue stream of $24 million.

The shares have risen sharply coming out of the pandemic. How are you looking at upside from today's $13.20 price?

INVESTMENT SNAPSHOT

TransAct Technologies
(Nasdaq: TACT)

Business: Domestic U.S. provider of software-driven technology and printer systems used in vertical end markets including casinos, convenience stores and restaurants.

Share Information (@9/29/21):

Price	**13.16**
52-Week Range	4.93 – 17.18
Dividend Yield	0.0%
Market Cap	$134.8 million

Financials (TTM):

Revenue	$32.7 million
Operating Profit Margin	(-29.2%)
Net Profit Margin	(-21.7%)

Valuation Metrics
(@9//29/21):

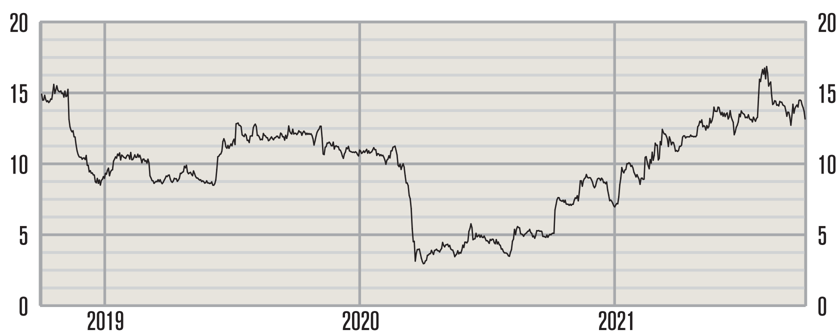
	TACT	S&P 500
P/E (TTM)	n/a	31.1
Forward P/E (Est.)	n/a	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
325 Capital	8.1%
Harbert Fund Adv	5.9%
Grand Slam Asset Mgmt	5.6%
Vanguard Group	3.7%
Renaissance Tech	3.7%

Short Interest (as of 9/15/21):

Shares Short/Float	0.3%



THE BOTTOM LINE

Now focusing on one healthy legacy business and one exciting new one, the company is positioned to deliver a much better future to shareholders than it has in the past, says Matthew Sweeney. Valuing the legacy business at its estimated sale value and the new one at 5x rapidly growing revenues, he believes the shares today are worth at least $22.

Sources: Company reports, other publicly available information

MS: We think the legacy printer business based on precedent deals and its cash-generating ability could be worth $70 to $80 million to a strategic acquirer. Backing that out, at today's share price TransAct's adjusted enterprise value would be around $45 million. If BOHA's run-rate recurring revenue comes in at $24 million, that means it's being valued at less than 2x revenue.

I wouldn't argue that this deserves the type of multiple most software-as-a-service businesses earn today, but BOHA should ultimately be highly cash-flow generative and it's growing at more than 100% per year. At 5x that business' revenue – which again takes out the legacy printers, assumes only currently announced deals, and factors in no future growth from the Apple partnership – the shares would be worth $22. There are obviously a lot of steps between here and there, but if the software business takes off as it can, this is one we think could be a multi-bagger over time.

Importantly here, I don't believe there's much real downside. The slot-machine-printer business should provide significant ballast, and we like that there are now three activist shareholders who seem to be working effectively with the board and management. I wouldn't be surprised if down the road the traditional business is sold and the company brings on a new CEO to run what will then be more of a software business. Things appear to be very much on the right track and we expect them to stay that way.

Whole Earth Brands' shares are right around where they were when we spoke about it earlier this year. Please update us on your latest thinking on it?

MS: As I mentioned, there were a lot of moving parts here that made it interesting. The company was newly public through a SPAC, with its own independent and highly qualified management and the financial wherewithal to build a substantial business around non-sugar and organic sweeteners and other food ingredients. They made two material acquisitions early on, which combined with the fact they were going through an extensive operating overhaul meant the historical financials weren't at all representative of what the company could be in the future. There was plenty of opportunity for organic growth and the capacity to do additional strategic M&A. Combine that with a share price that would indicate very few people were paying attention, and that's exactly the type of idea we like.

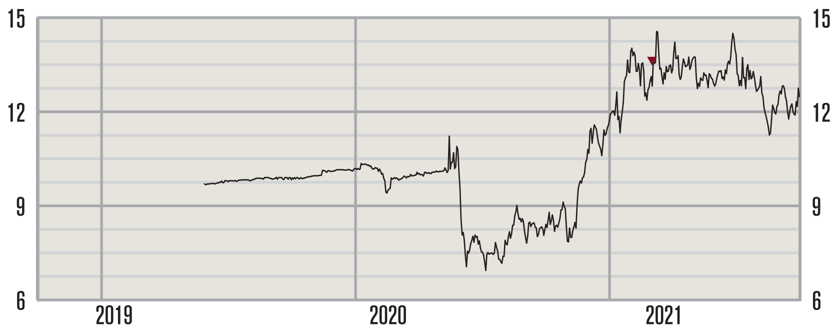
Our thinking about the potential opportunity here hasn't changed. There haven't been any real surprises in reported results and there has actually been some good news on the company's products taking shelf space. They're now in Costco for the first time, for example. It's possible the market is somewhat nervous that Whole Earth will be too aggressive in going after shelf space, which might squeeze margins in the short term, but if that does happen we don't expect it to be to a concerning degree and we wouldn't find it inconsistent with management's strategy to build scale.

One interesting thing about the stock is that it appears to be trading more in line with other recent SPACs than it is with consumer packaged-goods companies. That makes no sense. The deal closed 15 months ago and there's no reason for any SPAC-related overhang.

With the stock now at $11.50, update us on your latest thoughts on valuation.

INVESTMENT SNAPSHOT

Whole Earth Brands
(Nasdaq: FREE)



Share Information (@9/29/21):

Price	**11.47**
52-Week Range	7.78 – 14.95

Valuation Metrics (@9/29/21):

	FREE	S&P 500
Trailing P/E	n/a	31.1
Forward P/E (Est.)	11.0	22.0

ORIGINAL BOTTOM LINE – February 28, 2021

Unshackled by constraints under previous ownership, the company's prospects are much brighter than its pedestrian share valuation would indicate, says Matthew Sweeney. At peer multiples on his 2021 pro-forma estimates, the shares would trade at least at $22.

NEW BOTTOM LINE

It makes no sense that the company's stock trades more in line with other SPACs than with packaged-goods companies, says Matthew Sweeney. On his estimate of free cash flow over the next 12 to 24 months, he thinks the shares can trade into the mid-$20s.

Sources: Company reports, other publicly available information

MS: At today's price the market cap is just under $500 million and the enterprise value – including an earn-out on one of their acquisitions – is around $920 million. We still believe that by 2022 or 2023 the company will be earning $100-110 million in annual EBITDA, which would translate into free cash flow of $1.50-1.60 per share. At even a market multiple of around 16x free cash flow, that would get you a $25 stock.

There are plenty of comparable companies that trade at a higher valuation, but that's probably fair for the time being because Whole Earth's management has been vocal about growing the company to at least $1 billion in annual revenue, and the only way to get there from roughly half that level today would require some additional M&A. There's some risk they lever up a balance sheet that is already levered at 4x to do that. I don't want that to happen, but I would agree the stock probably doesn't deserve a higher multiple until it's clear how they are going to protect the balance sheet.

Describe something you've sold recently and why.

MS: One long-time holding that we recently parted with is Iteris [ITI]. This was originally one of those good co./bad co. ideas, where the success of the company's lead business in traffic-monitoring systems was being somewhat obscured by a smaller agricultural-technology business that management was high on. We'd argued for years they should get out of the agricultural business, which they finally did, but we also concluded that the remaining company was under-scale and could best realize value through a sale. They actually received a takeover proposal in March, worth at least $8.15 per share, but they turned it down, saying an all-stock bid in wildly overpriced shares wasn't good enough. That was OK, but as more time went by it appeared management saw themselves as buyers rather than sellers. Then the CEO started selling stock. In the end we decided our time and money would be better spent elsewhere. The stock price today [at around $5.30] is 35% below the March offer price.

You're off to a great start, performance-wise. How do you avoid letting success go to your head?

MS: First of all, I recognize that it's clearly not sustainable. We've done well against the market, but the market itself has been pretty fantastic.

I think the most important thing I can do is try to stay honest to my strategy and process. I've defined pretty well where I believe I can have an edge, and I'd argue that where people are most likely to trip up is when they stray from that. I have no interest in running a big organization or managing people, so if the firm's assets under management ever get to a level where I worry I have to stretch outside of my comfort zone, I'll stop taking new money or even return some of the capital I have. That's not an issue so far – I'm optimistic I'll be able to cross that bridge safely when I come to it. VII

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Tale of Two Markets

Despite what might appear to be the market's calm surface, Voss Capital's Travis Cocke – whose picks in VII less than a year ago have performed exceedingly well – is finding plenty of opportunity today in the relative turmoil down below.

INVESTOR INSIGHT

Travis Cocke
Voss Capital

***Editor's Note:** We try not to call too frequently on the talented investors we speak with for VII each month. We appreciate the time they spend with us and don't want to overstay our welcome.*

But after looking at the performance of the highlighted stock ideas Travis Cocke of Voss Capital shared with us last November [VII, November 30, 2020], we decided to take the risk. Since the issue appeared, the five ideas – Nintendo, Avid Technology, Extreme Networks, Louisiana-Pacific and Rimini Street – are collectively up more than 80%, vs. a 20% rise in the S&P 500. We asked Travis and colleague Jon Hook if they were still finding interesting ideas in today's market and if so, whether they'd share a few of them with us. Happily, they answered yes to both questions.

When we last spoke you described finding a pretty rich environment for investment ideas. Is that still the case?

Travis Cocke: It's sort of a tale of two markets. You've got quality mega-caps that have been consistently strong, while further down the market-cap spectrum there's quite a bit of turmoil. There has been a flood of new IPOs, secondary offerings and SPACs. Retail traders are anchoring on only a dozen stocks or so at a time. We find all that leading to many of the small- and micro-cap companies we tend to follow getting even less attention than usual. At the same time, it's a confusing and difficult-to-analyze time. You've got to assess normal business cycles and the Covid cycle. How persistent will supply-chain issues be? How much of recent demand is real and how much pulled forward by the pandemic? Companies are trying to respond to all that, operationally and in exploring strategic options. It's muddied the waters for investors, resulting in a wider dispersion of potential outcomes and a wider dispersion in valuation. That to us creates a fertile environment for ideas.

Let's dive right into some examples. What do you think the market is missing in International Money Express [IMXI]?

Jon Hook: Intermex provides money-remittance services, focusing on transactions emanating from the U.S. and going to Mexico, Guatemala and other Latin American countries. It makes its money by charging a fixed fee for each transaction – which accounts for 85% of total revenue – and from earning a variable spread on the currency exchange. The customer base is primarily low-income and underbanked.

With money remittance, one can execute a transaction either in person through retail agents or do it online. If in person, the customer typically goes to an agent location, often a bodega or convenience store, cashes a paycheck and then pays in cash to send money. The money is then directed to a specific location, often a bank, where the cash can be retrieved. If remitting digitally, customers use the company's website or app, although this requires that the sender has a bank account.

While all the talk in the industry is about digital, we don't believe Intermex's target customer is there yet. It deals with the underbanked who are often undocumented and are less likely to want a bank relationship. They want to send money through a trusted source in their neighborhood, often from the same place where they cash their paycheck, and without having to produce ID. We think by sticking more to its traditional knitting that Intermex can grow for years at 15%-plus annually. The stock's valuation would indicate the market expects quite a bit less.

What specific factors would be driving such attractive growth?

JH: Latin American remittances have risen at a solid pace for years, fueled by immigrants whose financial responsibility extends back home. The relative breadth and depth of the U.S. economy and job market leads us to believe that dynamic won't moderate any time soon.

We also think Intermex has an opportunity to take share from competitors who are distracted by all-in efforts to go digital. In fact, Intermex has been consistently growing faster than Western Union and MoneyGram by a wide margin, quarter after quarter. The company claims to have 20% market share for its core receiving countries of Mexico, Guatemala, Honduras and El Salvador, but on the sending side it isn't geographically balanced across U.S. markets with large Hispanic populations. They have 35-50% market shares in Florida and the Southeast, for example, but only 8-12% in Texas and California. Management has been disciplined and methodical about opening new locations and we believe they can translate that into significant organic growth.

We don't really build this into our expectations, but the company also has the potential to make tuck-in acquisitions. This would likely be most effective in building out receiving-market positions in what are now secondary markets like Peru, Nicaragua, Ecuador, the Dominican Republic and Costa Rica.

INVESTMENT SNAPSHOT

International Money Express
(Nasdaq: IMXI)

Business: Provider of international money remittance services primarily originating in the U.S. and going to Mexico, Guatemala and other Latin American countries.

Share Information (@9/29/21):

Price	**16.27**
52-Week Range	13.14 – 18.96
Dividend Yield	0.0%
Market Cap	$635.2 million

Financials (TTM):

Revenue	$351.0 million
Operating Profit Margin	2.0%
Net Profit Margin	11.8%

Valuation Metrics
(@9//29/21):

	IMXI	S&P 500
P/E (TTM)	15.3	31.1
Forward P/E (Est.)	10.8	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Wellington Mgmt	9.0%
Federated Global Inv Mgmt	7.1%
Conifer Mgmt	6.1%
BlackRock	5.4%
Vanguard Group	4.8%

Short Interest (as of 9/15/21):

Shares Short/Float	2.5%

THE BOTTOM LINE
The company recognizes the digital transition underway in its industry, but is also likely to incrementally benefit from that transition taking longer than expected, says Jon Hook. Assuming mid-teens annual revenue growth, modest margin expansion and an EV/EBITDA multiple of 9x on his resulting 2023 estimates, the shares would trade at close to $30.

Sources: Company reports, other publicly available information

How cheap do you consider the shares at a recent price of $16.25?

JH: The stock today trades at 9x forward free cash flow and less than 7x forward EV/EBITDA. We think that's very cheap for a company we believe can grow its top line, for multiple years, by at least 15% with strong operating leverage.

We estimate revenue through 2023 can grow at a 16% compound rate and that EBITDA margins will expand modestly to 21%. That would result in sales of nearly $575 million and EBITDA of just over $122 million. Assuming a conservative 9x EV/EBITDA multiple, the shares would trade at close to $30.

The biggest risks?

JH: Regulation is a primary one. There are legitimate concerns about money laundering and companies can get into trouble if they're lax about following the rules. MoneyGram, for example, is under restrictions others don't have because of past regulatory infractions. Positive on this front is that Intermex has a squeaky-clean record historically and appears to take its regulatory responsibilities quite seriously.

This is somewhat of an unusual idea for us because we often find opportunity in companies leading the digital transformation charge, when it's early and hard for the market to handicap how it will play out. We actually started looking in this sector at MoneyGram with that initial thesis. We're not saying the digital transformation here won't happen, we just think it's further down the road than expected and that a company like Intermex that recognizes that is going to be at a relative competitive advantage.

Why are you high on the prospects for small-cap financial holding company ECN Capital [Toronto: ECN]?

TC: We started looking into ECN in January when a friend suggested we look at it as a misunderstood company that had undergone a transition from capital-intensive railcar/aviation leasing to an asset-light model focused on the origination, bundling and sale of specialty consumer loans.

At the time, there were three primary businesses. The biggest, Service Finance, makes home-improvement loans sourced through a network of 14,000 contractors and retail partners in the U.S. and Canada. The second, called Triad, offers loans to purchase manufactured homes, sourced similarly through dealers and manufacturers. The third business, Kessler Group, works with mostly small banks and credit unions to help them manage, market, and buy and sell credit-card portfolios.

We liked each business, but were most attracted to Service Finance given our positive outlook for home remodeling. We were getting exposure to higher spending on home improvement without having to pick which door manufacturer would be the winner. Then last month ECN announced it was selling Service Finance to Truist Bank for $2 billion. That took us off guard at first, but we've come to see it as very much a positive. We want management to be willing to part with any business if doing so can improve share value. Here they caught a $2 billion bid for a business they bought in 2017 for $305 million. Nothing really to argue with there.

So the question now is to assess what's left. Triad is the second-largest originator of manufactured-home loans in the U.S. It has portfolio sale agreements with third-party investors such as pension plans and insurance companies, so it earns origination and servicing fees without recourse to the underlying credit performance. A decent portion of the revenue is recurring and EBITDA margins are 50%-plus.

We believe the outlook for this type of lending is quite good. Manufactured-home shipments have been running at 40-50% below the trailing 30-year average in the U.S., but we think such homes have a key role to play in alleviating affordable-housing problems that are prevalent in the U.S. Triad is well-positioned to expand share in a still-fragmented market, where it's currently a market leader with only a 10% share. It also has a variety of new loan programs in the works that can drive incremental growth.

The Kessler business has recurring and transactional elements, but overall is levered to clients' desire to more profitably acquire and manage their credit-card portfolios. Kessler is quite profitable, earning 65% EBITDA margins, and here as well there are multiple growth initiatives just rolling out. One is a fee-based service to take over a small client's entire credit-card portfolio, from customer acquisition and credit decisioning to servicing. The company is also expanding into other verticals, helping telecom operators or student lenders, for example, improve their customer-acquisition effectiveness and profitability.

INVESTMENT SNAPSHOT

ECN Capital
(Toronto: ECN)

Business: Partners with clients on originating, securitizing and managing consumer credit, with focus on manufactured-housing-related loans and credit-card portfolios.

Share Information
(@9/29/21, Exchange Rate: $1 = C$1.27):

Price	**C$10.45**
52-Week Range	C$4.97 – C$11.97
Dividend Yield	1.1%
Market Cap	C$2.54 billion

Financials (TTM):

Revenue	C$284.6 million
Operating Profit Margin	21.9%
Net Profit Margin	2.3%

Valuation Metrics
(@9/29/21):

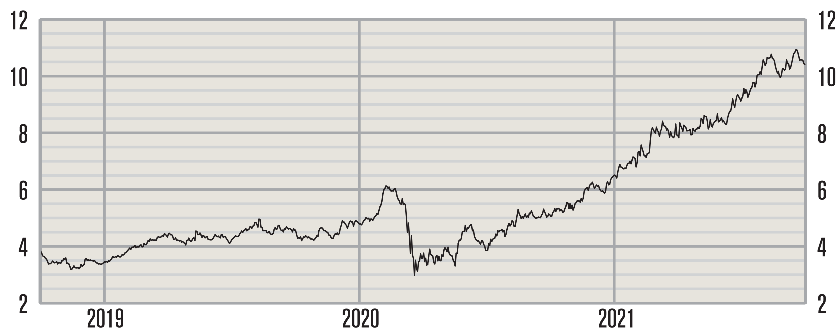
	ECN	S&P 500
P/E (TTM)	104.5	31.1
Forward P/E (Est.)	38.7	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
North Peak Capital Mgmt	12.8%
Private Capital Mgmt	2.7%
Invesco Adv	2.7%
Fidelity Mgmt & Research	1.4%
RBC Global Asset Mgmt	1.3%

Short Interest (as of 9/15/21):

Shares Short/Float	n/a



THE BOTTOM LINE

While the market seems nonplussed, Travis Cocke believes the company's recent agreement to sell a prized asset makes sense and illustrates its focus on maximizing value. Assigning a 20x P/E to the pro-forma company's expected 2021 EPS and adjusting for a coming C$7.50-per-share special dividend, the stock would double from today's price.

Sources: Company reports, other publicly available information

How are you looking at valuation with the shares now trading at around C$10.50?

TC: ECN announced it's going to pay a C$7.50 special dividend from the proceeds of the Service Finance sale after it closes. So you're essentially paying C$3 per share in the market for a pro-forma business that management expects to earn around 30 Canadian cents per share this year. I think they'll exceed that, but even at that level the shares trade at a 10x P/E.

First of all, we believe that P/E is way too low given the 30%-plus top-line growth and high-50% EBITDA margins for Kessler and Triad combined. Service Finance sold for the equivalent of around 23x earnings. Goldman Sachs earlier this month agreed to pay 23x estimated next-12-months EPS for Greensky, which is inferior in almost every way to Triad. So if you assume even 20x is reasonable for ECN – again, pro-forma for the special dividend – the stock would trade at C$6.

For that you'd still own a rapidly growing, high-margin business. Eventually there's a good chance that if they're successful in scaling the remaining businesses like they did Service Finance, they'll end up selling to the highest bidder and distributing the proceeds.

Describe the upside you see in telecom company Sierra Wireless [SWIR].

JH: Sierra has gone through a number of strategic pivots over the past 20 years, but we think today it's very well positioned as a provider of cellular-enabled Internet access. It offers each component of a vertically integrated solution – including chips, routers, connectivity and software – for in-the-field networked applications where Wi-Fi isn't a feasible or cost-effective op-

tion. One common example would be outfitting a fleet of vehicles, say, for a police force. Another might be providing access to the Internet through cellular connection for a widespread branch-office or retail network. There are also a number of Internet-of-Things-type applications, say connecting a network of power meters or electric charging stations.

We expect the big tailwind behind the business to be the ongoing rollout of 5G wireless in the United States and other developed markets. 5G enables high-speed and widespread data collection and transmission using low power sources, facilitating exactly the kind of mobile and/or distributed connectivity Sierra provides. We also think the company will benefit as the only scale provider in the U.S. of the modified silicon chips, called modules, that are critical in facilitating machine-to-machine communication in cellular networks. The biggest competitor in this market is a Chinese company called Quectel, which would be hurt if U.S. regulators continue to clamp down on Chinese technology in domestic telecom networks. If that comes to pass, it would almost certainly have a positive impact on Sierra's revenues and margins.

Sierra named a new CEO who took over in July. Is that a welcome change?

JH: We think so. If you benchmarked the performance of each piece of the company's business to direct competitors in that particular business, Sierra regularly came up wanting, That's a key reason an activist investor, Lion Point Capital, took a stake in the company in April of 2020 and started calling for change. That change began fundamentally with a reconstitution of the board and we think the naming of the new CEO, Phil Brace, is another positive step in that process. His charge is to more effectively balance operating efficiency with focused growth. We think there is a lot of cost that can be taken out of the business without sacrificing growth.

Now at just over $15, what upside do you see in the stock?

JH: Looking out a year we estimate in our base case that the company can generate roughly $650 million in revenue, 70% non-recurring and 30% recurring. We expect gross margins to increase from 35% to 40% and that $25 million can be taken out of annual operating costs. With those assumptions we estimate EBITDA at $105 million. If they deliver those numbers, we'd consider a 10x EV/EBITDA multiple to be reasonable, which would translate into a $28 target share price. There's plenty of potential upside beyond that, as we think the company can grow at least 10-15% annually over several years as 5G rolls out.

I should mention two important near-term risks here. Sierra in July had to shut down production at its primary manufacturing plant in Vietnam due to a Covid outbreak. It's also been facing the types of supply delays and shortages that are plaguing a number of manufacturers. While we don't consider even the combination of those a liquidity risk, if they drag on much beyond next quarter the company will be burning a material amount of cash. We don't believe that would change the fundamental story, but it would obviously set back the timetable for it to play out. VII

INVESTMENT SNAPSHOT

Sierra Wireless
(Nasdaq: SWIR)

Business: Provider of hardware, software and systems that enable cellular-network Internet access where Wi-Fi and/or hard-wired applications are not practically viable.

Share Information (@9/29/21):

Price	**15.05**
52-Week Range	10.45 – 22.22
Dividend Yield	0.0%
Market Cap	$575.7 million

Financials (TTM):

Revenue	$474.7 million
Operating Profit Margin	(-14.3%)
Net Profit Margin	(-10.7%)

Valuation Metrics
(@9/29/21):

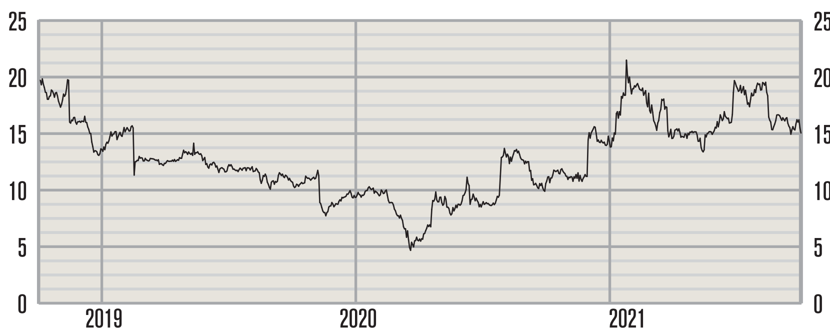
	SWIR	S&P 500
P/E (TTM)	n/a	31.1
Forward P/E (Est.)	68.4	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Trigran Inv	13.0%
Lion Point Capital	5.8%
Brandes Inv Partners	4.3%
Goldman Sachs	3.4%
Renaissance Tech	3.0%

Short Interest (as of 9/15/21):

Shares Short/Float	1.8%



THE BOTTOM LINE

Jon Hook believes a new board and CEO are bringing the operational and strategic focus the company needs to capitalize on the secular growth in its market. Applying a 10x EV/EBITDA multiple on his estimates a year out – which call for organic revenue growth, higher gross margins and lower operating costs – would result in a share price of $28.

Sources: Company reports, other publicly available information

Land of the Rising Discounts

The rally in small-cap value stocks that many developed and emerging markets have experienced over the past year has largely bypassed Japan. Therein lies opportunity, argue Rick Friedman and Drew Edwards of contrarian-minded GMO.

Money manager GMO is well known for its Asset Class Forecasts, in which it identifies the equity and fixed-income classes it expects to earn the highest real returns over the next seven years. Topping the most recent list: Japanese small-cap value stocks, for which it forecasts an annualized real return of 8.4%. For comparison, GMO expects U.S. large caps to deliver a comparable return of *negative* 6.6%.

The prospective appeal of small-cap stocks in Japan has two primary sources, says Rick Friedman of GMO's asset allocation team. One is straight valuation, as the global rally in small caps and in value over the past year have largely bypassed Japan. Small-cap value stocks normally trade at a 25% discount to the Japanese market, but as of the end of August that number was 45%. Driving upside as well is a secular improvement in corporate returns on capital, says Friedman: "Japan for decades has suffered from a combination of low profit levels and inefficient balance sheets. We believe that's changing for fundamental, structural and cultural reasons and that returns on the capital base in Japan will continue to move toward levels in other developed countries."

As a specific example of the type of opportunity GMO has been finding in Japan, Drew Edwards, who heads the firm's Usonian Japan Equity team, cites Jafco Group. Jafco is the country's largest venture capital firm, investing third-party capital in early-stage companies, typically earning a 2% annual management fee plus 20% of the profits on what is roughly $1.0 billion in outside capital today.

While the company's business model is quite straightforward, Edwards found some surprises on its balance sheet. Translating all into U.S. dollars, there is roughly $750 million in cash. There's a stake in former corporate sibling Nomura Research Institute [Tokyo: 4307], an IT services firm, also worth at today's market price close to $750 million. Finally, the company has another $750 million – not marked to market – representing its own capital invested in its venture capital funds. That's a total of $2.25 billion in asset value for a company whose current market cap is around $1.8 billion – and whose market value was closer to $1.0 billion when GMO started buying the shares in July of last year.

Edwards makes the case that almost none of those three balance sheet items should be there. "This business has almost no need to hold cash and if we wanted to own a stake in NRI or a Jafco venture capital fund, we could do that on our own," he says. "We like the economics of investment management firms, and that's what we want to own here." He says he's having constructive conversations on all fronts with management – they have already sold a portion of the NRI stake – but in the meantime he's content to hold Jafco shares at a material discount to obvious asset value while getting the core investment-management business and the potential upside in the internally owned venture capital holdings for free. VII

INVESTMENT SNAPSHOT

Jafco Group
(Tokyo: 8595)

Business: Japan-based asset manager investing clients' and its own capital primarily in early-stage venture capital opportunities.

Share Information
(@9/29/21, Exchange Rate: $1 = ¥111.9)

Price	**¥7,230**
52-Week Range	¥4,315 – ¥8,260
Dividend Yield	1.9%
Market Cap	¥198.58 billion

Financials (TTM):

Revenue	¥31.94 billion
Operating Profit Margin	64.7%
Net Profit Margin	150.2%

Valuation Metrics
(@9/29/21):

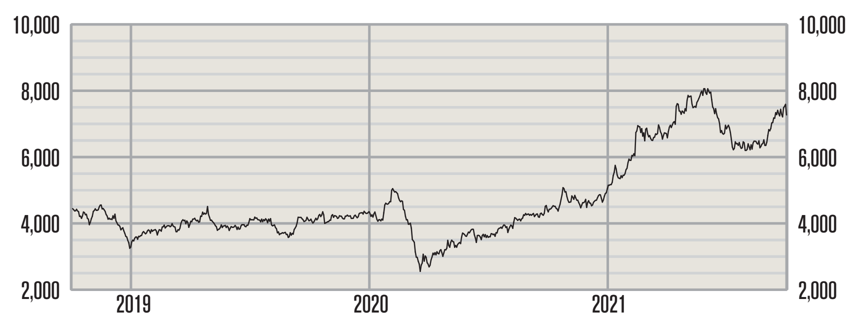
	8595	S&P 500
P/E (TTM)	4.5	31.1
Forward P/E (Est.)	n/a	22.0

Largest Institutional Owners
(@6/30/21 or latest filing):

Company	% Owned
Oasis Mgmt	6.3%
Asset Mgmt One	6.3%
Nesna LLP	6.0%

Short Interest (as of 9/15/20):

Shares Short/Float	n/a



THE BOTTOM LINE

As can happen in Japan, the company has three large and valuable assets on its balance sheet that don't need to be there, says Drew Edwards. Combined they're worth 125% of the current market cap, valuing the lucrative underlying business at less than zero.

Sources: Company reports, other publicly available information

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