

ValueWalk Interview With Amit
Wadhwaney Of Moerus Capital
Management, LLC

ValueWalk

ValueWalk Interview With Amit Wadhwaney

ValueWalk: To start off, could you give our readers a brief description of Moerus Capital Management and your background?

Amit Wadhwaney: We started Moerus Capital Management last September and the Moerus Global Value Fund was incepted in October. The fund is a limited partnership replicating what we did for a number of years earlier, while at Third Avenue.

Going onto my background, I spent roughly 20 years plus at Third Avenue, in two chunks, a five-plus year chunk and a 15-plus year chunk. This second chunk ran from about 1999 to 2014 and I used to run a number of things, mainly two vehicles run side by side with different portfolios. One of these was a limited partnership and the other was a mutual fund. The limited partnership invested in smaller companies around the world with an emerging market focus, while the mutual fund had to invest in larger companies with a developed market focus. But we weren't limited in terms of the markets that we could invest in around the world. We had the mandate to invest in both emerging and frontier markets.

What we are trying to do at Moerus Capital is a combination of our previous experience in one investment vehicle. The way we approach investing is from a value perspective. Now, let me just clarify here. There are many different types of value investors out there from the statistical screeners, whose portfolios hold many different companies to the new, new style value investors who follow a contingent value style with a highly concentrated portfolio – a style popularised in the early 2000s. We are more at the old fashioned end of the scale but we don't use statistical screens and we don't fill the portfolio with very many different investments. We like to buy individual businesses very cheaply using a valuation process that focuses on the business value of the individual security.

Of course, here we need to clarify what cheapness is because cheapness means different things to different people. Typically, our approach to assessing the cheapness of a given company tends to revolve around assessing it in the here and now, which means the balance sheet features heavily in our analysis, more so than the income statement. When you base your analysis on the income statement, it generally requires you to make some guesses about future economic performance and we tend to be averse to doing that. We simply don't have a macroeconomic crystal ball with which to forecast future trends, so we don't try.

That being said, when we are trying to value a company we do consider the macro environment. Specifically, we look at how different macro factors have helped the company over the years and how changing macro conditions could help or hinder the company going forward. So, we do consider macro factors in our analysis to a certain degree, but we don't engage in macro forecasting. We like to focus much more on what we know in the here and now. We also tend to be much more conservative in our valuations than our peers. We tend to think in terms of liquidation values as though the company fails as a going concern, or to put it another way, we try and work out if something were to go wrong, how much would the business be worth if it were dead, rather than alive.

This approach has really helped us achieve reasonable returns over long periods – it's certainly helped us avoid a lot of great blowups.

When we think about risk, we are thinking about the risk of permanent impairment of capital, not the day-to-day fluctuations of the stock price. We are really concerned about whether there are any factors, internal or external to the business that might permanently impair the business, and by implication, its long-term value. There are a number of internal factors that could permanently change the outlook for the company in question and present a risk of permanent capital impairment. To list a few, a bad balance sheet, poor management or an unsustainable business model are risks that we attempt to avoid. External risk factors to be watchful of can include unusual exposure to government regulation or to an industry that has low barriers to entry for newcomers.

I just want to dig a little bit more into your valuation process here. In your first letter to investors, a copy of which was published on ValueWalk, and in your answer above, you state that you shy away from any valuation models that rely on cash flows, such as the DCF model. So could you explain why this is the case and why you prefer asset-based valuation models over cash flows?

Well, let me use an example to explain how we think about valuing assets or businesses. With the DCF model two numbers are critical, the numerator and the denominator, and in order to decide on each of them, you have to make several assumptions. We believe that the fewer assumptions you need to make, the more robust your valuation model will be, and the less fraught with valuation risks.

Different methodologies will give you vastly different valuations for the same security. For example, in 2002 it was the third year of the tech downturn, which gives you some kind of context of the environment we were in. An opportunity presented itself as the large financial institutions began to retreat from Stockholm. Now, why Stockholm? Well, throughout the tech bubble Ericsson became a very important company on Stockholm's stock exchange. Ericsson's shares fell when the bubble deflated, dragging down the rest of the market. But Helsinki Exchange had had a bigger problem in the form of Nokia. As the tech bubble deflated, the valuations of these companies declined, pulling the rest of their respective markets down with them.

Financial firms in Sweden and Finland were hit hard by this change in sentiment. This led to an opportunity in D. Carnegie & Co, one of the largest securities brokers, asset managers and investment banks in Norway, Finland, Sweden and Denmark. It was a very big player in each of those segments in each of the markets.

The company had a very flexible cost structure and a relatively clean balance sheet. A big unknown was how long would the economic or financial downturn last? So, any valuation methodology for the shares of Carnegie would have to be robust under extended periods of uncertainty. We set about valuing the three key parts of the business. The first part was the brokerage business. Here we made the assumption that if the bear market were to continue, trading volumes would slowly evaporate over time and staff would leave the company, as talent in the financial industry is highly mobile. If this scenario were to play out, then we assessed that this business would be worth its tangible book value. That was how we valued the brokerage business on its tangible net asset value alone with no regard to prospective earnings.

Then came the investment banking business. This is quite a hard business to place a valuation on because the people that work in this division tend to be extremely profitable, making sizable profit contributions in good times, but expensive to retain in bad times. These employees were also highly mobile. So, we thought, what would people like this be worth in a protracted bear market? We arrived at the controversial assumption that this business had the potential of being worth zero in a protracted bear market.

And then we had the third part of the business: asset management. Carnegie had a fairly sizeable asset management arm and ran a number of mutual funds throughout the Nordic countries. What's more, the group had recently acquired two smaller asset managers for around 2% of assets under management. Mutual funds suffer attrition through withdrawals in a protracted bear market, so this is something we had to factor in. We thought a multiple of 2% of assets under management is a fair way to value the asset management arm but we shaved the number down a bit to 1% to 1.5% of assets under management.

If you put all together, our valuation looked like this: we had the brokerage business at tangible book, the investment bank at zero, and the asset management business valued at 1.5% of assets under management. We came up with a bedrock valuation of 40 to 45 Swedish krona per share.

We waited a few months for the stock to come down into the 30s so we could start nibbling and building a position. After a few months of this, brokerage firm Cazenove came out with a research note on Carnegie and it turns out Cazenove had a much better crystal ball than mine. They used a DCF methodology. They expected the market to bottom in 2002 and start to improve during 2003 and 2004. Carnegie operated in businesses which had very high operating leverage. As soon as markets started to improve, the brokerage business, investment banking and asset management would do better. By assuming that the market would bottom in 2002, Cazenove concluded that Carnegie's equity was worth 135 Swedish krona per share. This is a great example of how one little number in your valuation methodology can completely change the valuation you arrive at.

I'd like to dig a little deeper into your investment process here. There are two main questions I'd like to ask, firstly how do you go about finding the ideas? And secondly what kind of margin of safety or discount to your estimate of intrinsic value do you look for before beginning to buy into a new position?

I'll tackle the second part of that question first. With the regard to the margin of safety, it really depends on the opportunity in question. When I look at a business obviously I see different types of businesses and each different type of business comes with a different level of risk. You have businesses that are relatively capital intensive, businesses that may need huge amounts of capital spending to continue operating, businesses in industries that are fragmented and businesses in industries that are cyclical. When these kind of companies appear on our radar, we expect much bigger discounts than we usually would, quite simply because there is a greater risk attached to these companies. So we estimate the value much more conservatively and look for a wider discount. Conversely, with capital-light, less-cyclical businesses in more concentrated industries, we are okay with a smaller discount.

Is there a specific discount you look for?

Not really. In the past we've bought at discounts of 30%, 40% and even 60% -- actually that one turned out to be by accident. I thought I was buying at a 40% discount and it turned out to be 60%.

On the other hand, if you take a company like Carnegie it was clear the business was operating in a consolidated industry, they were making money, and so there was limited risk that the business might go under. Here you could get away with buying at a discount of 20% to 30% to the very conservatively estimated Net Asset Value. But really we tend to look at it from the point of view of what sort of discount would make sense for us. We also think about our buying behaviour; we like to buy more as the price falls. The first and second tranches, are the least price sensitive so when we've bought these we hope prices decline further so that we can add to our position. The next tranches are more price sensitive because with these purchases the position size starts to get larger. So that's how we think about both the discount to intrinsic value and how we implement a position.

On to the question of where do these ideas come from? Well, I think it would be easier to say first of all what we do not do. We do not use screens. The problem with having statistical screens is that these screens are based on historic accounting figures, and they obscure as much as they illuminate.

For example, in the mid-2000s we were looking at zinc mining companies. Zinc prices were going through a protracted downturn and many miners were haemorrhaging cash. Accounting practices required that these miners wrote the value of their mines down to whatever people thought their economic value to be. Now, your estimates of what something is worth, the economic value, is based on recent experience, and recent experience dictated that zinc production was worth almost nothing. As a result, miners were forced to write down the value of gigantic zinc mines to virtually zero. Was this really an accurate reflection of how much these mines were worth? I would have argued that it is not an accurate reflection of the value of the mines because at some point, if the protracted period of low prices continued, the lack of exploration and capital

spending in the industry, coupled with the consumption of above ground inventories would lead to higher prices. If this scenario did indeed take place, would the mines still be worth nothing? Of course not, the mines would suddenly become wildly cash generative in relation to the depressed valuations of the mines as carried on the balance sheets, which is exactly what happened a few years later.

The other reason why we don't like screens is because the accounting figures represent a business and an industry at a certain point in time. The problem with this is that when an industry is going through a period of extreme stress, the industry structure starts to change. Companies close down, companies may merge, and companies may get acquired, changing the profit dynamics of an industry. If you look at historic accounting numbers, they really give you no idea of how these structural changes might unfold.

So that's what we don't do. What we do is we keep a lookout for individual businesses and collections of assets that we can buy at a deep discount to intrinsic value. Various scenarios have presented us with these opportunities. For example, we could have an individual company slipping on a banana peel, presenting us with an opportunity. To give an example, a number of years ago Skandia, the large Swedish company was having problems in the United States. They also slipped in Sweden where they gave the senior management extremely luxurious apartments in the centre of Stockholm for very little, sparking public outrage and a loss in market share in that country, where they were the leader.

The world seemed to be falling apart for the company but none of the problems affecting the group were life-threatening. They still had a number of excellent businesses around the world. This was an opportunity that came about due to a company specific mishap.

We also find opportunities in industrywide downturns. You can always find industries that are going through periods of stress. For example, right now you've got the mining and oil and gas industries.

The third way we look for opportunities is in the midst of some kind of financial market mishap, such as the financial crisis, Eurozone crisis, Asian crisis or the Tequila crisis.

And the fourth way we find opportunities is by digging into complex corporate structures, which often mask value. People tend to shy away from these companies and corporate structures, which often leads to some great opportunities.

As an international value fund, you can invest anywhere in the world but are there any regions that you specifically want to avoid?

Ultimately, we invest in individual companies so we're more concerned about things going wrong at the company level. We don't really pick and choose regions. Even if you're in a wonderful part of the world there are still many companies that we would avoid. We have had our share of hiccups in countries that are very, very safe and investor friendly.

For example, a great country for investing is Norway. However, in the late 2000s the country, for whatever reason, decided it was going to change the tax regime for the shipping industry and as a *quid pro quo* for this change, companies had to pay substantial amounts of back tax. So, the shipping companies, most of which already had a large amount of debt on their balance sheets, were suddenly hit with this huge liability. This reduced shareholder equity across the sector and suddenly industry debt-to-equity ratios spiked, leading to bankruptcies and near bankruptcies across the region. This is a great example showing that even the most stable regions in the world can be extremely unpredictable.

It is really difficult to try and say exactly where we will and won't invest. Even in countries like Singapore which has a relatively developed legal code, entirely unexpected situations can develop. There are plenty of regions where it's not easy to invest but I would never say I would definitely not invest there. Indonesia and Russia for example, both are difficult places to invest but we've had great experiences in Russia over the years. And of course there are issues regarding accounting standards in China which present challenges.

One thing you can't protect against is outright fraud. That can happen anywhere. It's happened to us earlier when we were invested in a very large U.K. company called Cable & Wireless. In the early 2000s, after the tech bubble had burst, we became interested in buying attractively valued telecom assets. Cable & Wireless had what looked to be a very strong balance sheet with a sizable cash balance as well as some mature telecoms businesses that were throwing off cash. By valuing these mature businesses at around 3 to 4 times earnings and discounting some of the more foolish acquisitions the company had made over the years (shareholders were demanding that many of these businesses were closed down within two years) as well as the cash, we arrived at our valuation. After arriving at a valuation we waited around a year for the price to come down to a level at which we were comfortable buying. Then, sometime after we'd started buying, the company's credit rating was downgraded due to concerns about the effect the loss-making businesses owned by the group were having on the overall business. Initially, we thought this downgrade was a good thing as the company might be motivated to sell some of these loss-making businesses. Then, it emerged that because Cable & Wireless had lost its investment-grade credit rating, they had to post collateral of, I think it was around £750 million, against a potential tax liability for one of their acquisitions. Suddenly, this huge chunk of cash disappeared off the balance sheet, with no obvious path or timetable for its return. We asked ourselves how did this happen? Cable & Wireless is listed in both the UK and US, two regions with impressive legal and financial regulations. But the company had not disclosed this liability in any of the financial documents filed with regulators. We asked the company why, and they said because it wasn't an actual liability, only a contingent liability..... So yes you can get burned in any region around the world.

You mentioned earlier that while you would be happy to invest in China, this is one region that is well-known for its financial frauds. Are there any investments you own in the country or region at the moment?

Right now we have a couple of investments in the region, one is Hong Kong listed and the other one is Singapore listed. One of the companies is called Sino Land, which is Hong Kong listed and has real estate in both Hong Kong and Mainland China. The company has both investment and development properties. The investment properties are totally in Hong Kong and the inventory of development properties is in both Hong Kong and Mainland China.

We were attracted to this company because it is selling down its development property portfolio in China and these sales have translated into cash. More than 20% of the company's assets are now cash. So this is one company that's Hong Kong listed with Chinese exposure.

The other company we own in the region is a Singapore listed company called Global Logistics Properties, the largest operator of logistics properties in Asia and the third largest in the world. The company has an enormous portfolio of logistics properties in China, Japan and Brazil. Once again, there is no guarantee that this will or won't turn out to be a profitable investment, but this appears to be one of the cleaner ways of investing in China. Concerns about China's economic growth have knocked the stock hard, allowing us to get in at a reasonable price.

When you find an idea you like, how do you weight it in your portfolio, do you tend to run a highly concentrated or well diversified portfolio?

Well, at any given point in time there are going to be several countries and sectors that are more interesting than others. So, there's going to be some degree of clustering of holdings by geography or industry in the portfolio. Given the amount of time we spend researching each idea, and the length of time we plan on holding each investment for -- many years -- we prefer to concentrate our investments. Ideally, thinking about our portfolio, we will typically have around 25 to 30 core positions, things we want own for long periods of time. Ideally, the smallest position size would be around 2.5%.

What would be your maximum position size?

We've gone up to the high single digits. I think the fund is permitted to go up to 10% in any single investment. We tend to be more concentrated than most of our peers.

Historically, the portfolios I managed had a turnover of around 10% to 20% per annum, and in some years we didn't sell anything. We had an average holding period of around six years. Ideally, the holding period at Moerus Capital will be around three to five years. The reason for this has a lot to do with the kind of things we buy. A lot of the things we buy tend to be very cheap for a reason, a reason which generally tends to dissipate over time. And if you buy something at a severely depressed price, you get the benefits of compounding over time.

Looking at the markets right now, are you still finding bargains in this environment or have you decided to take a step back from buying for the time being?

Moerus Capital has only really just started, and the way we think about our strategy is to put our assets into two buckets. You have the riskless bucket called cash, and the other risk bucket is your investments. We are happy to buy things at prices which we believe are attractive despite wider market volatility. Conversely, if there's nothing trading at the prices we want, we will sit back and do nothing. We are permitted by our mandate to hold good quantities of cash in the absence of sufficiently attractive opportunities. We are not those people who are fully invested all the time with just a scattering of cash. However, we will not hesitate to deploy cash aggressively if opportunities appear. By way of example, coming up to 9/11 we had around 25% to 30% of our portfolio in cash. After the markets reopened following 9/11, the subsequent declines presented us with plenty of opportunities and within around three weeks we were down to just 3% cash.

Right now we have slightly more than 50% of our assets in cash, and we continue to buy steadily. There are currently 15 or 16 investments in our portfolio and we are looking to buy a number of other securities in the near future assuming prices cooperate.

I think we're out of time but thank you very much for those comprehensive answers.

Thank you, it was a pleasure.

Disclosures

Past performance is not indicative of future returns. This information should not be used as a general guide to investing or as a source of any specific investment recommendations, and makes no implied or expressed recommendations concerning the manner in which an account should or would be handled, as appropriate investment strategies depend upon specific investment guidelines and objectives.

Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. This document contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized investment advice.

The views expressed here are the current opinions of the author and not necessarily those of ValueWalk. The author's opinions are subject to change without notice.

There is no guarantee that the views and opinions expressed in this document will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. No representations, expressed or implied, are made as to the accuracy or completeness of such statements, estimates or projections, or with respect to any other materials herein.

Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security, and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable.

No part of this material may be copied, photocopied, or duplicated in any form, by any means, or redistributed without ValueWalk's prior written consent.