Asset-Based Investing in an Earnings-Focused World

January 2016

Introduction

Happy New Year! In this, our first memo of 2016, we will discuss the following:

- A brief refresher on the asset-based investment approach that we implement at Moerus.
- Implications of the approach – which types of investments result from it, and why.
- Real-world examples of attractive asset-based investment opportunities from the past.

Revisiting Our Approach

In our previous memo, "Moerus Capital: An Introduction," we tried to provide a brief introduction to our investment approach. For those who are interested in reading more, we invite you to take a look at that more detailed memo.

To very briefly recap in a few words here, we employ a fundamental, bottom-up investment process, with the goal of investing in assets and businesses at prices representing significant discounts to our estimates of intrinsic value, all the while placing heavy emphasis upon risk avoidance and mitigation. Importantly, the risk that we seek to mitigate is not short-term share price volatility, but rather the risk of a permanent loss of capital. In fact, we embrace short-term share price volatility as a provider of periodic opportunities to invest in what we believe are high-quality assets or businesses at bargain prices. We believe that buying as cheaply as possible is critical both to risk mitigation as well as to the potential generation of attractive long-term returns.

In striving to buy as cheaply as possible, we estimate intrinsic value using very conservative estimates that weigh a company's balance sheet and what is known today much more heavily than projections of future earnings and cash flow, which may or (may not) materialize. In other words, as a general rule of thumb, we try to buy shares of businesses at sizeable discounts to what we think that they would be worth if they sold their assets today, using conservative assumptions. The asset-based investment approach that we follow at Moerus stands in contrast to the approach of many in the investment community who tend to focus more heavily on earnings and cash flows.

Our estimates of a company's intrinsic value generally do not heavily weigh forecasts of cash flows years into the future, simply because we believe the future is notoriously, inherently difficult to predict. We are not willing to "pay up" for businesses at prices that would only be attractive under optimistic assumptions of continued prosperity years into the future. By contrast, we believe that a conservative, asset-based valuation methodology often yields a "bedrock" (lower-bound) valuation, and that buying at a steep discount to such a bedrock valuation provides a cushion that not only provides downside protection, but also offers meaningful upside potential in the event of favorable future outcomes, which typically aren't "priced in" to the stock at such beaten down levels.

Implications of the Asset-Based Approach
Our approach to investing has several noteworthy implications regarding which type of situations tend to find their way into the portfolio, and why.

What's the catch?
At Moerus, we search for high-quality, long-term investment opportunities which are available at attractive prices relative to what we believe their net assets are worth today – without attributing any value whatsoever to forecasts of earnings or cash flows, visions of the future which are far too often seen through rose-colored glasses. One implication of our approach is that, at the risk of stating the obvious, such opportunities do not come easily or often – alas, there is usually "a catch," or something "wrong" which drives pricing down to the unusually attractive levels which pique our interest. As detailed in our previous memo, common examples of what might be "wrong" include, among others, a challenging short-term outlook facing a company's relevant industry or geography, or a company-specific misstep or hiccup that results in share price declines.

For traders and investors with very short time horizons, near-term uncertainty and turmoil might rule out any such investment. But our long-term focus allows us to look past temporary rough patches that render a company, industry or geographic market out of favor in the broader market as they often prove to be interesting sources of longer-term investment opportunity, provided that the turmoil is indeed temporary, and the potential investment has the staying power and wherewithal to survive tumultuous times and thrive if, as and when the situation normalizes.

Unappreciated, Misunderstood, or Event-Driven
In addition to situations involving short-term (but temporary) turmoil, asset-based investing has also often led us in the direction of two other scenarios that sometimes lead to atypically attractive investment opportunities. First, companies that are underappreciated, underfollowed, complex and/or misunderstood occasionally provide interesting opportunities, in part because fewer eyes are examining and recognizing the value that may (or may not) be present within the business in question. Second, opportunity periodically can be found in situations in which there is hidden value that could potentially be unlocked through event-driven scenarios; examples of these include liquidations, corporate reorganizations, mergers and acquisitions, and changes in industry or shareholder structure, among others. While we touched on these concepts in our prior memo, later on we will provide two real-world examples of companies which we hope will better illustrate how and why event-driven opportunities of this nature become available from time to time.

Deep Value and Emerging/Frontier Markets: Compatible…at Times
Another implication of our asset-based investment approach is that while opportunities to implement it in emerging and frontier markets are apt to be sporadic and infrequent, occasionally compelling balance sheet-based investments can and do become available at attractive prices in even these markets, which traditionally have not been considered a welcoming destination for deep value investors. Notwithstanding the bloodletting currently taking place in many emerging and frontier markets, in general these markets have historically appealed to growth investors due to their attractive growth potential relative to that offered by more mature markets. Simply put, many investors have historically been willing to pay up for the future – in the form of expected future growth – in emerging and frontier markets, whereas at Moerus we look for bargains here and now, based on our estimates of the net assets on the balance sheet today. Partly as a result of this dichotomy, the predominance of investors who are willing to pay for projected future earnings growth in emerging markets has, in our view, *generally* translated into less frequent opportunities for the asset-based value investor such as Moerus.

However, the very fact that these markets are heavily populated by growth investors provides us, from time to time, with intriguing investments that fit our approach. Examples of situations that could create such opportunities include the following:

- Quarterly earnings disappointments, or revenue growth figures that fall short of what had heretofore been lofty expectations – the kind that are typical of many emerging market securities during the good times – might result in growth investors heading for the exits, leading to a plunging stock price. For example, Company ABC might produce earnings per share growth of 5% – not spectacular, but certainly respectable – yet still see its share price punished, if shares had previously been priced based on expectations of, say, 15% annual EPS growth. In that sense, temporary slowdowns, setbacks, and disappointments occasionally offer opportunities to invest at reduced prices in companies that are usually well-loved, and consequently rarely marked down except when inflated hopes are dashed.

- Broader macroeconomic slowdowns and turmoil could be particularly punishing to investors in emerging markets given the growth bent of many who typically invest there. For example, many Brazilian stocks, which only a few years ago had lofty growth expectations baked into their shares, have since seen their share prices decimated as Brazil has subsequently descended into an economic recession and political turmoil. Heavenly expectations – the kind that are typically heaped upon market darlings and "the next big growth stories" – leave investors vulnerable to adverse shocks which could yank sentiment back to Earth in a steep, rapid descent. Amid the ensuing rubble, even previously well-loved gems can sometimes become available at compelling prices.

A final important point to make on this subject is that share price declines in emerging and frontier markets could be and often are <u>exacerbated by the relative illiquidity of many of these markets</u>. When investors flee illiquid markets, dramatic share price declines could result, potentially turning a stock that used to trade at a sky-high valuation a year or two ago into a bargain today. In sum, the main point which we'd like to make clear is that although emerging and frontier markets have traditionally been considered the preserve of the more adventurous, growth-oriented investor, we believe that <u>compelling asset-based, deep value investment opportunities periodically can and do become available there, albeit perhaps more sporadically than in developed markets</u>.

<u>Patience</u>
We think that it's worth reiterating the point that we made in our previous memo, that given the nature of these sources of opportunity, <u>patience is indeed a virtue when it comes to implementing an asset-based investment approach</u>. Patience is needed to hold cash in the absence of attractive pricing and wait for quality investments to become available at truly modest prices. Once a promising long-term investment becomes available at a price that is cheap enough, patience is often required to hold (or add to) the investment, as the poor near-term conditions that contributed to the deep discount continue to run their course. Of course, patience must go along with and be backed by conviction – developed through research, analysis, and considerable reflection – that such a prospective investment has the <u>staying power</u> (financial, operational and otherwise) to navigate its way through temporary difficulties until its underlying value is ultimately realized.

Asset-Based Investing: Examples

Not for the Fashionable
The asset-based investment approach requires patience because investment opportunities available at the type of valuations we seek do not make themselves available frequently, and when they do, it is usually at a point in time in which the assets in question are underappreciated and/or out of favor. Attractive value investments, particularly those at the deep discounts to conservative intrinsic value estimates that we require, are not available whenever they are "in fashion." In that sense, we often find ourselves looking for bargains in some of the most far-flung or "out-of-fashion" places, to which many others in the investment community for various reasons are biased against venturing. Importantly, the "far-flung places" in which we often find ourselves are not always specific *geographic* locations, but also include *classes of companies* that, for any of a host of possible reasons, by and large fall under the radar of many analysts and investors who are more earnings-based.

One such class of companies is made up of those which, at some point, execute a sale of their principal operating business (and thus their principal source of earnings), thereby becoming cashed-up in the process, but often also falling off the radar of many earnings growth-oriented analysts and investors as a result of the sale. While infrequent and sporadic, in select cases "falling off the radar" could contribute to such a dramatic effect on a company's stock price that the business could become available at a meaningful discount to the current value of its primarily liquid net assets. This may (or may not) provide genuine opportunity, as we will discuss shortly. **To be clear, neither of the following is or has ever been a Moerus investment**, but in hoping to better illustrate the risks and attractions that such an event-driven situation might periodically provide, we point to two historical examples of companies that sold their primary operating businesses:

- Risk Capital Holdings, Inc. ("RCHI"), a U.S.-listed reinsurance holding company, which sold its operating subsidiary (Risk Capital Re) to Folksamerica Reinsurance Company in 2000.

- Piramal Enterprises Ltd. ("Piramal"), an India-listed business development company, which sold its generics pharmaceutical business to Abbott Laboratories in 2010.

Common Threads
These two companies, different as they are, shared several common features:

- Each company sold its principal business on very favorable terms, realizing significant cash proceeds and (in the case of RCHI) offloading meaningful liabilities.

- Yet in each case, analysts who had been covering the company dropped research coverage after the transaction.

- In each case, the sale of the principal operating business left little to no forward earnings visibility, as well as no obvious earnings growth for analysts to point to, forecast, and model.

- Further, the little to no meaningful recurring earnings going forward in the case of each resulted in a stratospheric P/E ratio[1] (since there was no "E") and in virtually no ROE[2] (with no earnings to make up the numerator) – two basic statistics that are closely followed by many earnings-focused investors.

- As a result, subsequent to the sales of their respective businesses, these two companies presumably "screened badly," or did not rank highly on the quantitative screens of investors searching for, among other statistics, low P/Es and high ROEs.

- Each company was (and still is, in our opinion) controlled by committed, competent owners and/or management, with long-term track records of growing shareholder value (through both operations and thoughtfully timed deal-making), and with significant skin in the game via equity ownership.

- With the well-timed sales of their respective primary operating businesses, both companies monetized their assets in impressive fashion, leaving behind very strong, liquid balance sheets. Piramal's sale of its generics business to Abbott was priced at a whopping 30 times EBITDA[3], while in the case of RCHI, the sale of its operating subsidiary left the company with a large pool of liquid assets and few encumbrances.

- Subsequent to the asset sales, opportunities became available to invest in each business at a material discount to reported book value, much of which, importantly, was attributable to <u>cash and other liquid financial assets</u>.

<u>*"Killing" the Messenger…Who Brought Great News*</u>
In sum, in both of these cases, the asset sales were clearly positive events for the companies, given that they were completed on attractive terms and left both companies with massively liquid balance sheets in the hands of owners who were proven in creating value. However, somewhat paradoxically, these <u>impressively value-realizing transactions</u> were greeted by many analysts and investors with a response that could be characterized as anything from <u>indifference to skepticism to outright negativity</u>. Why?

- Many sell-side research analysts dropped coverage, we suspect because the companies no longer neatly fit into the specific industries in which the analysts specialize, and because the companies, post-sale, no longer produced recurring earnings from continuing operations of the kind that analysts could easily forecast and model in a straight-forward manner.

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[1] The Price-to-Earnings (or P/E) ratio is a commonly used measure of a company's valuation in the stock market, and is calculated as: Share price / Earnings per share.
[2] Return on Equity (or ROE) is a commonly used measure of a corporation's profitability, and is calculated as: Net income / Shareholders' Equity.
[3] Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) is a measure of operating cash flow that is commonly used in the financial and analytical community.

- Many earnings and growth-based investors – which we suspect make up the majority of players in most markets, especially in emerging and frontier markets – also likely lost interest, given the absence of recurring and growing earnings from continuing operations.

- Additionally, investors who generate ideas by screening quantitative, earnings/cash flow-based variables such as P/E, ROE, price-to-cash flow, *et al.*, likely would not have identified these opportunities through screening alone.

- The transactions essentially eliminated recurring earnings while raising cash. In our experience, we have found that <u>the value of the optionality that cash provides is often significantly underappreciated by the market</u> as compared to metrics relating to ongoing operations (such as P/Es and ROEs). This is even, at times, the case when such cash is in the hands of skilled and proven management teams. <u>This phenomenon is counterintuitive to us given our view that cash is a much sounder component of intrinsic value than is an assumption-laden estimate of cash flows to be generated for years into the future</u>.

Situations like these – in which there is a clear discrepancy between unambiguously positive events from the standpoint of <u>economic reality</u> on one hand, and the <u>recognition</u> and <u>appreciation (or lack thereof)</u> that those transactions receive in the <u>public securities markets</u> on the other hand – are often sources of great long-term opportunity. <u>Unusual bargains can sometimes be found in corners where many market participants are biased against looking</u>. In these examples, both companies, although they became substantially liquid after the asset sales, for reasons such as those listed above ceased to fall within the parameters of attractiveness for many in the investment community. Such situations, in our opinion, often provide opportunities.

<u>Subsequent Events</u>
The results? After the sales of their respective operating businesses, each company, in our view, reasonably and thoughtfully redeployed the sales proceeds into new investments.

- RCHI raised capital from strategic partners amid a tightening insurance market, brought aboard two new underwriting teams (the first in reinsurance and the second in insurance), and reconstructed a new (re)insurance operating business under the company now known as Arch Capital Group Ltd., which in our opinion has been very successfully run ever since.

- Piramal reinvested the proceeds from the sale of its generic pharmaceutical business in numerous areas, including pharmaceutical services, financial services, and real estate. In the process, they built a stable of new businesses that today generate almost US$1 billion in sales annually.

Investors who took advantage of the opportunity to invest in these companies at the unusually modest prices that had prevailed in the market after the asset sales have, in our opinion, been well rewarded as, over time, the share prices of both Arch Capital Group (ACGL) and Piramal (PIEL IN) have, in our view, come to reflect the substantial value creation at the corporate level that we believe has been generated by the reinvestment of the proceeds raised from the asset sales.

Caveats and Concerns
Again, neither RCHI/Arch Capital nor Piramal is or ever has been a Moerus investment; we only bring up each case in the hope of better explaining a specific type of special situation that sometimes offers opportunity. An obvious point that we'd like to nevertheless emphasize clearly is that, while investments made in RCHI/Arch Capital and Piramal – following the sales of their respective principal operating businesses – have since performed well, clearly there must be many other cases of companies that sold a significant chunk of their assets, which did not subsequently perform well at all. As in all industries, geographic markets, indices, and investment portfolios that bear risk, this "class" of companies – those which have sold their primary business(es) – has had its share of both glowing successes as well as catastrophic failures over the years. A company that builds cash on its balance sheet by selling its main assets might offer an intriguing investment opportunity over the years that follow the transaction, but on the other hand, in many other cases such a transaction raises a host of red flags that must be identified in order to avoid impending investment disappointment, if not disaster. And this specific class of companies, in general, brings with it a lot of baggage in the form of issues that must be thoroughly considered and vetted before daring to invest. To that point, in our view there are a couple of very significant issues (among others) surrounding this specific group.

First, when a company sells its principal operating business, we cannot overstate the degree of uncertainty that such a transaction adds to a company which had previously compiled a history of operating results, a history which many investors use to anchor their future expectations. Uncertainty abounds regarding a number of issues, including the loss of recurring income (the question of, "Where to from here?"), the eventual use of the sales proceeds, and the timing and nature of the potential payoff from the investment.

Additionally, investors in companies with cashed-up balance sheets, in which much of the value is attributable to cash and liquid assets, are inherently heavily reliant upon the management team and/or controlling shareholders for prudent decision-making in order to generate a successful investment outcome. We cannot overemphasize the importance of a thorough assessment of the management team and/or controlling shareholders – of any company, truthfully – but even more so in situations in which a large pile of unencumbered, liquid capital sits at the discretion of a company's decision-makers. A strong, liquid balance sheet can easily be squandered if the management/owners put their own interests ahead of those of other shareholders, or if they damage asset value through poor strategic decision-making (even when well-intentioned). Assessing and appraising management is another topic that deserves much more attention than it is getting here, and we will likely elaborate much further on these thoughts in a future memo.

Suffice to say, these are major concerns that must be very carefully considered prior to making any investment decision. In many cases, such issues can and do cause us to pass on otherwise interesting investment propositions. But uncertainty often brings opportunity with it, and if we are able to gain comfort in our appraisal of management's skill, ability to create value over time, and integrity, such situations can occasionally offer compelling investment propositions.

Summary Conclusions

- The deep value, asset-based investment approach that we apply stands in stark contrast to those of many/most investors who tend to be heavily earnings-focused.

- We believe that buying at a substantial discount to a bedrock valuation, one which is estimated using a highly conservative, asset-based methodology, provides downside risk mitigation while also offering attractive upside potential, since favorable scenarios typically are not priced in at such depressed levels.

- Attractive investment opportunities that become available at sizeable discounts to conservatively estimated, balance sheet-based intrinsic values are unusual. Typically, there must be "a catch," or something "wrong" that has created bargain pricing.

- Common "catches" include short-term turmoil affecting a company, industry or geography, a situation that is complex or underappreciated, neglected, or misunderstood by the broader market, or event-driven scenarios which cause a business to become "unfashionable" in the minds of most market players.

- Although sporadic, compelling asset-based value investments can and do become available even in emerging and frontier markets, which have traditionally been considered the stomping grounds of growth investors.

- Companies which have sold their principal operating business(es), thereby cashing-up but losing the attention of heavily earnings-focused analysts and investors, represent one class of "unfashionable" companies that have historically offered compelling asset-based investment opportunities from time to time.

- However, a company's sale of its primary operating business adds significant uncertainty regarding the loss of recurring income, the eventual use of sales proceeds, and the timing and nature of any potential payoff.

- Further, the ability and willingness (or lack thereof) of management to redeploy the proceeds prudently and profitably, in the best interest of all shareholders, is critical to the ultimate success or failure of any such investment. As a result, a thorough assessment and appraisal of management is critical to the due diligence process.

- Unusual bargains can sometimes be found in corners where, in our opinion, many market participants are biased against looking. Asset-based investment opportunities, in the form of companies that create value by means other than recurring earnings from continuing operations, are at times neglected in an earnings-focused world.

Many thanks – as always, your interest and curiosity are very much appreciated! For those interested in learning more about us, we invite you to visit our website at www.moeruscap.com or to follow us on LinkedIn.

Best wishes to all for a happy, healthy and prosperous 2016!

Sincerely,

Amit Wadhwaney, Portfolio Manager and Founding Partner

Michael Campagna, Research Analyst and Founding Partner

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