Corporate Activity as a Driver of Value Creation

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With the notable exception of 2022, it could be argued that the better part of the past decade has generally been a challenging period (at least in a relative sense) for those who follow Value-oriented, price-conscious investment strategies that invest based upon corporate fundamentals, such as the one we employ at Moerus. The latest reminder of this was in 2023, a year in which the highly concentrated, top-heavy nature of benchmark performance was again dominated by mega-cap Growth stocks that already had been trading at what, in our view, were quite gaudy valuations (e.g., "the Magnificent Seven"). Further, the recent euphoria surrounding Artificial Intelligence has resulted in soaring stock prices of a number of Technology stocks that are deemed – credibly, in some cases, but perhaps not so much in others – to have meaningful potential exposure to this rapidly developing technology. Combined with a "*bad news is good news*" narrative – in which developments such as the U.S. regional banking crisis or heightened concerns of a recession were, oftentimes, deemed "good news" by the market at large for expensive Tech stocks because they lowered interest rate expectations – this made for a general market backdrop that saw mega-cap Tech and "story stocks" return with a vengeance after a very painful 2022 for most of them.

For Value-oriented investment strategies that, like all others, are often judged by many in the investing world, rightly or wrongly, relative to short-term benchmark index performance, this market environment presented its share of challenges. However, it also highlighted the importance, in our view, of constructing an investment portfolio that is not dependent solely on the market coming around to agree with your point of view or deciding to favor your particular investment style in order to succeed. Instead, we believe that investors benefit from having access to multiple potential paths to value realization across portfolios. But how can this be achieved? We believe that one way to do this is through striving to build a portfolio of holdings that are rich with potential for individual corporate events and developments, which could positively impact returns in a way that, importantly, is not overly dependent upon (and thus potentially less correlated with) the overarching market sentiment of the day or top-down economic developments around the world that investors tend to fixate on.

In our experience, most investors tend to estimate the majority (oftentimes all) of a business' value based on it just being a "going concern." While we do believe that it is of paramount importance for a business to remain a going concern – as in it will not be forced out of business in the near future – we also believe that value realization shouldn't be exclusively reliant on the path of recurring earnings and eventual recognition in the market. Value could be created and realized in other ways as well, including via corporate activity.

Although we doubt anyone would disagree with that statement, we believe this potential source of returns is often overlooked or underestimated by investors – likely because both the timing and magnitude of such events are often unpredictable, and therefore do not lend themselves well to financial modeling like going concern earnings do. As a result, we believe there is a bias among investors and analysts in favor of the income statement, the near term, and going concern metrics such as earnings. We believe this often offers us attractive long-term investment opportunities in the form of businesses that may not seem attractive to those who are largely focused on next quarter or next year's earnings, but which possess the potential to create significant value from their assets through corporate activity.

We believe that our investment approach at Moerus, which entails striving to own a collection of undervalued, asset-rich companies, provides the added benefit of the potential for value-accretive corporate events – carried out by the company itself or by external actors (e.g., a bidder). In short, we believe this approach offers potential upside in a couple of different ways: either through the market eventually coming around to recognize and adequately reflect the value that we believe is present in our holdings; or, failing that, through corporate events that could crystallize such value when markets don't.

Examples of such corporate activity include M&A, significant returns of capital to shareholders (e.g., share repurchases), spin-offs, sales of assets or a complete division, as well as others. We will touch briefly upon a few of these potential sources of value creation below.

Spin-offs
One way in which companies can sometimes create value for shareholders is by spinning off one or more of their businesses into independent, separately traded entities. Doing so could be value-accretive in cases in which the pre-existing company is being valued in the market for less than what the sum of its individual components would be worth if they were listed separately. In addition to the possibility of being valued by the market at higher multiples separately than they had been valued together, spin-offs could also potentially allow for management teams to better give the respective businesses that they are charged to manage (post-separation) their undivided attention and strategic focus.

Asset Sales
Another way that companies can create value for shareholders is through the sale of an asset or business unit. Provided that it takes place at a good price, such asset sales can sometimes unlock value that was not being fully recognized within the whole company (as implied by its stock price), while strengthening the financial position of the remaining company and generating capital that could be either redeployed into remaining businesses or returned to shareholders (e.g., through share repurchases or dividends).

Asset Acquisitions from Distressed and/or Motivated Sellers
On the flip side of things, sometimes value can be created by *acquiring* assets or businesses. Now, to be clear, we believe a healthy amount of skepticism towards acquisitions, in general, is warranted; we believe that not a small number of the Mergers & Acquisitions seen in the headlines are of dubious strategic and/or financial merit and risk destroying shareholder value rather than creating it. However, there are times when quality assets or businesses that would make an attractive acquisition candidate for strategic and financial reasons become available at bargain prices for one reason or another – perhaps there is a distressed or otherwise motivated seller who needs to raise capital quickly, for example. In such a scenario, an asset-rich company with a strong financial position could seize the moment and acquire assets for less than they are worth from a longer-term perspective. In doing so, the opportunistic buyer may also be able to grow its footprint and operational reach, remove a competitor from the market, extract cost synergies, and/or diversify its business across different business lines or geographies.

Share Repurchases at Discounts to Net Asset Value (NAV)
Sometimes the most value-accretive acquisition a company can make is that of its own shares. The key word there is "sometimes"; as in the case of acquisitions, not all share buyback plans are created equal. If a company is repurchasing shares when its stock is overvalued in the market, or it is increasing its debt levels to fund such buybacks – or both at the same time – share repurchases could very well impair shareholder value longer-term rather than create it. On the other hand, we believe that asset-rich, well-financed companies could potentially grow their NAV per share considerably over time through stock buybacks – provided they are done only when the shares are trading for less than they are worth and done

without imprudently leveraging the balance sheet. *If those conditions hold*, we believe share repurchases can often create value for remaining shareholders, in a way somewhat akin to how you would get wealthier over time if you had the opportunity to purchase dollar bills for 70 cents and do so repeatedly.

Takeovers

If a company's discounted valuation persists in the market for long enough, it sometimes becomes a target for strategic or financial buyers (provided that no material structural impediments to a change in control exist). Because we generally prefer to invest for the long-run in assets and businesses that could potentially compound value over many years, at times takeovers could be a mixed blessing – particularly if, for example, a buyer swooped in at a time of temporary adversity to buy the business for less than its longer-term worth. Still, in many cases a bidder must offer a substantial premium to the stock price in order to get management and enough existing shareholders to agree to a sale. As such, in our history, takeovers have offered us another potential road to value realization in cases in which the stock market, for one reason or another, has not come around to more appropriately reflecting the value of a business.

Some Closing Thoughts

A caveat worth emphasizing, however, is that the timing of value-realizing corporate events are uncertain and unpredictable. Although we have conviction in the underlying value proposition of our investments, it is quite often unclear to us precisely *when* that value will be either unlocked via corporate activity or eventually more fully appreciated by the securities markets. Indeed, at any given point in time, while some areas of our portfolio may have already *realized* some of their value via recent corporate events, other holdings may have yet to be rewarded via value *realization* in the market, despite taking actions that, in our opinion, are *creating* shareholder value that is not being recognized yet – though we believe such activities are likely to be eventually recognized over the longer term. Indeed, in our experience, we have often noticed that some of the portfolio's leading *positive* contributors to performance in any given year had also been meaningful *detractors* from performance in prior years; although some of the latent value in those holdings was *realized* through share price appreciation in that same proximate year, we'd argue that in many cases, much of the value was actually *created* over the months and years prior, even though the stock market might not have been giving those holdings credit for it at the time. Again, the eventual timing of value realization at the individual company level is uncertain.

It is also worth emphasizing that we do not make investments with an expectation of the specific path that a company may take. We are not investing in situations where we believe that we have identified a "catalyst" as we think that this catalyst would already be reflected in the valuation and thus creates price risk if the catalyst fails to materialize as the market anticipated. Instead, we seek to make investments in securities that we believe are cheap enough that there is a situation of *many potential* catalysts, none of which are certain and thus none of which are priced in already.

However, these uncertainties notwithstanding, we believe that an investment approach that is focused on finding well-financed, asset-rich businesses whose shares are undervalued – if well-executed – may lend itself well to the creation of a portfolio that possesses ample potential candidates for value creation via corporate events – in addition to value creation from the more traditional going concern route. If one is successful in identifying and assembling a portfolio of well-financed, undervalued investment opportunities, with management teams that are creating shareholder value rather than destroying it over time, we believe that corporate activity could positively contribute to performance over the long-term on a *portfolio* basis – with, at any given time, some holdings further along in the path towards value realization while others are earlier in their journey, sowing the seeds for future value creation.

Furthermore, we believe such opportunities for event-driven value realization may be less correlated with, nor heavily reliant upon, top-down macroeconomic factors or the whims of market sentiment and whatever might be the flavor of the day in the market's eyes – a feature that could be helpful during times in which the market is frowning upon your style of investing for one reason or another.

About Moerus Capital

Moerus Capital Management LLC, founded in 2015, is an investment management firm offering investment products to institutions, financial intermediaries, and individuals. Through our fundamental, value-oriented investment process we aim to buy securities of predominantly well-financed companies that trade at substantial discounts to our conservative estimates of intrinsic value. Our portfolios are unconstrained by geographic, industry, or index considerations, resulting in portfolios that are built from the bottom up and based on the best absolute value opportunities currently available. We believe that this investing discipline provides investors with a unique portfolio, long-term price appreciation potential, and mitigated downside risks.