Hidden Value Stocks Q4 2017 Small-Cap Roundup

As part of our goal to bring subscribers the best small-cap ideas from hedge funds around the world, we've compiled this list of small-cap value picks profiled in some of our favorite funds' year-end letters.

We've chosen these ideas in particular because they stand out for their simplicity and value. This is by no means a comprehensive list of value ideas, it's just a collection of some of the best, designed to be a starting point for further research.

Some ideas have already been profiled in Hidden Value Stocks, but we have included insights from different funds to provide a fresh perspective.

We welcome any comments you may have.

Sincerely,
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This is just a teaser: To access the rest of the ideas, as well as four new in-depth ideas from two value-focused hedge funds every quarter, and exclusive access to all funds profiled, sign up to Hidden Value Stocks today!

Corsair Capital: Houghton Mifflin Harcourt Co.

Houghton Mifflin Harcourt Co. ("HMHC") declined 23% during Q4. In October, a competitor warned the market about slowing sales driven by school districts deferring textbook purchases until the next major overhaul of curriculums is released in 2019. The market reacted as if there was a new structural problem and that these sales were permanently lost. While the delayed sales are disappointing, we believe these sales will ultimately occur. Further, the market does not appear to appreciate the prior successes of the new CEO and his ability to refocus HMHC into a more profitable company with a growing emphasis on the remedial, enrichment and assessment side of the business. HMHC should generate ~$1/share of annualized free cash flow through its cycle and should be worth towards 15x. We see additional upside through HMHC's substantial tax assets, yielding a stock that could trade in the high teens. HMHC closed the quarter at $9.30.

Hound Partners: Credit Acceptance

The Credit Acceptance analyst would argue that CACC is actually a compounder, as we do feel the company has the potential to grow earnings materially over time, but I call it contrarian because there was such a large short interest (as high as 40% of the float). In fact, short interest was so high that we were able to lend our shares to short sellers, for a low- to mid-single-digit yield incremental to CACC's high-single-digit earnings yield on a nicely growing business. This lending added $8 million to our PNL across the funds. So what were the bears so concerned about? Well, from a very high level, the business sounds kind of scary. First, the company makes subprime auto loans to the bottom half of subprime borrowers that most lenders reject. Second, the auto industry was operating near cyclical highs, and there was evidence that the auto market was rolling over. Given there are only a few pure-play subprime auto lenders and not that much market cap between them, it seemed as though many bears were playing an industry downturn with a basket of all the names, lumping Credit Acceptance in without doing company-specific diligence. We think CACC is a gem of a company and has a very differentiated model where they partner with dealers who take the junior tranche of loans and bear a lot of the risk. Compared to the other subprime lenders who write off a high-single-digit percentage of their loans, CACC has a 15-year track record of taking only ~1% losses. We loved taking the other side of this consensus short. Our view of the company's intrinsic value growth path hasn't changed much this year, but the bears have somewhat capitulated: we can no longer lend the shares, short interest has declined a bit, and the stock has risen around 50% this year, so we've reduced the position.

Greenhaven Road: BlueLinx

BlueLinx is a building supplies distributor that was started in the 1950s as a division of Georgia Pacific, meant to distribute Georgia Pacific products as well as to store excess inventory. Put simply, the company's facilities have been – and are currently – larger than they need to be given the distribution volumes. In 2004, Georgia Pacific sold BlueLinx to Cerberus, who took the company public in shortly thereafter. In 2006, Cerberus put additional debt on the enterprise secured by the real estate in the form of a 10-year loan with significant pre-payment penalties. This effectively tied the company's hands with respect to sale leasebacks or other ways to monetize the real estate. Not surprisingly, a highly levered building products distribution company did not fare well during the housing crisis. Macro issues coupled with an ill-fated decision to centralize the sales force created operational challenges for BlueLinx. Shares traded from a high of $150 in 2004 to a low of $4 in 2016.

There are, however, signs that there is a turnaround underway with three primary drivers. First is the continued strengthening in new home starts, which is out of the company's hands. By most estimates new home starts are still approximately 20% below normalized rates. In the short term, new housing demand will be further bolstered by post-hurricane rebuilding efforts in Florida and Texas. The second leg of the turnaround relates to improved sales efficiency and improved margins as the company shifts its emphasis from volumes to profitability. As a point of reference, their primary competitor – Huttig Building Products (HBP) – has margins almost double those of BlueLinx. I am not holding my breath...

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