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Hidden Value Stocks

small caps with little or no coverage

From ValueWalk

www.hiddenvaluestocks.com

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Interview One: Chris McIntyre, McIntyre Partnerships


Chris McIntyre

McIntyre Partnerships is a concentrated, 130/30 fund with a goal of significant outperformance over the market cycle. The fund focuses on event driven, non-cyclical GARP, and distressed investments, with an emphasis on high-quality, predictable business models.

Chris McIntyre has eleven years of investment experience across several funds: MAK Capital, Cobalt Capital, MDR Capital, and FNY Securities. Most recently he was a Managing Director at MAK Capital, a value focused equity and credit fund, where he managed investments in consumer, telecom, and special situations. Chris is a CFA charterholder. He is a University of Virginia graduate with degrees in Economics and Government.

Interview Two: Joe Frankenfield, Saga Partners


Joe Frankenfield

Joe Frankenfield is the founder and co-portfolio manager of Saga Partners. Based in Cleveland, Ohio, Saga Partners is a registered investment advisor that manages a fundamental, long-only, public equity portfolio for investors through separately managed accounts. The Portfolio looks for high-quality, undiscovered or misunderstood compounder companies with a durable competitive advantage.

Prior to founding Saga Partners with partner Michael Nowacki in 2016, Joe started his career in corporate banking at PNC Bank before working in equity research at Key Bank Capital Markets covering the transportation and logistics sector. Joe holds a B.S. in finance from Miami University and is a CFA charterholder.

Since inception on January 1, 2017 to the end of Q3 2018, the Saga Portfolio returned 47.6% net of fees, compared to the Russell 2000 Index and the S&P 500 of 27.8% and 34.7%, respectively.

Fund Updates

Update from Livermore Partners on Jadestone Energy:

Livermore Partners picked Jadestone energy as one of its hidden value ideas in the December 2016 issue of Hidden Value Stocks. David Neuhauser, Livermore's founder, and portfolio manager explained in his third-quarter letter to investors why he continues to believe this company is undervalued:

"Jadestone Energy (JSE:LN), continued with very strong returns in the quarter (over 10%) and now year (50%). Its new to London given our IPO and the stock is gaining some justified attention. With its Montara acquisition from Thailand National Oil Company (NOC), PTT now officially closed, we should begin to witness strong financial performance and hopefully even higher prices. The company has 50% of current production hedged, very strong cash flows (2X 2019 est.), $100 million in annual FCF, and solid management (Ex-Talisman Energy). Our favorite International producer given its potential to scale to $1 billion market cap and very attractive valuation."

A new idea from Stanphyl Capital:

The second ever issue of Hidden Value Stocks featured Mark B. Spiegel the managing member of Stanphyl Capital. Spiegel highlighted his four favorite small caps in the issue all of which went on to produce huge returns for investors. Each of these stocks yielded an average gain of 119% over the next 12 months. Spiegel's latest idea is Aviat Networks, Inc.

From Stanphyl's November 2018 letter to investors:

"We continue to own Aviat Networks, Inc. (AVNW), a designer and manufacturer of point-to-point microwave systems for telecom companies, which in November reported a mediocre Q1 for FY 2019, with revenue up 7.7% year-over-year but a slight increase in net loss (from .12/share to .14/share).

Nevertheless, the company (mostly) reiterated its guidance for FY 2019, projecting approximately $255 million of revenue (a $5 million cut from previous guidance and approximately 5% better than 2018) and non-GAAP EBITDA of at least $12.5 million (a $500,000 cut from previous guidance).

Because of its approximately $332 million of U.S. NOLs, $10 million of U.S. tax credit carryforwards, $214 million in foreign NOLs and $4 million of foreign tax credit carryforwards, Aviat's income will be tax-free for many years; thus, GAAP EBITDA less capex essentially equals "earnings." So if the non-GAAP number will be $12.5 million and we take out $1.7 million in stock comp and $6 million in capex we get $4.8 million in earnings multiplied by, say, 16 = approximately $77 million; if we then add in at least $30 million of expected year-end net cash and divide by 5.42 million shares we get just under $20/share.

However, the real play here is as a buyout candidate; Aviat's closest pure-play competitor, Ceragon (CRNT) sells at an EV of approximately 0.85x revenue, which for AVNW (based on 2019 guidance) would be around $217 million. If we value Aviat's massive NOLs at a modest $10 million (due to change-in-control diminution in their value), the company would be worth $227 million divided by 5.43 million shares = around $42/share."

Fund Updates

Update from Choice Equities on BlueLinx Holdings:

Choice Equities' Mitchell Scott picked BlueLinx Holdings Inc. as one of two ideas in the Q3 issue of Hidden Value Stocks. Since the issue was published, the stock has underperformed the market, but Choice is holding on. From the firm's Q3 letter to investors:

"Early in the quarter, we completed the sales of our positions in building products companies GMS and BMCH which we began exiting earlier this spring. With rates likely heading higher and investors to soon follow the playbook to sell all building products companies, both were sold to lessen our exposure in this area and make room for what we believe are higher returning investments. Though we have lightened up in this area, we still own two building products companies in Bluelinx (BXC) and Beacon Roofing (BECN). We are holding on to them, despite the market's temporary concerns, because we believe they represent highly compelling values."

The letter also profiled a new idea added to the fund in the third quarter, Destination Maternity (DEST):

"There is much work to do, but there is much to build on. Despite the recent issues, the company maintains an impressive customer list with a market leading share in a category known for customer loyalty. The company has a store base of ~1,000, comprised of ~400 company-operated locations and ~600 leased locations inside department stores. The stores operate under the three banners: Motherhood Maternity, Pea in the Pod and Destination Maternity. Together, the company earns an impressive 50%+ gross margin but has an SGA margin that is worst in its class. Combined with a store footprint where ~50% of the stores will be up for lease by the end of 2019, it seems there is an opportunity for addition by subtraction for the company. Additionally, the company has been late to the eCommerce game. But recent initiatives there auger well there too. The online channel has grown from practically zero a year ago to nearly a quarter of the sales mix today and is still growing at a high teens rate. Our conversations with the new CEO point to a team that is intent on furthering these initiatives and cutting costs to create a leaner and more profitable company.

Recently changing hands at a little north of $4 per share today, the company is trading at 5x FY2018 EBITDA and .4x sales versus peers who generally trade around 6-8x and 1–1.5x TEV / sales. The activist case suggests improved performance could again position the company to soon earn $2 as they nearly did in 2013. It is unclear if this outlook may prove optimistic. But even if new management is able to get halfway there towards the goal of $2 of EPS, it seems shares still represent a compelling bargain."

Chris McIntyre **McIntyre Partnerships**

To start, could you give us a brief overview of your background and McIntyre Partnerships?

My background is that I've worked in hedge funds/ investment management since graduating from the University of Virginia in 2007. I'm that kid who went off to college thinking he'd be a lawyer but ended up trading stocks in the back of class instead. I bit the investment bug in school and have been hooked since. Coming out of school, I went to work for First New York, where I worked on a risk arbitrage desk during the Great Recession. Quite the time to start! After a few years, I wanted exposure to long-term investing and pivoted to analyst roles at several value-focused hedge funds, including Cobalt and MAK, the latter of which I spent four years at as a managing director before launching McIntyre Partnerships.

Over those years studying and experimenting with different investment strategies, I always religiously tracked my investment performance. Eventually, I settled on a concentrated contrarian value strategy; I focus on a small number of ideas, no more than five or eight, and know them in depth. The strategy made sense to me, matched my temperament, and most importantly, worked. After a few years of running my personal account in the strategy, I was consistently outperforming the market, and I felt convinced I could continue to perform. I left my job and launched McIntyre Partnerships in January 2017. The fund is "one man band" on the analytical side – I will always be the only senior investment professional.

Further, the fund focuses on small to medium-sized companies, and I am committed to keeping the fund's assets small to maximize our total investment universe. The fund had a strong 2017, returning 46% gross. 2018 has been a rough year, consistently lagging, but I believe the market has created opportunities in this volatility.

What are you looking for in an investment – what makes you say yes or no?

I employ a contrarian value style, which I simplify to three general categories: compounders where the market is underestimating long-term earnings growth, event-driven investment where a stock is mispriced and a catalyst will cause a repricing, and contrarian/distressed investments where I believe the market is strongly underestimating future earnings. When looking for an investment, I want to find ideas that fall into at least one of these categories, preferably all three.

When most investors hear "fat pitch," they think "stocks with a lot of upside," which is true – my genius strategy is to buy stocks that could go up a lot. But when I say "fat pitch," I also mean limited long-term downside. Far more significant than large upside, my biggest hurdle to investment is a high probability of minimal long-term risk.

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I look through dozens of stocks a year that fit those criteria, but what makes me say yes or no is whether I believe it's a "fat pitch." When most investors hear "fat pitch," they think "stocks with a lot of upside," which is true – my genius strategy is to buy stocks that could go up a lot. But when I say "fat pitch," I also mean limited long-term downside.

Far more significant than large upside, my biggest hurdle to investment is a high probability of minimal long-term risk. "Look down, not up" is a favorite investment quote of mine. From there, I balance my sizing according to upside potential and catalysts. It sounds cliche, but it's the core of what I do.

What makes this strategy different to other value funds?

My overall investment philosophy is not wildly different from most value investors. Value strategies have repeatedly been employed successfully for the past 80+ years – Buffett, Klarman, Greenblatt, Loeb, etc. Despite its obvious success, most value funds fail to beat the market. I hate to say it and risk the ire of the trading gods, but the key "bet" an investor in the fund makes is on me – that I possess the analytical skills, judgment, and temperament to successfully implement tried and tested value strategies. However, if do possess those skills (and that's a big if…), the fund is differentiated in that I am committed to taking concentrated bets, being the only senior investment professional, and keeping AUM small.

I am willing to invest in much higher concentration than the overwhelming majority of funds – we had a 30% position at launch, for instance. While that adds single name risk, it's a lot easier to find five good ideas in a year than fifty. As I run a "one man band," I'm able to bring focus and rigorous research to the handful of critical decisions I make a year. Finally, by keeping the fund small, the fund has a wide potential investment universe. I think it's a lot easier for one person to find five good ideas in the ~25,000 stocks with greater than $100 million market caps than for 20 people to find 50 to 100 good ideas in the ~1,400 public stocks with greater than $10 billion market caps.

You must be comfortable running a concentrated portfolio. Can you talk a bit about why you decided on this approach?

One of my favorite Warren Buffett quotes is "No one ever got rich off their eighth best idea." Another I'm fond of is Andrew Carnegie, "Put all your eggs in one basket and then watch that basket." Simple financial math shows that a five-stock portfolio achieves 82% of the diversification benefit of a 500 stock portfolio. While most investors understand that math, they remain scared of making a mistake when running so concentrated. The trick for me is that I do the work myself, only invest in companies I believe I understand thoroughly and am obsessive about risk. I also spend significant time on each investment – I'll typically put at least a few weeks of research into any one investment. Frankly, I sleep much better with 70%+ of my net worth in five things I know in depth than 30 names I barely know.

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Could you give us a case study of a company that shows off your strategy?

The best example is the fund's investment in Chemours (CC), not only because of its strong performance but because it is the largest bet the fund has taken and touches all three of our categories: a high-quality business spun out in a time of distress. I invested in 2015, and when the fund launched, we had an ~30% position.

Chemours came across my desk as part of my usual spin off research process. In June 2015, DuPont spun out Chemours, which consists of DuPont's

(DWDP) legacy TiO2 (a chemical that makes paint opaque), fluorochemical (think Freon and Teflon), and some smaller commodity chemical assets.

For a variety of reasons, Chemours was spun in a frankly irresponsible manner. The TiO2 business was entering a bad recession, the dividend was unsustainable, the debt load was too high, and Chemours had indemnified DuPont in a large class-action lawsuit. Management should have postponed the spin or restructured Chemours, but an activist was pressuring the company, so Chemours was pushed into an unprepared market. Further compounding matters, the entire commodity equity/credit market imploded in August 2015 due to China fears, and Chemours's natural competitor group – of other publicly traded TiO2 producers – fell 50%. It was a perfect storm – a complicated story, spun incorrectly, into a market that tanked.

One of my favorite investment types is very complicated stories that can be boiled down to simple concepts. Despite the stock volatility and fears of insolvency (shares went from $20 at spin to $3 in January 2016), Chemours was an exceptionally high-quality business with predictable, albeit cyclical, earnings. Chemours's key differentiators are that their TiO2 business is one of the most dominant businesses I have analyzed and the TiO2 market is relatively predictable. For over sixty years, Chemours has been the low-cost TiO2 producer by a substantial margin. The business has a several hundred dollar per ton cost advantage, which equates to roughly double the margin of competitors through the cycle. Further, while TiO2 prices are volatile, TiO2 volumes are relatively stable – global inventories are at most several months of supply and end market volumes grow and contract in line with GDP. As a result, when pricing tanks and the marginal producers' margins fall to cash costs, Chemours still generates significant EBITDA. Normally the market awards low-cost producers with less stock volatility and higher trough multiples, but as Chemours was a recent, opaque spin, these qualities of the business were lost on the market – the proverbial baby with the bathwater.

Entering 2017 and the launch of McIntyre Partnerships, shares of Chemours had rallied considerably, yet I felt the equity remained significantly undervalued. Chemours was trading $22 and I estimated mid-cycle earnings over $4. Further, I felt there were strong catalysts – continued TiO2 price increases and the resolution of the PFOA lawsuit. A high probability, high reward investment with strong catalysts deserves a large position. On TiO2 prices, the market turned in Q1 2016 and producers put through several price hikes, yet the marginal producers still were operating at breakeven levels. As TiO2 prices held strong in normally seasonally weak Q4 2016, I assumed prices would rally again in 2017 and that sell-side forecasts were underestimating this impact. On the PFOA lawsuit, Chemours had indemnified DuPont in a large lawsuit. While words like "indemnity" and "multi-district litigation" appear scary, most legal liabilities are just like any other risk – they may have a wider range of outcomes, requiring a wider margin of safety, but they are rarely entirely unknowable events. I felt the market was drastically overestimating the risk. When the parties settled in February 2017, Chemours shares traded over $30 before rallying to $50 over the summer.

More recently, Chemours shares have come under pressure and fallen back below $30. I still believe the market is drastically overestimating Chemours cyclicality and underestimating mid-cycle earnings. The fund again has a significant position.

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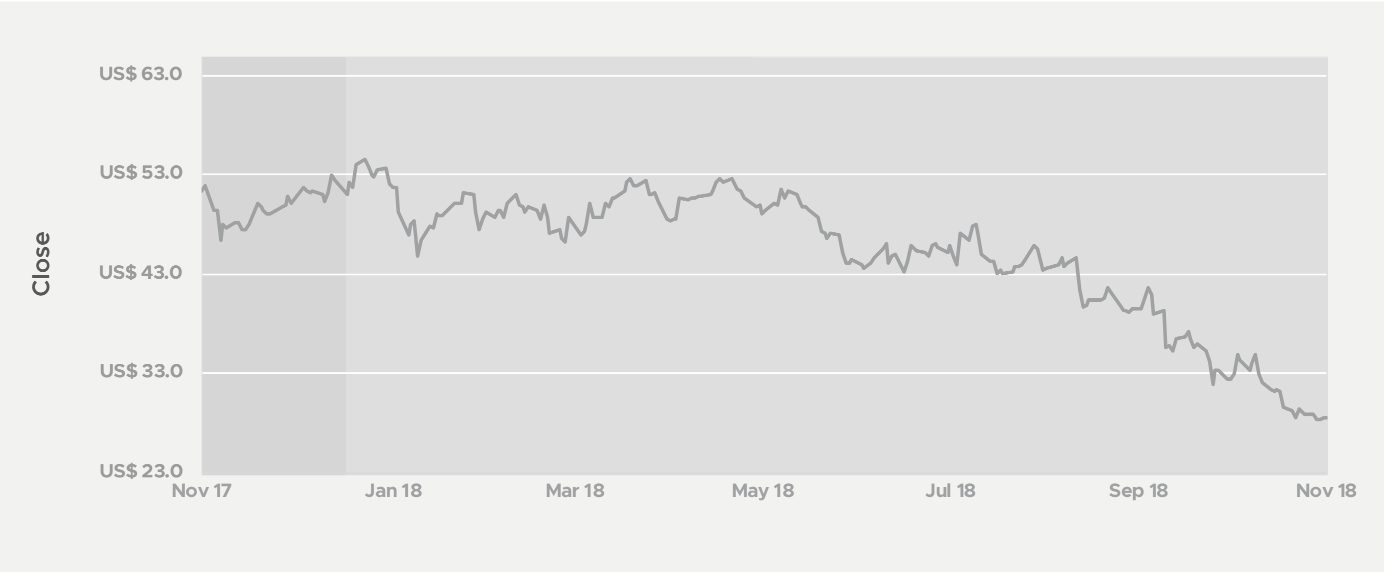
What sort of company would fit into your contrarian/distressed portfolio?

When I call a stock contrarian/distressed, I mean a liquid stock with a high yield on my estimated earnings. (Bonds and illiquid securities are a different matter.) That almost always implies the perception of operating or financial distress, and that I am going against the grain.

A recent example is our investment in Garrett Motion Inc. (GTX).

I found our Garrett Motion investment in a place where one could hope for a bargain: a complicated, recent spin of a small-cap from a mega-cap where the relevant peer group fell 30% to 50% in the two months preceding the spin. I think of Garrett on two levels: a bet on auto suppliers broadly and a bet on Garrett specifically.

The Chemours Company, inc.



Share Information December 7,2018

Market Cap. $4.5bn	**P/E (forward)** 4.6	**EV/EBITDA** 4.2	**Dividend Yield** 3.80%
Average Volume (3m) 1.9m	**P/B** 3.9	**ROIC (5-yr)** 8.10%	**Debt to Equity (net)** 239%

Data Source: Morningstar

Auto stocks are one of the worst performing sectors year-to-date, with the auto supplier subgroup falling ~35% and trading at ~7x to 8x 2019 EPS. Global auto purchases have begun to slow, lead by a low-double-digit decline in China, and memories of the 2008 recession linger. Further, the evolution of battery electric vehicles (BEVs) requires a change in the auto supply chain, adding a degree of secular risk. However, I believe certain auto stocks more than reflect these cyclical and secular risks. While individual countries can exhibit substantial cyclicality, global auto demand is more robust, with a peak-to-trough decline of ~10% to 15% in the Great Recession. BEVs are a long-term concern, but a very long-term concern versus current valuations. BEV penetration is presently minimal, and the combined internal combustion (ICE) and hybrids market are unlikely to decline until the late 2020s. The subgroup's teens FCF yield more than reflects the prospect of a substantial decline beyond 2030.

Garrett is a leading manufacturer in the moat-rich turbocharger (TB) market, with a global end-market, industry-leading margins, and a robust medium-term growth story from hybrid penetration. Garrett was recently spun from the much larger Honeywell. As Garrett represented under one percent of Honeywell's equity value, I believe most Honeywell shareholders sold their shares with little research or regard for price. Garrett shares now trade at ~3x to 4x my estimated 2019 FCF/share, the lowest multiple in the auto-supplier space. I believe investors are ignoring the group due cyclical fears and Garrett's asbestos liability, which makes Garrett screen as highly levered. Auto suppliers are inherently cyclical, but the firm has a global end-market, an 80% variable cost structure, and the TB market is forecast to grow ~500-600bps above the market rate, which lowers the operating risk in a recession. Garrett screens as having ~$3.2 billion in debt/liabilities versus ~$650 million in 2018 EBITDA, but ~$1.4 billion of the debt/liabilities is the asbestos

liability, which is structured as a junior obligation with a $175 million annual cap that can be deferred in the event of default. The business only has ~$50 million in annual interest expense and ~$25 million in maintenance capital needs, implying substantial coverage versus "true" fixed costs even in a significant recession.
I believe Garrett can earn >$4 in EPS in 2020 and, as the stock de-levers and the story is better understood, can trade at a 10x or better valuation.

According to your latest letters to investors, your portfolio seems to be heavily concentrated right now in media stocks, notably CBS. What do you like about this sector, and how does it fit into your strategy?

I like "legacy" cable TV media because it's disliked (thus cheap), historically the companies have been high-quality businesses, and I have a differentiated view on specific names. The space is generally hated because "TV is changing" so "who knows what will happen." I agree that TV is changing, but I think the market is overestimating the earnings impact, particularly on specific investments. Strategy-wise, I particularly like that cable TV media are a contrarian bet in what would otherwise be high-quality compounders.

I believe CBS (CBS) is particularly well situated to manage the change in TV. CBS owns the CBS Network and Showtime. The critical detail to understand when comparing CBS to other legacy TV businesses is that the CBS Network is under-monetized in the current ecosystem. Historically, CBS and other broadcasters were distributed for free over-the-air (OTA) and monetized entirely through advertising dollars. However, consumers now demand streaming-video-on-demand (SVOD) content, which CBS does not provide for free OTA. Unlike traditional cable networks, this shift creates an entirely new subscription revenue stream for the business. CBS has rapidly grown its subscription fees ("retransmission fees" in media parlance) over the last few years, yet CBS is only ~$3/month in cost to the consumer despite representing 10% to 15% of total viewership. Also, CBS has an active studio business, which can produce shows for other networks, and Showtime is relatively insulated from the linear-to-SVOD shift and growing. CBS currently trades ~9x forward earnings, which I believe can grow earnings at a teens or better rate over the next few years. In a recession, CBS should only see modest EPS impact due to their >60% recurring revenue model.

Beyond secular fears, investors also fear a merger between CBS and Viacom Inc.(VIA), as Viacom's traditional cable TV business is more at risk from the shift to SVOD. While I agree Viacom is a lower quality business, a merger has strategic merits from scale, significant synergies, and I believe Viacom shares are exceptionally cheap in their own right. Pro-forma, I think a merger would boost earnings 10% to 30% in 2020 with a significant "hidden asset" in Paramount, which currently generates little profit but could be worth $5 billion in a sale or ~15% of my estimated pro-forma market cap.

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Over the course of 2018, cable TV stocks have generally outperformed, as sub declines have slowed and ad dollars have been more robust than feared. I've modestly trimmed our media investments as they've outperformed, but the fund retains a large bet.

What would make you sell a core idea?

The timeless investment question – it's always more art than science. Skipping past the easy part when the idea has worked out, I try hard to remain honest and level-headed with myself. When I make an investment, I always keep a written record of what my investment logic is and where I could be wrong. I never mind if the price goes against me or if an idea is stuck as dead money, but I am very, very sensitive to when part of the thesis has been proven incorrect.

There's also the "retail shorts" basket in your portfolio. Would it be possible to give us some more insight on this?

Shorting is not a focus of the fund, but I do selectively short secular losers. As an investor, I simply must be aware of which industries/sectors are in secular decline. If I don't, I'll inevitably end up long one, as my contrarian strategy involves looking at lots of cheap stocks that are cheap for a good reason. However, instead of concentrated bets as I do in the long portfolio, I diversify as a bet is against the industry rather than a specifically bad management team or product.

As for retail, my thesis isn't unique: the internet is changing consumer habits and physical retailers face significant obstacles. US e-commerce sales were roughly 10% of total retail sales in Q3 2018, up from 9% in Q3 2017 and 8% in Q3 2016. They were 3.6% in Q3 2008. I think that trend will continue for years and years. There's no reason e-commerce couldn't represent 30% of total retail sales in 2030. Physical retailers face a slew of issues in this new reality. Retail was already a brutal business; now they have to spend money to build out e-commerce while sales decline in their existing higher-margin business. I've shorted a handful in the space, and without naming specific stocks, I'm focused on retailers who primarily sell "other people's stuff," as opposed to branded retailers. If you are Prada or Lululemon, you're selling your own brands and while location and convenience are important, you're primarily competing on the product. But if your business is buying blenders, TVs, and/or sneakers wholesale and trying to out-compete Amazon on convenience and price.... Good luck.

And another basket outside of the primary portfolio is the "Small-Cap Financials Basket." What are your goals for this basket?

One of the few areas where I think diversification makes sense is in "easy" to identify statistically cheap financials.

A simple stock screen will return plenty of cheap price to book value stocks, which for financials such as banks should theoretically be a proxy for liquidation value. I spend a lot of time looking through these, hoping to find a gem that can be sized for a serious bet. However, most tend to be illiquid, only a modest discount to book value, and without a strong catalyst. My strategy is to instead buy several in a basket, with 10% to 20% of the funds capital, where the goal is to modestly outperform the market with below-market risk. Conceptually, if we buy three positions at a 30% discount and two reach net asset value while one drops another 10% to 20%, we will do reasonably well. By buying several of them in modest size, we can realize the general gains from buying undervalued securities, increase our non-cyclical exposure, and, whenever one continues to fall, as cheap stocks without catalysts often do, we have room to significantly increase our position.

Of note, we strongly prefer investments with minimal leverage – an equity with a 30% discount to fair value with no debt is wildly different from a similar discount with 10x leverage. The financials basket is also more micro-cap focused than our overall portfolio. Our large investments are typically operating companies, where scale matters and micro-cap businesses are structurally disadvantaged except in rare niches. The opposite is true in finance; much like hedge funds, banks and REITs arguably face disadvantages from scale as their opportunity set decreases.

Could you give a case study of a stock in the basket that showcases your aims for the basket?

A recent example is Owen's Realty (ORM).

Owen's is a mortgage REIT. Originally, Owen's was a private fund focused on bridge loans that suffered steep losses in the Great Recession and