ValueInvestor INSIGHT
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May 31, 2019

Investor Insight: Brad Radin

Brad Radin and Joseph Fei of Radin Capital Partners describe the investment-philosophy insights they borrowed from John Templeton, how as global investors they're processing the ongoing trade discussions, why they believe they're well prepared for market turmoil, and why they see unrecognized value in Krones, Stella International and Ontex Group.

INVESTOR INSIGHT

Brad Radin
Radin Capital Partners

Brad Radin has no problem making highly contrarian investment bets, but he wants to make clear he doesn't believe that means taking outsized risks. "We don't invest in distressed companies," he says, "just those with distressed share prices."

He's made that distinction well. He outperformed the relevant MSCI global index by more than 600 basis points per year in 11 years running the Templeton Global Smaller Companies Fund, and has continued his market-beating ways since founding Toronto-based Radin Capital in 2012. Casting a wide global net, he's finding small-cap bargains today in such areas as personal-hygiene products, shoe manufacturing and industrial equipment.

You've spent most of your career, first with Templeton and now on your own, investing internationally in small-cap companies. Why do you consider that such an attractive opportunity set?

Brad Radin: First of all, and this is something John Templeton considered important, having a global view offers you more choice, and we feel more choice is better in a global economy with a number of different crosscurrents and influences. We like that smaller companies tend to be more monoline, making them somewhat easier to analyze and also often producing bigger swings in valuation. There aren't the offsets more diversified companies have when things are going well, or when they aren't for what we consider short-term and fixable reasons. We try to take advantage of the frequency and magnitude of the valuation swings.

We'd also argue that with the increasing focus on indexed products and on big money managers getting even bigger, we should benefit at the margin from global small caps getting less buy-side and sell-side attention. A popular mega cap in the U.S. might have 40 or more sell-side analysts covering it and practically every buy-side money manager on the planet will have somebody looking at it. We would rather invest where there are only three or four analysts paying attention and many of the buy-side firms choose to pass because there's not enough liquidity. We feel that for most types of companies in the world we can find a small cap where the drivers of the business are similar to a large cap, but the growth opportunities – and the valuation multiple you have to pay – are more attractive.

What advantages do you think you can have as an investor over local-market competitors?

BR: Having perspective across borders we believe is a real competitive advantage. I've specialized on this asset class for two decades and have invested in more than 30 countries. That should provide a base of knowledge about what works and what doesn't that most single-market investors don't have.

I'd also say it's helpful that we usually don't bring the same baggage to ideas that many local-market participants do. We're looking at companies that have stubbed their toes, put up disappointing numbers and have had their share prices crushed. Local-market players probably hate it because they've lost money in the name and the sell-side has been disappointed as well. A fresh set of eyes not clouded by having ridden the company down can be very helpful.

In what ways is your strategy, as you put it, "classic opportunistic value"?

BR: There is clearly a broad range of value investors. Some managers call themselves value investors because while they might be investing in a crazy-expensive sector, they're buying stuff that's 10% cheaper than the peer group. That's one end of the spectrum. We're more at the other end. We don't want companies that are slightly underpriced relative to their peer groups or to where they've traded historically, but those that are trading at half off and can at least double over the next five years. That's what I mean by a more classic value approach.

The opportunistic element is that we're targeting good companies with proven business models that happen to be facing short-term challenges that have made their stocks bargains relative to their future normalized earnings potential. That can happen for a variety of reasons, but we're trying to buy, as John Templeton used to put it, at the point of maximum pessimism.

I would emphasize that we're not looking to invest in distressed companies, just those with distressed share prices. Approximately one-third of the companies we own today have net cash on their balance sheets. It's relatively rare, but sometimes fairly modest fundamental hiccups can spiral into more dramatic moves in share prices. That's where we're looking for value and to be opportunistic when we find it.

Can you generalize about the types of "fundamental hiccups" that attract your attention?

BR: We've probably seen all the reasons. There's a fire at a factory. There's a one-off operational misstep. There's a crummy acquisition. There's a missed product cycle. The general cycle is unfavorable. There's a macroeconomic issue. Again, it comes back to being opportunistic and working to get to the bottom of things through fundamental analysis.

It's likely helpful to describe some representative examples. One classic one we use as a textbook case of a short-term fixable business problem that resulted in a surprisingly big share-price overreaction is Berendsen, a U.K. company that specializes in the rental and cleaning of things like sheets, towels, workwear and washroom mats. Near the end of 2016 the company surprised the market by announcing that forced downtime at some of its cleaning plants was going to require unexpected costs for repair, transportation and overtime to correct, and the share price fell roughly 40%.

While operational execution is obviously critical to a business like this, we concluded that the problems were actually relatively mundane and would be fairly straightforward to fix. The underlying business was essentially the same and quite healthy, it was just the share price that had been tossed all over the place. We bought a full position in early 2017 and by June the company agreed to be acquired by a competitor, France's Elis Services, at a 60% premium to its low less than six months earlier.

ON PERSPECTIVE:

I'd say it's helpful that we usually don't bring the same baggage to ideas that many local-market participants do.

Another good example that is currently in the portfolio would be China Lesso Group [Hong Kong: 2128], which is China's largest manufacturer of plastic water pipes. As you might expect from a Chinese small-cap stock, the share price can be a bit jumpy, especially when there's news flow about the state of the country's housing market. Concerns about that were exacerbated in 2017 and 2018 by information coming out pointing to the fact that some company growth initiatives weren't coming along as quickly as expected. As a result, between early 2017 and late 2018 the share price fell nearly 40%.

Our investment thesis was, and is, that China Lesso is the best-positioned company in a business with solid growth prospects, driven by government-led infrastructure policies related to urbanization, pollution control, water management and housing. But when we were buying the stock it was trading at only 6x forward earnings and only 4x forward free cash flow. That was for a market leader with annual revenues of over US$2.5 billion, a clean balance sheet and that was paying a dividend yield of 3%. That's the kind of setup we like. [Note: After hitting a 2018 low of HK$3.83 in December, China Lesso shares currently trade at around HK$5.10.]

Brad Radin

The Templeton Way

His interest in seeing the world was more evident than his interest in investing when Brad Radin graduated from Canada's Western University in 1990 with degrees in biology and business. He moved to Hong Kong without a job in hand, eventually spending two years at global advertising firm Young & Rubicam before friends convinced him to try his hand at investing. After two years as a research analyst following Asian stocks for investment bank Credit Suisse, he says, "I was hooked."

Radin returned to Canada and earned an M.B.A. at his undergraduate alma mater's Ivey Business School before joining Franklin Resources' Templeton Global Equity Group in Toronto in 1995. By 1999 he was running the firm's Global Smaller Companies Fund and earned stellar returns there during an 11-year tenure. When he left to start his own firm, Radin Capital Partners, he says he brought with him many of the core investing tenets originally laid down by John Templeton: "Sir John always believed in looking all over the world for ideas, having a long-term outlook, buying stocks only at the point of maximum pessimism, and being opportunistic and brave when opportunities present themselves. We think that's still a pretty good formula for investing success."

How often do the share-price woes stem from more macro factors?

BR: It certainly happens, and we think the portfolio benefits from having stocks that move based on very different, idiosyncratic drivers.

To highlight one macro source of opportunity, broadly speaking we're finding more stocks to look at today in the United Kingdom as Brexit drags on. You can understand why investors with a more top-down view of the world or who have shorter time horizons might say "no thanks" to U.K. stocks at the moment, but the result is that some good companies with bright futures trade as if they're bad companies with no future.

Joseph Fei: An example we've added fairly recently to the portfolio is Bakkavor [London: BAKK], which is the U.K.'s largest producer of fresh prepared foods. The company's basic business is providing ready-to-go meals and salads sold through supermarkets, which is an expanding category as people prepare fewer meals at home and want fresher and more healthy alternatives to fast food. Brexit appears to be weighing on the stock for a couple of reasons. One is just general concern over the economy and consumer spending if there's a hard Brexit. Another is the risk to the company's supply chain, which relies heavily on imported foods from the rest of Europe.

Longer term, we still consider the outlook for the prepared-foods market and Bakkavor's position in it to be very attractive, despite any short-term demand dislocations that might come from Brexit. We also don't think the market is giving the company adequate credit for how well it constantly reconfigures its recipes and ingredients in response not only to consumer tastes, but also to specific-input price inflation and availability. In a hard Brexit they would have issues to deal with, but they're well prepared to so do and we think the market in pricing the stock at less than 9x forward earnings and a 5%-plus dividend yield is overestimating the potential impact.

BR: It's not a primary focus, but we will also invest in commodity-driven businesses on the expectation that a return to more normalized earnings levels can drive significant share-price increases. That would be the case today for a company like Precision Drilling [Toronto: PD], which owns and rents out drilling rigs to exploration and production companies, mostly in the U.S. and Canada.

ON MACRO ISSUES:

To highlight one macro source of opportunity, we're finding more stocks to look at in the U.K. as Brexit drags on.

This is a business that is only slowly recovering from the impact of the dramatic fall in oil prices a few years ago, but the company generates decent free cash flow and is paying down debt now that it has largely completed a massive and not very well timed equipment-upgrade cycle. Debt leverage is higher than we'd like to see, but it's well-structured in that only a small portion of it comes due within the next four years.

The stock today trades at around C$1.80, down from C$15.00 five years ago and below where it traded in the depths of the financial crisis. We believe, though, that over our five-year time horizon as E&P companies increase spending, the company can earn 70 cents (Canadian) per share, making the current multiple on that less than 3x. To us, this looks to be at least close to the point of maximum pessimism.

You've mentioned your five-year time horizon. What's the rationale behind that?

BR: We generally consider that to be a reasonable period of time for earnings to normalize and for full value to be realized. Sometimes that happens faster and sometimes slower, but it generally takes time to fix whatever issues are at hand, to have those fixes show up in the operating results, and for a skeptical market to believe it's for real.

We're making calls well before it's obvious that the challenges have been worked out. We think the market pays us to take that kind of risk – that's how we can buy a stock at what we believe is 50% off. Our portfolio turnover, at around 20% per year, has historically matched up well with our time horizon.

For an investor in small-cap stocks, the dividend yield on your portfolio of nearly 4.5% seems surprisingly high. Is that by design?

BR: That stems from the types of companies and stocks we look for. These are firms that typically have been around and profitable for some time, with decent balance sheets and a history of paying good dividends. They're trucking along at a high-teens P/E and maybe paying a 2% dividend, but then the stock gets slammed, the P/E is cut in half and the dividend yield doubles. That's when we try to step in.

Describe what you think the market is missing in German industrial-equipment company Krones [Frankfurt: KRN].

JF: The company provides entire systems for clients to produce, package, bottle and label beverages and liquids. Roughly 90% of the business worldwide is to customers in the beverage industry, with the balance in industries like pharmaceuticals, chemicals and cosmetics. In their bread-and-butter filling and packaging business they are the global market leader with a roughly 25% overall share, and in certain product lines they have close to 50% market share.

The stock was off roughly 40% in the second half of 2018 due to what we consider standard operating hiccups that don't take away from a positive long-term outlook. There were some projects put on hold as a result of recent mergers among clients. Rising aluminum and steel prices have hurt margins. They've also been a bit slow to diversify their production base outside of Germany, so have been incrementally impacted by unexpectedly high cost and wage inflation in their home market.

Most global companies experience issues like these, and Krones is both well-equipped to ride out short-term problems and has been quite effective over time in responding to more structural ones. Their balance sheet has net cash on hand. They also have a clear plan to geographically diversify their production base, including an ongoing effort to shift capacity to new facilities in Hungary.

BR: Despite the issues that seem to be concerning the market, Krones remains an innovative, competitively advantaged global market leader in an attractive market. The beverage industry benefits from increasing income levels and urbanization in emerging markets. As in other consumer-goods categories, beverage makers are continually putting out new products or packaging. Every time Coke decides to launch another flavor or wants a thinner bottle or a fatter bottle, that's good for this company. There's also an increasing digitization of plants meant both to capture more data and improve production efficiency. Krones spends heavily on R&D and is typically out ahead in meeting customer demand for the latest technology.

Are the increasing environmental concerns around beverage packaging a potential problem?

JF: The biggest issue seems to be around plastic, and we think a shift away from it to glass, or even a heightened emphasis on how to better recycle and reuse plastic would be positive for Krones. Changes in how things are put together require new machines or upgrades of old ones. We believe they're more likely to contribute to the solution than the problem on the environmental front.

How are you looking at upside in the stock from today's price of around €70.50?

JF: We're forecasting revenues to grow in the 5% annual range over the next five years, with EPS growth running at closer to 10% as operating margins normalize and then improve somewhat from the changes underway in the manufacturing footprint. We also don't believe, if the company can achieve these targets, that the stock will deserve to trade at the 12-13x multiple on forward earnings we've been able to buy it at lately. Based on our normalized five-year estimates for earnings and P/E, we believe the share price can double over the next five years.

Before we ask about another of your Chinese ideas, describe generally how you're processing the ongoing trade discussions.

BR: Today, our portfolio weight in Hong Kong is just over 20% and our China weight is 15%, so at first glance it might appear that our strategy is particularly trade-war sensitive. But the 15 or so such companies we own trade collectively at a forward P/E of less than 10x, the majority of them have a domestic-revenue focus and many of the rest are involved in the manufacture of fabric, accessories and shoes and have been gradually moving

INVESTMENT SNAPSHOT

Krones
(Xetra: KRN)

Business: Based in Germany, develops and builds manufacturing processing systems used primarily by end customers in the beverage and liquid-food industries worldwide.

Share Information
(@5/30/19, Exchange Rate: $1 = €0.90):

Price	**€70.55**
52-Week Range	€63.80 – €122.80
Dividend Yield	2.0%
Market Cap	€2.23 billion

Financials (TTM):

Revenue	€4.00 billion
Operating Profit Margin	5.2%
Net Profit Margin	3.7%

Valuation Metrics
(@5/30/19):

	KRN	S&P 500
P/E (TTM)	15.0	21.7
Forward P/E (Est.)	11.4	16.9

Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Deutsche Bank	3.0%
Oddo BHF	2.9%
Tweedy, Browne	2.2%
Allianz	2.0%
Pictet Funds	1.6%

Short Interest (as of 5/15/19):

Shares Short/Float	n/a

KRN PRICE HISTORY

THE BOTTOM LINE

The company's stock has been hit hard by what Joseph Fei considers "standard operating hiccups that don't take away from a positive long-term outlook" for the underlying business. Assuming 5% annual revenue growth, improved operating margins and a normalized P/E multiple, he believes the share price can double over the next five years.

Sources: Company reports, other publicly available information

production out of China for years. When we adjust for the percentage of non-China production and non-U.S. sales, our exposure to a potential China/U.S. trade war is closer to 5% of the portfolio. As a comparison, Apple's iPhones are all assembled in China and China sales represent nearly 20% of the company's total. That's not at all to say we'd welcome a trade war, but we think our fundamental downside risk if it does happen is low.

Describe the particular upside you see in shoe manufacturer Stella International Holdings [Hong Kong: 1836].

JF: Stella is one of the world's largest footwear manufacturers, producing more than 60 million pairs of mostly mid-line casual and fashion shoes for a wide range of brands, including Clark's, Nike, Timberland, Cole-Haan, Michael Kors and Prada. Roughly 50% of the shoes are sold in the U.S., 30% in Europe and the balance in Asia Pacific.

We've owned this stock for a few years, first buying in 2016 after it sold off sharply because some key clients were slow to respond to the "athleisure" trend with their footwear, and also because the company was moving production from China and was working through some underutilization of capacity. We considered both of those issues to be fixable and that Stella would continue to prosper over time due to its scale and cost advantages and its excellent long-term relationships with clients.

To the point Brad made earlier about time horizon, it has taken time for sales to recover and for the production transitions to have a positive impact, but it's now starting to happen and we still think the recovery in the stock price is in the relatively early innings.

How do you think through the more specific trade-conflict exposure here?

BR: Particularly with a ramp up of capacity in Vietnam, Stella's production footprint has gone from roughly 70% China in 2016, to 53% at the end of 2018 and it should be closer to 40% at the end of this year. At the same time, maybe 40% of the shoes made in China are sold in the U.S. So while it's not inconsequential, roughly 15% of revenues could be impacted by a tariff war, and that number will continue to decline. With where the stock trades today, and given that the company has net cash on its balance sheet to ride out any disruptions, we think we're being paid to take that risk.

You've owned multiple shoe manufacturers, including another current holding in Yue Yuen Industrial [Hong Kong: 551]. What do you like about the business?

BR: On the demand side, these companies benefit from the increasing fashion and specialization elements of shoes. When I was a kid I had one pair of everyday shoes and maybe a pair of dress shoes that I never wanted to wear. It's a much different ball game today, with a proliferation of different shoes for different sports and social occasions, sold on a global basis. All of that increases the velocity and complexity of shoe manufacturing, which we

INVESTMENT SNAPSHOT

Stella International Holdings
(Hong Kong: 1836)

Business: Development, manufacture and sale of casual and fashion footwear, mostly under contract to third-party brand owners; factories are in China, Vietnam and Indonesia.

Share Information
(@5/30/19, Exchange Rate: $1 = HK$7.85):

Price	**HK$13.20**
52-Week Range	HK$6.36 – HK$14.38
Dividend Yield	4.3%
Market Cap	HK$10.46 billion

Financials (2018):

Revenue	US$1.59 billion
Operating Profit Margin	3.1%
Net Profit Margin	4.1%

Valuation Metrics
(@5/30/19):

	1836	S&P 500
P/E (TTM)	20.3	21.7
Forward P/E (Est.)	11.5	16.9

Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Invesco	5.0%
Marathon Asset Mgmt	4.9%
Sun Life Financial	2.1%
Dimensional Fund Adv	1.3%
Prudential PLC	1.1%

Short Interest (as of 5/15/19):

Shares Short/Float	n/a

STELLA PRICE HISTORY

THE BOTTOM LINE

The market appears more concerned about potential trade-conflict impacts on the company than enamored by its defensible position in a secularly growing market, says Joseph Fei. Assuming 10% annual growth in earnings per share combined with some normalization in the multiple, he expects the shares to reach HK$23-24 within the next five years.

Sources: Company reports, other publicly available information

believe is a good thing for the established players.

The experience, expertise and scale of these companies also create relatively important barriers to entry. They are constantly being pushed to produce cheaper, lighter, more attractive shoes, at higher speeds, with better quality and at lower cost. These big companies have track records of doing that, creating with clients long, entrenched relationships that are not easy to undo. Nike is not going to let just anybody make its latest $400 Jordan shoe. We think all this adds to the sustainability of businesses like Stella and Yue Yuen.

After bottoming below HK$7 last October, Stella's shares today trade at around HK$13.20. How attractive do you consider the stock today?

JF: The key inputs in our valuation model are compound annual revenue growth of 2-3% and core operating margins increasing from roughly 7% to 10% within the next five years. That's a function of operating leverage and ongoing improvements in production efficiency. All in, we're expecting bottom-line growth at closer to 10% per year.

With the stock having recovered a bit, we don't see it quite doubling from today's price over the next five years. But we still see plenty of upside over that time – to HK$23-24 per share – driven by earnings growth and some normalization of the multiple. In the meantime, we'll also be collecting what to us is a better than 5% dividend yield, which we think can be safely maintained.

Back to Europe, why do you think the stock-market woes of consumer-products firm Ontex Group [Brussels: ONTEX] will prove temporary?

BR: This is another company that we believe has a nice, steady underlying business that is currently being masked by some temporary problems. It's a leading producer of disposable hygienic products, with baby diapers accounting for about 60% of total revenues, adult diapers for 30%, and the balance in feminine-hygiene products. Roughly 55% of the business is private label, which is their focus in more-developed markets like Western Europe, while 45% comes from selling their own branded products, primarily in emerging markets.

We generally consider this a defensive, stable business, with decent growth prospects as disposable incomes increase in emerging markets, and as private-label brands take share and populations age in more developed markets. It's a scale business, and Ontex in their private-label markets is often two to four times bigger than the next largest competitor. On the branded side, they are generally a top-three player in the markets in which they compete.

JF: The stock has sold off for a few reasons. One has been unexpectedly poor performance in Brazil, where the company made an acquisition in 2017 that has not at all gone well. A second big factor has been increases in raw-materials costs, especially for fluff pulp, which has increased in price by something like 30% in the past

INVESTMENT SNAPSHOT

Ontex Group
(Brussels: ONTEX)

Business: Manufacture, sale and distribution of private-label and branded disposable personal-hygiene products, including diapers, wet wipes, sanitary pads and tampons.

Share Information
(@5/30/19, Exchange Rate: $1 = €0.90):

Price	**€14.83**
52-Week Range	€14.54 – €27.46
Dividend Yield	3.2%
Market Cap	€1.20 billion

Financials (TTM):

Revenue	€2.29 billion
Operating Profit Margin	7.6%
Net Profit Margin	4.2%

Valuation Metrics
(@5/30/19):

	ONTEX	S&P 500
P/E (TTM)	12.4	21.7
Forward P/E (Est.)	10.6	16.9

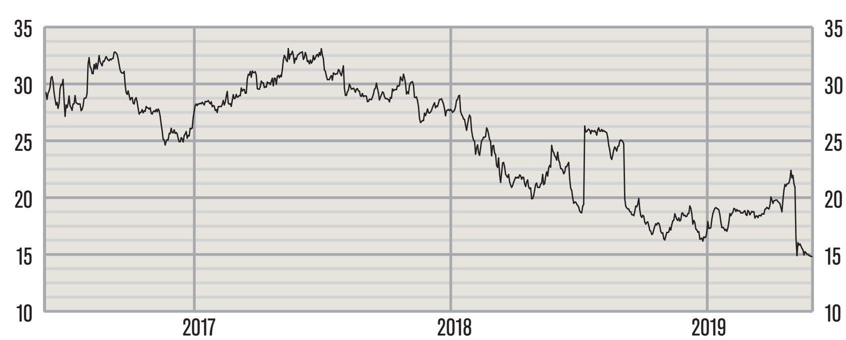
Largest Institutional Owners
(@3/31/19 or latest filing):

Company	% Owned
Groupe Bruxelles Lambert	20.0%
Janus Henderson	4.8%
Franklin Templeton	4.2%
CI Investments	3.3%
Allianz	3.1%

Short Interest (as of 5/15/19):

Shares Short/Float	n/a

ONTEX PRICE HISTORY



THE BOTTOM LINE

While problems in integrating a Brazilian acquisition and unexpectedly sharp increases in raw-materials costs mean the company is underearning its potential, Joseph Fei believes its strong market positions in a stable, defensive industry will deserve more market respect. As earnings recover, he believes the shares over the next five years can double.

Sources: Company reports, other publicly available information

year to nearly a 10-year high. The market also didn't seem to like the "Transform to Grow" plan Ontex announced in the fourth quarter of last year to boost operational efficiency and bump up innovation.

Our basic view is that the Brazil acquisition is a very fixable problem, that raw-materials cost increases can be passed on and, in any event, will revert to the mean, and that while the Transform to Grow plan disappointed the market in the short term, we believe that it will improve the overall competitiveness of the business over the long term.

How would that more positive view translate into expected upside for the stock, now trading at just under €15?

JF: The stock today trades at less than 11x forward earnings. That's low for a very resilient company that we believe can generate earnings growth of 5-7% per year and that pays a dividend yield above 3%. If we're right on the earnings growth, there's no reason the stock of a stable business like this shouldn't trade for a high-teens multiple. If that happens, the share price would hit our goal of doubling from today's level.

You've written recently about lessons learned from the popping of the dot-com bubble 20 years ago that you think are relevant to today. Can you elaborate on that?

BR: If you look at the numbers, the relative dominance of growth investing over value investing has not been as extreme as it is now since the dot-com bubble. Why that's relevant is because the last time equity markets strongly resembled today's, most investors lost a lot of money in the next few years when the S&P 500 was down nearly 50% peak-to-trough. Microsoft, then as now, was one of the world's best companies, but its share price fell 65% and required over 16 years to get back to its bubble price.

In retrospect, one of the best ways to mitigate the severe losses that came with the bursting of the dot-com bubble was to avoid the market darlings of the day and invest instead in deep-value stocks with very low expectations embedded in their share prices. Those stocks had already experienced their bear market and had the potential for uncorrelated idiosyncratic recoveries. We think those are precisely the types of stocks we own today. VII