Going Separate Ways
Investing around spinoffs has proven highly profitable for bargain-hunting investors – and will likely remain so, despite so many being in on the secret.

Bloomberg since the end of 2002 has maintained a US Spin-Off Index, which tracks the share prices of newly spun off companies with $1-billion-plus market caps for three years after they begin trading. Over that nearly 13-year period the index has increased 557%, versus a 137% return for the S&P 500.

This spinoff anomaly has been an open secret among value investors for longer than that. Early research on spinoff outperformance goes back more than 50 years. Joel Greenblatt wrote in detail on the subject in his 1997 book, *You Can Be a Stock Market Genius*. With spinoff activity near an all-time high, we examine the many structural reasons spinoffs can be mispriced and ask four experts where they’re looking for such mispricing today.

Strength in Numbers
Higher potential returns in small caps naturally come with higher potential risks. Ken Burgess excels at capturing the returns, while evading the risks.

Quality is in the eye of the beholder in assessing potential investments, but Systematic Financial Management’s Ken Burgess has a more straightforward filter than most: “When we talk about a high-quality company, all we’re looking for is superior financial strength,” he says. “We look at companies as S&P or Moody’s would in assigning credit ratings.”

Safety-first hasn’t meant sacrificing returns. The Small Cap Value Free Cash Flow strategy he’s managed almost since its 1993 inception has earned a net annualized 13.1%, vs. 8.8% for the Russell 2000.

With a positive U.S. economic outlook, Burgess sees upside today in such diverse areas as specialty retail, women’s footwear, home automation, building products and industrial equipment.

Inside This Issue
FEATURES
Investor Insight: Spinoffs
Examining the structural reasons spinoff companies can be mispriced and where to look for such potential mispricings today. See page 2

Investor Insight: Ken Burgess
Finding the glass half-full for such firms as Michael Kors, Steve Madden, Control4, Regal Beloit and Continental Building. See page 10

A Fresh Look: Keysight
Positive dynamics of spinoffs can take time to manifest. Shareholders here are still waiting. See page 18

Uncovering Value: Sino Land
What “unprecedented” distinction makes this real estate company worthy of attention? See page 19

Editor’s Letter
Food for thought for the contrarian, even cynical, investor. See page 20

INVESTMENT HIGHLIGHTS

<table>
<thead>
<tr>
<th>INVESTMENT SNAPSHOT</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental Building</td>
<td>16</td>
</tr>
<tr>
<td>Control4</td>
<td>15</td>
</tr>
<tr>
<td>Covisint</td>
<td>9</td>
</tr>
<tr>
<td>Fiat Chrysler</td>
<td>6</td>
</tr>
<tr>
<td>Keysight Technologies</td>
<td>18</td>
</tr>
<tr>
<td>Michael Kors</td>
<td>13</td>
</tr>
<tr>
<td>Regal Beloit</td>
<td>17</td>
</tr>
<tr>
<td>Sino Land</td>
<td>19</td>
</tr>
<tr>
<td>Steve Madden</td>
<td>14</td>
</tr>
<tr>
<td>Vista Outdoor</td>
<td>7</td>
</tr>
</tbody>
</table>

Other companies in this issue:
Going Separate Ways

Corporate spinoff activity, today at historically high levels, has proven fertile ground for market inefficiency. Why is that so, and how can discerning investors separate the wheat from the chaff in sifting through prospects?

In years of interviewing successful money managers, we’ve yet to come across one who when asked about corporate spinoffs as potential sources of ideas replied, “It’s a waste of time – people know to look there, so everything’s priced in.” Nor have we seen historical studies of spinoff-company investment returns indicating anything but material spinoff outperformance over time. One commonly watched barometer, Bloomberg’s US Spin-Off Index, over the past 13 years has bested the S&P 500 by almost 900 basis points per year.

Bargain hunters among spinoffs cite many structural factors that can lead to spinoff companies – and sometimes, by extension, their parents prior to the spinoff – being mispriced:

Limited Information

The documentation filed with the SEC when companies split can be quite complex and the pro-forma financials can be fuzzy, dealing with tricky questions such as how debt and overhead are allocated, how assets are depreciated and how costs will evolve in the separate companies. While some investors gravitate toward complexity, many others would rather look elsewhere.

The typical nature of spinoffs also tends to limit analyst interest and coverage. Since spinoffs usually are just distributed to existing shareholders, no underwriters are out beating the bushes to drum up investor demand by singing the company’s virtues. The dearth of interest often persists, as the analyst who followed the usually much-larger parent doesn’t bother with the smaller spinoff.

Forced Selling

Setting aside whether parent-company shareholders might even want to own the shares they receive in a spinoff, many by charter or strategy can’t. An S&P 500 index fund can’t own a spinoff company outside the index. A large-cap manager can’t own what is often a small- or mid-cap spinoff. Financial advisors may counsel the sale of spinoff shares because they don’t fit with the financial plan in place. The result of all this can be a material amount of indiscriminate selling not based on investment merits – a typical formula for market mispricing.

Sandbagging

While investors usually need to be on guard for excessively promotional man-
agement, the opposite can be true when it comes to spinoffs, where those in charge often have a significant financial incentive to underpromise and overdeliver. Top managers’ incentive-stock plans are typically based on average share prices of the spinoff company for the first 20 or so days of trading after the spinoff, which can lead to sandbagging of the highest order before those prices are locked in. In making the case for eBay spinoff PayPal [PYPL] in the last issue of VII [October 30, 2015], Adam Weiss of Stillwater Investment Management cited the example that management expected more than $400 million in standalone annual public-company costs for PayPal going forward. After studying all comparable large spinoffs since 2010, Weiss concluded the more reasonable number would be closer to $50 million.

“Capitalism Works”

The potentially most powerful reason for spinoffs’ success has less to do with the numbers and more to do with motivation. When CEO Meg Whitman announced the split of Hewlett-Packard’s personal computer and printer division from its technology-services business, she extolled each new business gaining “independence, focus, financial resources, and flexibility.” Joel Greenblatt described this power of focus in his seminal 1997 book, You Can Be a Stock Market Genius: “Another reason spinoffs do so well is that capitalism, with all its drawbacks, actually works. When a business and its management are freed from a large corporate parent, pent-up entrepreneurial forces are unleashed. The combination of accountability, responsibility, and more direct incentives take their natural course.” An added virtue for investors is that the unleashing of such forces can provide upside independent of any macro industry or market trend, particularly appealing today after six years of a mostly rising market.
The opportunity set remains robust for investors interested in spinoffs, driven in no small part by rising overall valuations, the market’s current tendency to value concentration of effort more highly than diversification, and the rise in influence and aggressiveness of activist investors. Research firm Spin-Off Advisors counted 60 completed spinoffs in the U.S. last year, the third-highest total in the past 30 years, behind only the Internet-bubble years of 1999 and 2000. This year’s total is expected to come in at 49, the fourth-highest level on record.

We turn now to four experts – Murray Stahl of Horizon Kinetics, Joe Cornell of Spin-Off Advisors, The London Company’s Jeff Markunas and Jim Roumell of Roumell Asset Management – for general insight on investing in spinoffs, as well as on where they’re looking for opportunity today. Elsewhere [see p. 18], in updating his thesis on Keysight Technologies, John DeGulis of Sound Shore Management sheds additional light on the timing involved when investing in spinoffs.

As a long-time student of spinoffs, you have identified what you consider an important change in the opportunity set around them in recent years. Describe it.

Murray Stahl: I’ll first give credit to all the reasons people cite for why spinoffs can be interesting – big company spins off smaller one that investors don’t know what to do with – because I agree with them. But there is a lot more to it than that, and it’s been changing.

Historically, companies were spun off from their corporate parents because they were perpetual underperformers. The idea from the parent company’s perspective was that you could get a higher valuation for your own stock if you got rid of your lowest-margin businesses. You wouldn’t get a decent price if you sold them and you didn’t want to pay capital gains if you did, so you spun them off.

When those businesses with low margins and low returns were on their own, they tended to be valued as if that was a permanent condition. If as an investor you could find those for which that wouldn’t be a permanent condition, you could make a lot of money. On a business with 1% margins that could reasonably be 10%, which was maybe just normal, in principle you could make 10 times your money even with no organic growth. Throw a little organic growth in there from the ability to actually reinvest cash flow in the business, and you could make a tremendous amount of money even without a higher valuation.

The logic behind spinoffs today is often different. Multi-industry companies in a modern context can be less highly valued than their independent parts. So what we’re seeing now are examples of profitable companies spinning off subsidiaries or divisions that have comparable profitability. Agilent Technologies, with an 18% operating margin, spins off Keysight Technologies, which has a 19% operating margin. B/E Aerospace, with a 17.7% EBITDA margin, spins off KLX, with a 16.5% EBITDA margin. Alliant Technologies spins off Vista Outdoor, whose EBITDA margin is 300 basis points higher than Alliant’s.

If one accepts the premise that low-margin businesses at least have the potential to become higher-margin businesses, but that higher-margin businesses have somewhat more trouble becoming even higher-margin businesses, one might view the current class of spinoff companies with a bit more caution. That’s not to say they will be incapable of producing an adequate rate of return, but the dynamic is different. You’re probably going to have to depend more on organic growth for success, which is a different proposition than a 1%-margin business getting to 10% margins.

As a result of this development, the tactics of the spinoff investor might have to shift somewhat. Historically, we’ve tended to discard the parent and keep the spinoff – although studies show that parents prosper after spinoffs as well – but in the current environment it’s more likely that either can present opportunity.

Timing today may also be different. I used to like to focus on spinoff companies that were publicly traded for six months or so and had traded off because the parent-company shareholders didn’t want them and few others were paying attention. I don’t think those ideas are going away, but today with so much spinoff activity happening with activist investors involved who are looking for immediate value enhancement, if you believe the value-enhancing case is rational, it might be more logical to buy companies before the spin takes place or is even announced [see table on p. 4].

In sifting through potential spinoff-related ideas, what are some general characteristics you look for?

MS: Not surprisingly, one would be when a higher-margin business is spinning off a lower-margin business. It happens less often today, but it can happen. Another would be when you see the CEO of the larger company decide the best place to be is with the spinoff. You don’t see that a lot, but when you do I think it’s a message to heed.

We also pay careful attention to capital structure. Sometimes a lot of debt goes to the spinoff, which can be a good thing or a bad thing. If it’s too much, it may be a burden the spinoff can’t bear and haunts it
On the Docket?

<table>
<thead>
<tr>
<th>Company</th>
<th>Ticker</th>
<th>Market Cap ($Bil)</th>
<th>Price@ 11/27/15</th>
<th>52-Week Price Change</th>
<th>Why on Radar Screen?</th>
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<td>Actuant</td>
<td>ATU</td>
<td>1.46</td>
<td>24.44</td>
<td>(-14.7%)</td>
<td>Separation of mini-conglomerate’s operating segments could improve underlying performance</td>
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<td>Advanced Micro Devices</td>
<td>AMD</td>
<td>1.84</td>
<td>2.33</td>
<td>(-12.7%)</td>
<td>Split in two could allow it to better compete with rivals and/or make it more attractive to acquirers</td>
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<td>Allegheny Technologies</td>
<td>ATI</td>
<td>1.36</td>
<td>12.42</td>
<td>(-62.2%)</td>
<td>Following Alcoa’s lead, could realize value from spinning off “High Performance Materials” segment</td>
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<td>AIG</td>
<td>AIG</td>
<td>78.77</td>
<td>63.08</td>
<td>17.0%</td>
<td>Under pressure from investors Carl Icahn and John Paulson to simplify by breaking up</td>
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<td>Chemed</td>
<td>CHE</td>
<td>2.60</td>
<td>154.08</td>
<td>40.0%</td>
<td>Disparate businesses – a hospice operator and Roto-Rooter – don’t logically go together</td>
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<td>DuPont</td>
<td>DD</td>
<td>58.80</td>
<td>67.09</td>
<td>(-0.6%)</td>
<td>Persistent activist pressure to improve management focus and accountability</td>
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<td>Exelon</td>
<td>EXC</td>
<td>25.40</td>
<td>27.62</td>
<td>(-23.0%)</td>
<td>Could consider separating regulated and unregulated assets, which are valued differently by the market</td>
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<td>Forestar</td>
<td>FOR</td>
<td>0.45</td>
<td>13.52</td>
<td>(-10.0%)</td>
<td>Complex portfolio of assets could be better understood by separating real estate and energy businesses</td>
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<td>Gap</td>
<td>GPS</td>
<td>11.05</td>
<td>27.36</td>
<td>(-30.0%)</td>
<td>Fitness and lifestyle brand Athleta would likely garner high stand-alone valuation</td>
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<td>Griffon</td>
<td>GFF</td>
<td>0.84</td>
<td>18.27</td>
<td>48.7%</td>
<td>Whole trades at a discount to the multiples awarded peers of its three disparate businesses</td>
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<td>LSB Industries</td>
<td>LXU</td>
<td>0.14</td>
<td>6.23</td>
<td>(-80.2%)</td>
<td>Keeping chemicals and climate-control units together provides few synergies and dampens valuation</td>
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<td>Merck</td>
<td>MRK</td>
<td>150.74</td>
<td>53.96</td>
<td>(-10.0%)</td>
<td>Ongoing internal review may lead to further divestitures that increase therapeutic focus</td>
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<td>Nationstar Mortgage</td>
<td>NSM</td>
<td>1.48</td>
<td>13.48</td>
<td>(-53.5%)</td>
<td>Value of Solutionstar real estate services business could be better recognized as an independent company</td>
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<td>Pitney Bowes</td>
<td>PBI</td>
<td>4.15</td>
<td>21.06</td>
<td>(-12.5%)</td>
<td>Could face pressure to separate businesses thought to be in secular decline from faster-growing assets</td>
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<td>Stanley Black &amp; Decker</td>
<td>SWK</td>
<td>16.33</td>
<td>109.06</td>
<td>16.0%</td>
<td>Separation of security business, as others have done, could add shareholder value</td>
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<td>Tredegar</td>
<td>TG</td>
<td>0.50</td>
<td>15.39</td>
<td>(-13.0%)</td>
<td>Recent management shakeup could trigger an array of value-unlocking transactions</td>
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<td>Vector Group</td>
<td>VGR</td>
<td>3.08</td>
<td>25.16</td>
<td>22.0%</td>
<td>Disparate tobacco and real estate operating units could both be valued more highly if separate</td>
</tr>
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</table>

Sources: The Spin-Off Report, Horizon Kinetics, LLC; other publicly available information

Are there any old-school, low-margin spinoffs attracting your attention today?

**MS:** There have been recent spinoffs more of the historical cast as media companies have split off what were their traditional print-publishing businesses. There’s no guarantee they’re going to work, but these are deals more like what used to happen. E.W. Scripps and Journal Communications merged their broadcast assets and spun off their newspaper businesses into Journal Media Group [JMG]. News Corp. split in two, with its newspaper assets, including The Wall Street Journal, staying under the News Corp. [NWS] name. Gannett [GCI] now runs its newspapers under its name and its television assets are in a separate company called Tegna. In all these cases the publishing businesses are lower-margin and struggling, and the question is whether they can reorient themselves in a way that allows them again to prosper.

The case can be made that as local newspaper businesses evolve into information-services businesses, mostly delivered online, that in the fullness of time there will be a cost structure and demand environment, both from readers and advertisers, that will allow these companies to perform much better than they do now. It’s going to take time, but eventually I believe it will work. What’s problematic is that you want to invest in low-margin businesses when you think they’re not subject to further margin pressure, and it’s not clear that’s the case today with newspapers. The most likely scenario is that they struggle for the first couple of years and then eventually find their way.

Do you expect the spinoff calendar to remain robust?

forever. But if there’s debt and you believe it’s manageable and can be paid down over time, those can make for excellent investments, basically like a publicly traded leverage buyout.

Another particular favorite of mine is the very small spinoff that those engaged in industrial-scale money management are unable or unwilling to own. It’s rare but fascinating what you find from time to time in the sub-$100 million market cap world of spinoffs.

Don’t you fall into that category of an industrial-scale manager?

**MS:** Yes, but my feeling has always been that if I’m walking down the street and see a $20 bill on the sidewalk, I don’t leave it there just because it’s not going to have a material impact on my net worth. I’m going to pick it up.
How would you characterize spinoff quality of late?

JC: It’s always a mixed bag. One factor in recent years has been how aggressive the activist community has been in pushing for spinoffs as a means of value creation. Sometimes they make a great deal of sense, but I tend to be more skeptical of activist-forced deals than if management has laid out a long-term rationale and plan for why it makes sense. If you look at some of the unmitigated disasters in the past year and a half, like Civeo [CVEO] being spun out of Oil States International or TimkenSteel [TMST] coming out of Timken, the common denominator was pressure from activists arguably looking for a short-term pop in value for the parent company’s shares.

These don’t have to be activist related, but I’m also always leery when the spinoff gets jammed with an irresponsible level of the former parent’s debt. I’d argue this was the case when DuPont spun off its performance-chemicals unit, now called Chemours [CC], this summer. Chemours not only inherited a debt load partly built to fund DuPont share buybacks, but it also had to take on some of the parent’s environmental liabilities. The stock closed on its first day of trading at $16.50 and now trades at less than $6.50.

One of your favorite ideas today, Fiat Chrysler [FCAU], is a parent company doing the spinning as opposed to the spinoff company itself. Is that unusual?

JC: Most of the research on the subject indicates that while there may be more bang for the buck in the spinoffs themselves, the shares of the parent companies tend to outperform the market as well.

In Fiat Chrysler’s case, the company in October sold 10% of its Ferrari business in an initial public offering, which now trades under the ticker symbol RACE. In a second step, Fiat is spinning off the remainder of its Ferrari stake in a transaction that’s expected to be completed in January. So in this case we’re looking at a sum-of-the-parts value for Fiat today, prior to its complete exit from Ferrari, and think the market is undervaluing the shares.

Describe the rationale for the spin.

JC: The rationale here makes sense to us. In Ferrari, Fiat had an ultra-high-end global brand that arguably was not being fully valued as part of a mass-market car company. At the same time, Fiat sees considerable potential to capitalize further on its merger with Chrysler. Carving out Ferrari not only provides extra capital to execute on its business plan, but also helps more clearly highlight the value of what’s left over.

Talk about what is left over and what they plan to do with it.

JC: The company has six operating segments. Four of those sell mass-market vehicles by global region, under such brands as Fiat, Chrysler, Jeep, Dodge and Ram. One sells the remaining luxury brands, Maserati and Alfa Romeo, globally. The final segment is a worldwide components business. Operations are in some 40 countries and the company has put a premium on centralizing design, engineering, development and manufacturing for the mass-market brands to best take advantage of global scale. Based on total vehicle sales in 2014, Fiat was the seventh-largest automaker in the world.

Management in May of last year laid out a five-year business plan meant to drive 9% compound annual growth overall through 2018, with particular emphasis on expanding the Fiat brand in Latin America, Asia and North America, while also expanding dramatically the global scale of Jeep, Maserati and Alfa Romeo. Through self-funding, the goal is to reduce net industrial debt to less than €1 billion, from €11 billion today.

While we consider the plan reasonable, I should point out that we’re not really making a call on whether it ultimately works out. With the spinoff as a catalyst, we’re looking at whether the business as it stands today is worth less than a fair
INVESTOR INSIGHT: Spinoffs

INVESTMENT SNAPSHOT

Fiat Chrysler
(NYSE: FCAU)

Business: Design, engineering, manufacturing and distribution of passenger cars and light commercial vehicles; brands include Fiat, Chrysler, Jeep, Dodge and Ferrari.

Share Information
(@11/27/15):

Price 14.35
52-Week Range 11.08 - 17.08
Dividend Yield 0.9%
Market Cap $18.50 billion

Financials (TTM):
Revenue $117.25 billion
Operating Profit Margin 3.9%
Net Profit Margin 0.9%

Valuation Metrics
(@11/27/15):

<table>
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<th>FCAU</th>
<th>S&amp;P 500</th>
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<tr>
<td>P/E (TTM)</td>
<td>29.8</td>
<td>23.2</td>
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<tr>
<td>Forward P/E (Est.)</td>
<td>9.4</td>
<td>17.5</td>
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Largest Institutional Owners
(@9/30/15):

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<tr>
<th>Company</th>
<th>% Owned</th>
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<tbody>
<tr>
<td>Baillie Gifford</td>
<td>10.7%</td>
</tr>
<tr>
<td>Harris Assoc</td>
<td>2.2%</td>
</tr>
<tr>
<td>Norges Bank</td>
<td>1.7%</td>
</tr>
<tr>
<td>Vanguard Group</td>
<td>1.4%</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>1.1%</td>
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</table>

Short Interest (as of 11/13/15):
Shares Short/Float 9.3%

INVESTMENT SNAPSHOT

THE BOTTOM LINE
With the second stage of the spinoff of its high-end Ferrari business still to come in January, Joe Cornell believes the market isn’t fully recognizing the value of parent Fiat Chrysler’s ongoing business. What he considers a conservative sum-of-parts analysis pegs Fiat Chrysler’s fare share value today at $18.50, 30% above the current market price.

Sources: Company reports, other publicly available information

How are you estimating intrinsic value today, versus a $14.35 share price?

JC: For the four mass-market regional businesses, we apply multiples on estimated fiscal-year 2016 revenues of 0.1x to 0.2x, which are below peer averages. We value the luxury segment 0.6x 2016 sales and the components business at 0.1x. For the remaining 80% stake in Ferrari, we use 2.5x 2016 revenues, which results in a discount to the actual market value.

Adding in a financial-services business at 1.5x book value, subtracting corporate overhead, and adding back net proceeds from the Ferrari IPO, we arrive at a target value of $18.50 per share. Even that level implies only a 1.7x EV/EBITDA on fiscal-2016 Fiat Chrysler estimates, a significant discount to peers.

Given that we believe Ferrari has until recently been somewhat overvalued – our value estimate for it is $46.75, around today’s share price – we’ve recommended going long FCAU shares and at the same time shorting RACE shares. To reflect the planned spinoff ratio, for every 100 FCAU shares we’d short 12 RACE shares. You can just go long Fiat Chrysler, but this trade gives you pure exposure to the mis-pricing we see in the ongoing business.

Jeff Markunas
The London Company

“The agenda has been sharpened for CFOs. If they don’t control the agenda, someone will take control of it for them.”

Are spinoffs an active area of focus for you or do good ideas just present themselves from time to time?

Jeff Markunas: We’re downside-protection investors, evaluating opportunities through the balance sheet, which naturally leads us to look at companies that we believe have underappreciated and undervalued assets. At a time when interest rates are so low and a sluggish economy makes it tough to produce organic growth, we’re also seeing this supercycle of activism.

That has sharpened the agenda for corporate CFOs, who recognize that if they don’t control the agenda, someone will come in and take control of it for them. So it’s not so much about our going out and looking to specifically benefit from spinoffs, but there’s a lot of activity centered on unlocking just the type of value we’re looking for, and spinoffs can certainly be a part of that.

Describe the genesis of your holding in Vista Outdoor [VSTO], which was spun off from Alliant Techsystems in February.

JM: We had originally bought into Alliant Techsystems in the first quarter of 2013,
when defense and aerospace stocks were in a funk over sequestration. The company at the time was in three businesses: military ammunition, aerospace systems (often with military applications), and what they called the Sporting Group, which focused on commercial ammunition and shooting sports. Given the widespread pessimism about military spending, Alliant’s valuation was extremely depressed at less than 5x EV/EBITDA and we thought we were buying the shares at a roughly 80% discount to intrinsic value.

The combination of the commercial and defense businesses was kind of an odd marriage, and it became clear to us that Alliant’s CEO, Mark DeYoung, wasn’t overly keen on running a defense company. Prior to any formal discussion of a split to unlock value, the company added to its commercial-ammunition business by buying a long-gun manufacturer, Savage Arms, as well as Bushnell, which makes scopes, binoculars and other hunting accessories. That indicated to us that they wanted the sporting business to be something substantial enough to stand on its own.

What interested you in Vista’s prospects?

JM: They were creating a very clean company out of the gate, underlevered and with good free-cash-flow generation. Most of the debt stayed with the parent, which was appropriate given that the military contracts accounted for the bulk of the company’s fixed costs. To give you a sense of the strength of the balance sheet, very soon after the spin Vista announced a $200 million share repurchase.

They also had a well-articulated game plan. Through its leading position in ammunition, the company has very strong distribution and retail relationships, and the idea was to broaden and deepen through intelligent acquisitions its product offering across outdoor-sports categories like hunting, shooting sports, camping, fishing, trail sports and water sports. Defining it broadly, they say the cumulative annual spending in the markets in which they see potential to expand is over $60 billion, much of it extremely fragmented. We’re not thematic investors, but if you look at our portfolio we gravitate toward industries that are fragmented and where there’s the opportunity for the strongest players to consolidate share over time. That’s exactly what we believe Vista is looking to do. They’re not trying to buy businesses and consolidate costs, they’re trying to buy businesses that are complementary and that they believe they can grow.

Are they also looking to diversify from guns and ammo?

JM: The goal, which isn’t far from the current situation, is to have roughly 60% of the business tied to shooting sports and 40% to other outdoor categories. People tend not to appreciate that shooting sports are actually a growth market, with the growth disproportionately coming from people age 18 to 34 and from women. The common perception is that it’s an older and male-dominated demographic, but it’s not.

That said, acquisitions are likely to be more focused on broadening the mix. Over the summer the company bought Jimmy Styks, a designer and marketer of
stand-up paddle boards, as well as CamelBak Products, which sells hydration packs, drink bottles and filtration systems used by outdoor enthusiasts.

It's worth noting that Mark DeYoung stayed to run Vista, the smaller company, after the spin. He's passionate about the strategy and the market opportunity, and we're confident in both the game plan and how he thinks about capital allocation. They've done exactly what they've said they're going to do.

The shares, at a recent $44.35, are up 18% from their first-day close in February. What upside do you see from here?

JM: Rather than have to rely on our ability to precisely forecast revenues and profits well into the future, our approach is to look at the run-rate of earnings before interest and taxes, make very modest assumptions on growth and margins, and then evaluate the balance sheet and assume a theoretical recapitalization that substitutes debt for equity up to a reasonable level and lowers the overall weighted average cost of capital. We then run those assumptions through a discounted-cash-flow analysis to arrive at an estimated intrinsic value.

In the case of Vista, we're assuming around 1-2% annual EBIT growth and that the company could theoretically lever up to 4x net debt to EBITDA, from a level of less than 2x today. Again, we're not saying that's what they're going to do, but it is something within their control. When we run the numbers we get a fair value of around $55 per share. We feel that gives us a solid margin of safety, with options to buy up to about $5.

I would put Covisint in the category of a spinoff that happened prematurely. Going back to the beginning, it was launched in 2000 by Ford, General Motors and DaimlerChrysler to create a secure, online supply-chain buying and selling platform for the automotive industry. They spent hundreds of million of dollars on it and created an industrial-strength platform that was sort of pioneering in what's known as federated identity management [FIM], which lets multiple enterprises use the same identification data to obtain access to the networks of all enterprises in the group. Think of it as a big house where you can come in from the front door, but there are lots of different rooms that only different subsets of people can enter. An FIM system manages all that securely and efficiently.

The supply-chain exchange never really took off, having more to do with the companies' and regulators' ultimate comfort with a common platform than the technology of the platform itself. Compuware bought the technology in 2004 and very deliberately started to build a business around it, but it was this small little software-as-a-service platform in this big mainframe-software company, so it never really got much attention. That changed when an activist, Elliott Management, came after Compuware in 2012, and one of the ideas hatched was to take advantage of the crazy valuations being put on software-as-a-service companies and spin Covisint off. It had $50 million in subscription revenues and 95% customer renewal rates, but from what we've learned, wasn't fully baked yet in terms of sales and marketing strategy and infrastructure. We assume you think that's been fixed.

JF: For anyone who has tons of data and wants to create a secure environment to allow multiple stakeholders to view discrete parts of it, that's what the Covisint platform does. In an increasingly cloud-based world, there are countless applications for such technology, and the company already has blue-chip customers, including GM, Ford, Hyundai, Roche and Shell. For GM, for example, Covisint's platform powers its OnStar system, which provides emergency, diagnostic and communications services to GM car owners. Going back to the company's early days, suppliers wanting to sell to GM do so through Covisint technology as well. Automotive customers account for about 50% of current overall subscription revenues, with GM making up about half of that. With the increasing emphasis on "connected" cars, we think that's a strength going forward.

On the sales and marketing front, management has decided it wants to go after big fish. Key to that has been the signing of strategic selling partnerships with both Cisco and Tech Mahindra, a large Indian IT-services group. Cisco's deal is a three-
INVESTMENT SNAPSHOT

Covisint
(Nasdaq: COVS)

Business: Provider of platform software services enabling organizations to securely connect with distributed communities of customers, suppliers and business partners.

Share Information (@11/27/15):
Price 2.56
52-Week Range 1.79 – 3.33
Dividend Yield 0.0%
Market Cap $101.49 million

Financials (TTM):
Revenue $82.09 million
Operating Profit Margin (-25.5%)
Net Profit Margin (-36.4%)

Valuation Metrics (@11/27/15):

<table>
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<tr>
<th></th>
<th>COVS</th>
<th>Russell 2000</th>
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<tbody>
<tr>
<td>P/E (TTM)</td>
<td>n/a</td>
<td>146.0</td>
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<tr>
<td>Forward P/E (Est.)</td>
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Largest Institutional Owners (@9/30/15):

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<th>Company</th>
<th>% Owned</th>
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<tr>
<td>Fidelity Mgmt &amp; Research</td>
<td>12.9%</td>
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<tr>
<td>Neuberger Berman</td>
<td>8.0%</td>
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<tr>
<td>Elliott Mgmt</td>
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<tr>
<td>Portolan Capital</td>
<td>7.5%</td>
</tr>
<tr>
<td>J. Goldman &amp; Co</td>
<td>6.9%</td>
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</tbody>
</table>

Short Interest (as of 11/13/15):
Shares Short/Float 1.1%

COVS PRICE HISTORY

THE BOTTOM LINE

Jim Roumell believes the company has righted itself strategically after a premature spinoff, focusing on “big fish” potential customers that he expects will soon to start to reel in. If the company grows as he thinks it can, he believes based on peer valuations that it could be worth 2.5x 2016 revenues, which would translate into a $5.50 share price.

Sources: Company reports, other publicly available information

year licensing agreement, at $6 million per year, to use Covisint’s technology in the cloud-platform services it’s selling. The $6 million per year covers a certain amount of sales and after that there’s a revenue share. Tech Mahindra is using Covisint’s technology in a key initiative it’s rolling out to sell a comprehensive suite of “Internet of Things” technology and services.

To be clear, there’s a great deal of skepticism about Covisint’s growth prospects. Given its history, that’s understandable. Our variant view is that the company has the right technology, is targeting the right customers and is enlisting the right partners. They’re certainly acting confident, having hired 20 new account executives and systems engineers so far this year and establishing a new office in San Francisco. We believe they have a lot of big fish close to the boat, but they obviously have to start reeling a few in soon.

With the shares at around $2.60, how are you looking at valuation?

JR: The company is tiny, with just over $100 million in market cap. Subtract $40 million in net cash, and the enterprise value is only around $60 million. Against that is a run rate of $67 million in subscription revenue – ignoring $20 million in to-be-deemphasized professional-services revenues – which we believe can increase 10% over the next 12 months. So the current enterprise value is only 80-85% of our estimated 2016 revenues.

Software-as-service providers with sticky revenue tend to trade for 2x to 5x total sales. If we’re right on sales growth, at what we’d consider a reasonable 2.5x revenues that would translate into an equity value of $185 million. Add in the cash and the total market value would be $225 million, or more than $5.50 per share.

Isn’t profitability, or specifically the lack thereof, a concern here?

JR: When you have subscription revenue that is so sticky, you want to spend on product and sales development to create growth, which is what they’re doing. If the growth isn’t there, they could cut back on sales and marketing and be nicely profitable right away.

If the company can’t grow to a sufficient scale, we think it’s highly likely that it’s bought out by somebody who can basically fold the operation in and eliminate SG&A. Cisco, for example, is paying $18 million just to license the code for three years. At today’s enterprise value, they could pay a bit more than 3x that and own the entire company and $70 million of recurring revenue. Covisint wouldn’t sell at that price, but we could imagine the math working for both sides at one point.

Are all the big-money investors out of the stock by now?

JR: Interestingly, no. Fidelity and Neuberger Berman are the two largest shareholders, and both added to their positions last quarter. Right behind is Elliott Management, which has kept the position it got after the spinoff. We were also pleased to see that Vector Capital, a well-regarded technology investor that often works constructively with firms it believes have real growth prospects, filed a 13D earlier this month disclosing a new 6% stake.
Ken Burgess of Systematic Financial Management explains his streamlined take on business quality, why one beaten-down sector in particular has attracted his attention, why his portfolios are more diversified rather than less, and what he thinks the market is missing in Michael Kors, Steve Madden, Control4, Continental Building Products and Regal Beloit.

It's rare to speak with a value manager these days who doesn't lead with his or her focus on high-quality companies. You're no exception. What does high quality mean to you?

Ken Burgess: The free-cash-flow strategy we started over twenty years ago was and is predicated on the belief that we can access the higher investment returns generally associated with small-to-medium sized companies without sacrificing portfolio quality. So yes, we're a high-quality manager, which isn't in and of itself that unique.

What I think is somewhat unique is how we define quality. It's not about consistent sales growth, or high returns on equity, or high operating margins, or many of the other metrics people typically cite. When we talk about a high-quality company, all we're looking for is superior financial strength. It's more akin to the credit analysis the ratings agencies do. They look at the cash flows of the business over time, their volatility and their sustainability. They compare those cash flows with the company's overall debt burden from interest and principal repayment. Companies generating lots of cash, with minimal debt and exceptionally strong debt-coverage ratios, get strong credit ratings. Those are the same companies that interest us.

Our focus is on operating cash flow – what the company could readily distribute in the form of a dividend. While consistency is a factor, that's not to say we wouldn't invest in a company with negative free cash flow due to a rough patch or the need to make big investments. We'd want to understand the cyclical or other impacts on cash flow and reflect that in a more normalized view over a cycle.

In terms of debt coverage, we won't invest in a company unless it can retire all of its total outstanding debt with free cash flow within ten years. To put some perspective on that, roughly 20% of the companies in the Russell 2000 Index today have negative debt-coverage ratios, meaning they have outstanding debt and are burning cash. The average number of years needed to cover all debt for Russell 2000 companies is just under 22. In our small-cap portfolio as of September 30th the comparable number was 5.5. While we like to believe we hit our share of home runs, the strategy is more about not striking out.

Systematic Financial [VII, October 31, 2007] puts a lot of emphasis on screening to generate ideas. How does that generally work with your strategy?

KB: Our quantitative analysts every Monday morning prepare what we call a research focus list, consisting of roughly 200 small-cap and 100 mid-cap companies that trade at low multiples to free cash flow, have limited debt, and have strong debt-coverage ratios. We look at longer-term historical data for cash flows and capital spending rather than just the latest 12 months, to help us correct for recent and temporary aberrations. If you screen without doing that you're more likely to miss potentially interesting ideas.

I would point out that while the focus list is extremely valuable for idea generation, we're not a slave to it. Screens capture what the company has done in the past and where it is right now. That can point you in the right direction, but there has to be an investible thesis about where the company is going and how value will be realized in the future. Take a company like Ennis [EFN], which primarily makes business forms. We’ve owned it in the past and it’s well run, throws off considerable cash, has a great balance sheet, pays a good dividend and trades at a low multiple of normalized free cash flow. That said, given the secular challenges to its business, it’s hard for me to see what's going to make the stock go up over the next five years. It’s regularly on our list, but it’s not one we’re compelled at the moment to dig into.

ON RETAIL STOCKS:
Something might still be a great business, but the whiff of slower growth can just devastate the share price.

Turmoil in retail seems to have gotten your attention, even in stocks with more of a fashion element, like Abercrombie & Fitch [ANF], Coach [COH] and Michael Kors [KORS]. Describe how these types of ideas fit what you do.

KB: We have found a number of what we think are undervalued opportunities in that space. A typical idea for us is the company that has been a strong growth story for years but starts to slow down, disappointing the growth investors who own it. It still might be a great business generating tons of cash flow, but the whiff of slower growth can just devastate the share price. Michael Kors stock early last year was at $100, and we recently bought it for our SMID-cap portfolio at around $40. Yes, the growth has slowed. Yes, profitability will be down. But what matters is whether the results we expect going forward, even with diminished expectations, yield a value much higher than the current share price. For companies like Michael Kors, Abercrombie & Fitch and Coach, the answer currently is yes.

We do have to have an opinion on whether management is doing the right
things in the stores. One reason we like investing in consumer-oriented names is that we can spend time in stores and see what’s selling, how products are merchandised and priced, and how effective the customer service is. I will admit to being early in both Abercrombie & Fitch and Coach, but we believe both have almost across the board addressed serious product, pricing and merchandising shortcomings and are poised to reap the benefits. Investors hate them, but they still generate ample free cash flow even when they’re not executing well. Those are the types of companies that get my attention.

There are also obviously shorter-term issues that are creating a lot of volatility in retail. People are understandably skeptical of blaming poor results on the weather, but the reality is that when stores are packed with colder-weather clothes and the weather is unseasonably warm to a significant degree, that is going to have a negative impact. Kohl’s [KSS] was at $80 earlier this year and now it’s at $48. Macy’s [M] was at $73 and now it’s at $40. It’s not that we believe the next quarter is going to be better than people expect in companies like that, but that the market is overreacting to what we believe is a short-term phenomenon. That provides opportunity. No one will remember or care five years from now that the fall of 2015 was unseasonably warm.

What other types of situations have you found that can make high-quality companies cheap?

KB: Rather than the growth stock becoming a value stock, we also find stocks trading at what we consider attractive prices because they’re generally underfollowed and their growth prospects are underappreciated. A good example in our portfolio today would be Universal Display Corp. [OLED], which sells organic-light-emitting-diode technologies that are used in a variety of applications – including smartphone screens, flat-panel TVs and solid-state lighting products – and can offer advantages over other technologies in terms of brightness, power efficiency, weight, display life and all-in manufacturing costs.

Sometimes as a technology is gaining traction and becoming commercially viable, the market gives companies too much benefit of the doubt and overappreciates their potential. In Universal Display’s case, while it’s becoming more recognized, the market in our estimation has taken more of a wait-and-see approach. But with a strong patent portfolio, multi-year license and supply agreements with companies like LG and Samsung, a ramping overall market for its technologies – and, by the way, $8 per share of net cash on the balance sheet – we still believe free cash flow growth in coming years will support a materially higher stock price. [Note: OLED shares trade today at just under $53, within 6% of their 52-week high.]

You’ve characterized your portfolio positioning today as “pro-cyclical.” Why?

KB: What’s behind that is our belief in a gradual improvement in the U.S. economy. While this expansion has seen muted growth relative to past economic upturns, the latter stages of the cycle could last for some time. There are few signs of overheating in terms of capital and labor deployment relative to late-cycle behavior in the past, and we’re seeing trends in the job market and with respect to energy prices that are positively impacting disposable income. That’s all constructive for our consumer-discretionary and information-technology names – two areas we’re overweight – that we expect to incrementally benefit from consumer-led growth.

Our biggest underweighting is in financials, which partly reflects our belief that our primary benchmark, the Russell 2000 Value Index, isn’t prudently diversified with a 44% share in financial stocks. (Our share at September 30 was 33%.) I’d also argue that if I’m right to be pro-cyclical, while banks and other financial businesses will do well, I don’t think from today’s prices and valuations that they have the upside that names tied more to consumer spending will.

ON FINANCIALS:

From today’s prices and valuations they don’t have the upside that names tied more to consumer spending will.
It’s surprising you own as many financials as you do, given your focus on free cash flow and debt coverage. Explain that.

KB: This gets somewhat to portfolio-management philosophy and our level of diversification. Our small-cap portfolio holds around 125 names, and while there are no hard-and-fast rules, we are cognizant of the sector weights of our benchmarks. We’re willing to be materially overweight or underweight a sector, but if the benchmark, for example, has a 21% share in banks – the case today in small-cap – we wouldn’t consider ourselves adequately diversified if we owned no banks.

With banks we stay true to our philosophy of focusing on superior financial strength, we just define it somewhat differently. Rather than looking for limited debt and strong debt coverage, we focus on banks with the strongest credit-quality metrics and the most excess capital. For valuation, we will look at P/E multiples, but put more emphasis on price to tangible book value.

An example of the type of small-cap bank we own is First Citizens BancShares [FCNCA] in North Carolina. It’s very well capitalized and non-performing assets represent less than 1% of total loans outstanding. The shares [at a recent $264] trade at less than 14x earnings and only 1.2x tangible book value. Let’s be clear, these are not particularly sexy opportunities, but we expect this type of combination of high quality and low valuation will produce attractive returns in a gradually improving economy.

How important in your due diligence is your assessment of management?

KB: We obviously want to be highly confident in management, but at the end of the day it’s more about the numbers to us. We realize as small-cap investors that we won’t always have the cream of the crop in charge, and even a bad management team can be undervalued relative to cash flow. If management isn’t as good as it should be, that isn’t typically a permanent situation. As I mentioned earlier, we want to see reasons why a stock can go up, and one catalyst is often a change in management. With Abercrombie & Fitch, for example, the departure of the long-time CEO was an important reason our conviction on the stock increased, and we’re now starting to see the benefits of that change work their way through the system.

ON MARGIN OF SAFETY:
Most people think about it in terms of downside, but it can build in upside as well. What if things happen to go right?

Describe generally how you approach valuation.

KB: We analyze businesses to arrive at future expected cash flows and then use a discounted-cash-flow model to estimate what something is worth. Built into that is a required total rate of return of at least 15%. In other words, we arrive at a share price we could pay and still earn 15% per year. We want to pay less than that, but will not pay more.

We take very much to heart Ben Graham’s notion of margin of safety and use what we believe are demonstrably conservative assumptions. If you can do that and still conclude a business is undervalued, that’s built-in margin of safety. Most people think about that in terms of downside, but it can build in upside as well. What if things actually happen to go right for the company?

Given the margin of safety you aspire to at the individual-stock level, why hold 125 positions to further mitigate risk?

KB: We’re careful with position sizes when investing a relatively significant amount of money in smaller-cap stocks that aren’t always the easiest to trade. We want to take advantage of the higher volatility in smaller-cap names – adding to long-term positions when they become depressed and lightening up on those positions when they get ahead of themselves – and it’s harder to do that well when you’re trading around large stakes. Our maximum position size is 5%, but our biggest names tend to be 2% to 2.5%.

By holding the number of names we do and taking into account our sector and industry weights relative to the benchmark, we’re striving to be more consistently good than intermittently great. The very concentrated portfolio can be dramatically off-mark at times, which isn’t to say that makes it wrong, it’s just not the type of risk we choose to take.

Is it hard to follow 125 companies at a time?

KB: If you’re focused as we are on companies’ long-term business and cash-generation prospects, we clearly believe you can follow that number of companies. If you’re constantly chasing down the latest short-term information, maybe it gets harder to do.

How do you respond to the, “Why own my 100th-best idea when I can own more of my top 20” type of argument?

KB: We actually run a focused small-cap portfolio, with roughly one-third the names we own in our regular portfolio. I can tell you that its performance has been no better than the more-diversified portfolio, which may speak to the difficulty over time of consistently identifying your “best” ideas in advance.

Why do you think the market is overreacting to what’s going on at Michael Kors?

KB: This to us is a classic case of a company that has grown hand over fist for a number of years and then, lo and behold, the business shows signs of fatigue. Same-store sales are starting to decline. Margins are under pressure. Our eyes are wide open to all of that, but in our experience there can come a point where the expectations built into the stock get so beaten down that there’s an opportunity just if
things turn out marginally better than expected. With Kors’ shares down nearly 60% from their high last year, we think we’re past that point.

We’re making a couple key judgments. One is that, unlike Coach, Kors hasn’t to any great extent made the big mistakes sellers of apparel, footwear and accessories can make as they expand rapidly. They haven’t gone too far afield in distribution or become overly promotional. Those types of things can deteriorate brand value and we don’t believe that’s the case here. The brand is maturing, but its strength is intact.

Second, we believe management has responded well to a changing environment. One big issue from a merchandising standpoint has been a fall-off in high-margin watch sales, a phenomenon that hasn’t been unique to Kors. Now when we go on store visits, instead of seeing three big tables up front selling watches, two of them now have things like an expanded line of bracelets, earrings and necklaces. It sounds simple, but the speed and skill with which the company responded to an important merchandising issue like that helped give us confidence to pull the trigger on the investment.

With the shares recently at $42.50, how are you looking at valuation?

KB: The company generates significant free cash flow, which we on a normalized basis estimate at more than $600 million per year. It has no debt and $1.3 billion in cash.

In our discounted cash flow model we assume minimal top-line growth over the next five years and that margins stay flat. By our numbers we could pay $44 for the stock and expect to meet our 15% IRR hurdle.

You spoke earlier about wanting to see, in addition to financial strength and a low valuation, catalysts that could make something go up. What are those here?

KB: There’s no arguing that the U.S. retail environment is questionable in the short run. But if we’re right that more disposable income will translate into higher consumer spending in a gradually improving economy, brand leaders like Kors should see tangible benefit from that. That’s more of an external catalyst. More specific to the company, as the shareholder base shifts further from growth to value, if the company manages the maturing of the brand franchise as well as we expect, that should be recognized in the valuation to a greater degree than it is today.

Staying in the worlds of fashion and retail, describe your investment case for Steve Madden [SHOO].

KB: The company designs and markets footwear and a variety of accessories under its own brand as well as others it has acquired over the years, such as Dolce Vita, Betsey Johnson and Brian Atwood. Roughly 25% of sales are made in company-owned retail stores, with the rest coming from wholesale distribution to department stores, specialty stores and mass merchants.

The business model is relatively straightforward and has generated consistently good performance and growth. They don’t try to create trends, but they
are the best in the business at identifying trends in the marketplace and basically recreating products that are working at a lower price point and getting them quickly onto store shelves. As fashion followers go, their products tend to be of higher quality and sell at higher prices.

The strategy is particularly compelling in the footwear market, where consumers consistently over time turn over what’s in their closets. So the buyer gravitates to trendier looks, and Madden has carved out a niche in delivering those looks for less than the $500 or more the leading designers might charge.

At a recent $33, the shares are off more than 25% from their July high. Is that a result of the dark cloud over retail or is it something else?

KB: It’s primarily the weak retail environment. Now is the time of year Madden is looking to exploit the latest trends in boots, but that’s going to be difficult when people overall aren’t buying boots.

The balance sheet is strong, with more than $150 million in cash and no debt. When we look at valuation, we assume low-single-digit annual revenue growth and relatively stable margins, leading to something on the order of $150 million in normalized free cash flow. The company this year will probably earn around $120 million. When we run it through our model, paying around the current price for the stock we’d expect to earn an IRR of 15% on our investment. We consider that quite attractive for a business that delivers as consistently as this one does in what can be a pretty volatile industry.

Is Control4 [CTRL] more of an underappreciated-growth idea?

KB: Control4 is a leader in the home-automation space, selling off-the-shelf hardware and software that allows people to control and monitor through one system any number of functions in their home, including lighting, audio, video, heating and cooling, alarms and intercoms. We actually first met management years ago at a conference when the company was still private but sort of pre-marketing itself. It went public in 2013 at $16 and we started watching it more closely.

As you can imagine, there are plenty of competitors, many of which, like Google’s Nest, provide devices to control only a subset of what Control4’s systems do. Security-system companies are targeting home automation, as are big cable providers like Comcast’s Xfinity. Others, like Crestron, provide only very high-end customized systems. Control4 has thus far positioned itself by the breadth of services it automates, the ease with which its systems are set up, and its pricing at the value end of the spectrum. We think that’s a viable position, but also believe the growth of the overall market can accommodate a number of competitors.

This is another example of what happens when a business growing 15-20% a year hits a speed bump, which happened in the second quarter of this year when revenue grew only 10%, margins declined and management took down full-year guidance. The company cited a number of reasons, including slow housing starts, some supply-chain issues and increased sales and marketing costs to back new-product launches. That all hit the stock,
which traded around $15 earlier this year and now sells for less than $8.

How inexpensive do you consider the shares at today’s price?

KB: This is one we consider pound-the-table cheap. The current market cap is about $185 million and the company has $80 million or so in cash and virtually no debt. It’s a market leader and generates free cash flow, which we estimate on a normalized basis at around $10 million per year. That assumes mid- to high-single-digit revenue growth, which we don’t at all consider aggressive and leaves plenty of room for positive surprises. Even at $9 per share, we believe we’d meet our expectation of 1.5% per year in return.

Does the high short interest – 21% of float – concern you?

KB: About 25% of the stock is controlled by private-equity investors, so part of that is a function of relatively limited float. Don’t get me wrong, there’s short interest in the stock – likely tied to issues and concerns around increased competition – but we obviously disagree with the short thesis. We think having more than 40% of the current market cap in net cash, in a business making money, protects us well on the downside.

We also believe there’s a very good chance Control4 attracts takeover interest. Google bought Nest. Harman bought a comparable company called AMX. For someone looking to be a leader in home automation, buying Control4 would instantaneously accomplish that, at what would likely prove to be an exceptionally attractive valuation.

Turning to an industrial name, describe the upside you see in Continental Building Products [CBPX].

KB: The company manufactures gypsum wallboard, serving residential and commercial construction markets primarily on the U.S. east coast. The market in general has seen a dramatic decrease in capacity post the housing bubble and financial crisis, and has settled into more or less an oligopolistic structure by region. The cycle obviously matters, but we believe that will continue to have positive implications for pricing power and margins long-term.

As is representative of the type of company we want to own, Continental because of its superior financial strength not only made it through the crisis intact, but also actually had the wherewithal to invest in new manufacturing capacity. As a result, today it’s one of the most-efficient, low-cost providers in the industry and the capital intensity of the business is low.

Are you betting at all on the cycle?

KB: When we originally bought the shares early in 2014, we thought housing was improving and that commercial construction, while sluggish, would get better. Since then housing has improved before stagnating more recently, while commercial construction has picked up a bit. Other than benefitting from the stable growth in the U.S. we’ve already talked about, we’re not expecting dramatic improvement in either residential or commercial construction.
How attractive do you consider the shares at recent $18.60?

KB: The more attractive competitive environment has resulted in improved margins, which we believe can be maintained. Assuming only modest revenue growth and pricing power from here, we arrive at a sustainable free cash flow estimate of around $70 million. Free cash flow last year was around $74 million. Running our assumptions through our model, we believe we could pay $20 for the stock and still earn our 15% IRR. As ideas go, this is more slow and steady wins the race.

Is fellow industrial Regal Beloit [RBC] a similar-type story?

KB: This is more of a plain-vanilla industrial company, with a number of different business lines and products focused on things like electric motors, electrical motion controls, power generation and power transmission. It’s headquartered in Wisconsin and has manufacturing, sales and service facilities in North America, Mexico, Europe and Asia.

The company over the years has followed the good-industrial-company playbook. It identifies bolt-on acquisitions for which it can bolster growth and take advantage of economies of scale. It builds up free cash flow in order to pay down debt, and then further builds the war chest to make new acquisitions. It’s always been a strong generator of free cash flow, which is typically much higher than net income because of all the non-cash depreciation and amortization charges associated with acquisitions. In 2014, for example, depreciation and amortization came in at $139 million, while capital spending was $88 million.

Are there catalysts to improvement here?

KB: The latest big move on the acquisition front was the $1.4 billion cash purchase a year ago of Emerson Electric’s power-transmission business, which serves the automotive, industrial and aeronautic sectors. We believe the integration is going well and will prove to be accretive to margins and free cash flow.

I’d also mention the tailwind we expect in the company’s air-conditioning-related business. The government mandates efficiency standards, and when new changes are announced that sets off a cycle of heavy buying of the older equipment at lower margins for manufacturers, a work off of inventory in the channel, and then a higher-margin opportunity as the new, higher-efficiency equipment comes on line. We’re now at the positive part of the cycle for manufacturers, which should benefit Regal Beloit.

The shares, at a recent $63.80, have been drifting down for much of the past six months. Is the market skeptical about those potential catalysts?

KB: We think the weakness in the shares has more to do with general malaise in the industrial economy, in no small part driven by the significant decline in energy-related exploration and production. Last year the company earned $210 million in free cash flow, but on a normalized basis we think that number can be closer to $250 million. We estimate we’d clear our return hurdle in paying up to $70 per share.
Debt coverage isn’t as strong as it is for many of our companies, but still easily satisfies our requirements. Normalized free cash flow would pay off the current $1.8 billion in debt in just over seven years. That coverage should improve as we expect them to pay down debt at more than $100 million per year for the next few years.

Describe what you consider a recent mistake and what in the end went wrong.

KB: One that comes quickly to mind was an investment in Tronox [TROX], a chemical company with a large business in titanium dioxide [TIO2], which is used for pigment in paints and other materials. The company met all our standards for business quality, and a key element of our thesis was that an improving housing market would lead to higher demand for paint, which would lead to higher demand and prices for TIO2. Two things happened. First, the housing market and the TIO2 pricing environment didn’t improve to the extent we expected. Then in February Tronox used cash and new debt to acquire a soda-ash business from FMC Corp. Given that the fundamentals were already weaker than we expected, when we saw the capital plan around the acquisition, we quickly concluded to eliminate the position. [Note: Tronox shares, around $23 at the time of the announced acquisition, now trade at around $5.85.]

It goes a bit further back, but eHealth [EHTH] would be another example that highlights the importance of recognizing when you’re wrong and should cut your losses. The company runs an online health-insurance exchange, earning commissions from insurance companies. Its biggest revenue generator had been the sale of individual plans, and we thought healthcare reform would significantly benefit that business as the non-employer health-insurance market took off. What in fact happened was that eHealth ended up losing significant individual business to Healthcare.gov. The company had a sizable earnings miss in last year’s fourth quarter and we concluded the normalized free cash flow generation we were counting on was permanently impaired. We admitted we were wrong and sold. [Note: Above $60 in early 2014, eHealth shares now trade at around $13.]

Small caps have been relative underperformers for the past couple of years. Would you make the case for that turning?

KB: Rising interest rates, or the threat of rising interest rates, don’t tend to be favorable to small caps. Just as in credit markets where spreads widen and investors favor higher-quality credit instruments, there’s a similar dynamic in equities that favors less-speculative, large-cap companies. If interest rates finally rise, that could continue to be a headwind for small caps. That said, from a relative perspective our strategy in this type of environment can be the most rewarding. Low interest rates provide a lifeline for many poorly financed companies, which are the ones we actively avoid. As rates rise and such companies face higher costs of capital and less access to capital, we would expect more differentiation by the market based on financial strength. That should work to our discipline’s favor.
Delayed Reaction

When spinoffs, as Gotham Capital’s Joel Greenblatt puts it, unleash “pent-up entrepreneurial forces,” the impact can be substantial, if delayed. How long should Keysight Technologies investors expect to have to wait?

In a seminal study on shareholder value creation from spinoffs, professors James Miles and Randall Woolridge of Penn State University found that the largest stock gains for spinoff companies occurred not in the first year of independence but the second. That’s not overly surprising. It takes time for any initial selling pressure on spinoff shares to wear off. More importantly, the entrepreneurial changes made by newly independent management rarely bear immediate fruit.

John DeGulis of Sound Shore Management is counting on such a timeline for his investment in Keysight Technologies. He called the company, whose equipment and software is used to develop and test electronic equipment, a “classic spinoff situation” earlier this year [VII, January 30, 2015], soon after its November 2014 separation from Agilent. Institutional research coverage was thin. As part of Agilent its cash flow had been reinvested elsewhere, and it operated far less efficiently than peers. With a heightened company focus on product development and cost control, he expected Keysight shareholders to eventually reap the benefits.

The progress so far? The company has stepped up research and development spending, from 11.5% of revenues to just over 13%. It has used its pristine balance sheet following the spin to make acquisitions, the most prominent being the August purchase – for around $600 million in cash – of U.K. based Anite, expanding its presence in wireless-technology end markets. Despite the increased deal-making its balance sheet retains dry powder, as run-rate annual EBITDA of around $600 million matches current net debt. On the margin front, while the company has not closed its deficit relative to peers, the 19.6% margin earned in the just-closed fiscal year was an 80-basis-point improvement over the prior year.

The payoff for shareholders has yet to arrive. At a recent $30.80, the share price hasn’t budged from when the stock started independently trading. The primary culprit has been sluggish top-line growth, impacted by currency effects – Keysight does twice the business outside the U.S. that it does in it – and weak spending on telecom equipment in key markets such as China. DeGulis is content to stand firm. He expects higher spending on product development, accretive acquisitions, and continued expense savings to result in earnings power reaching $3 per share within the next year or two, up from $2.50 today. At a market multiple, that would translate into a $50 share price. That target is even less than his estimate of Keysight’s private market value, based on multiples paid in industry transactions such as NetScout Systems’ purchase last year of Danaher’s communications division.

“There are spinoffs where value gets unlocked quickly because it’s a faster-growing business that gets investors excited,” says DeGulis. “In others, like Keysight, the operational turn is going to be measured in years, not months. They don’t have forever, but we think the earnings engine can be quite powerful once it gets going. If it does, that should get the market’s attention.”

INVESTMENT SNAPSHOT

Keysight Technologies
(NYSE: KEYS)

KEYS PRICE HISTORY

Share Information (@11/27/15):

Price 30.80
52-Week Range $28.55 – $38.99

Valuation Metrics (@11/27/15):

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<tr>
<th>KEYS</th>
<th>S&amp;P 500</th>
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<tr>
<td>Trailing P/E</td>
<td>10.3</td>
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<tr>
<td>Forward P/E (Est.)</td>
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ORIGIINAL BOTTOM LINE – January 30, 2015

The company is a “classic spinoff,” says John DeGulis, with upside from a rejuvenated product portfolio, significant margin expansion and balance-sheet flexibility to accelerate capital return to shareholders. Putting a market multiple on the annual $3 per share he believes the company can earn within two years, the shares would trade at closer to $50.

NEW BOTTOM LINE

The efforts of the company’s newly independent management may take time to bear fruit, says John DeGulis, but he still believes its “earnings engine can be quite powerful once it gets going,” and that the shares can reasonably reach $50 within 12 to 18 months.

Sources: Company reports, other publicly available information
Unique Approach

It can be difficult to draw significant distinctions between the Hong Kong-based real estate companies that from time to time capture value investors’ fancy. Amit Wadhwaney is doing just that when it comes to Sino Land.

During his tenure managing international portfolios for Third Avenue Management, Amit Wadhwaney rarely saw fit to own Hong Kong-based real estate companies, despite the fact that they were often important holdings in portfolios managed elsewhere within the firm. “I understood the thesis – a proxy on China, trading sometimes at big discounts to net asset value – but they never really fit with what I was doing,” he says.

Now at Moerus Capital Management, which he co-founded in September with two former Third Avenue colleagues, Wadhwaney today says one of his favorite ideas is none other than a Hong Kong-based real estate company, Sino Land. That’s not because his approach has changed, he says, but because Sino Land’s has.

The company’s business mix is not particularly unique. In commercial real estate it owns and operates a highly profitable Hong Kong portfolio of strip malls, typically anchored by a supermarket or convenience store and with tenants such as dry cleaners, florists and barbershops. It is also a significant developer of residential properties, with mostly mid- to upper-middle-market developments in suburban Hong Kong as well as in Fuzhou and Chengdu in China. Its hotel assets include full ownership of the ultra-high-end Fullerton in Singapore, as well stakes in the Conrad Hong Kong and The Westin Sydney.

What is unique is the company’s capital management. Unprecedented among its peers, Sino Land has been hoarding cash by selling residential properties into what Wadhwaney considers a “pretty bubbly” real estate market and not replenishing its land bank for future projects. From a net debt position of nearly HK$15 billion in 2010, the balance sheet now sports net cash of nearly HK$15 billion.

While management has been mum about its intentions with the cash, he sees positive optionality in it either sitting tight and waiting for Hong Kong and Chinese real estate prices to retreat, or in building out its hotel business using the highly regarded Fullerton brand.

While neither approach is likely to pay off right away, patience is made easier given the discount to net asset value at which the shares trade, says Moerus Capital’s Michael Campagna. He hairs the company’s stated book value by using actual revenues generated by the commercial properties, not market rents, and by using cap rates on those revenues of 7-8%, more in line with long-term averages than the 4-5% being paid for properties today. He values the residential-development properties at roughly 1.1x their cost base, far below values historically achieved. He uses an 8x EBITDA multiple for the hotels, half the rate at which comparable properties are trading hands. The result: estimated per-share NAV of HK$16.50, 45% above the HK$11.30 market price.

“If nothing happens we’re still buying a healthy business at a steep discount to a conservatively derived NAV that is 20% cash,” says Campagna. “The stock may go down before it goes up, but good things should eventually come from that.”

| Sino Land  
(Hong Kong: 83:HK) |
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<tr>
<td><strong>Business:</strong> Holding company engaged in the development and management of residential, office, retail and hotel properties located primarily in Hong Kong and China.</td>
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| Share Information  
(@11/27/15, Exchange Rate: $1 = HK$7.751): |
<table>
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<tr>
<td>Price HK$11.34</td>
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<tr>
<td>52-Week Range HK$10.42 – HK$14.20</td>
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<tr>
<td>Dividend Yield 4.4%</td>
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<td>Market Cap HK$68.99 billion</td>
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<th>Financials (FY ending 6/30):</th>
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<tr>
<td>Revenue HK$21.84 billion</td>
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<tr>
<td>Net Profit Margin 24.3%</td>
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<td>Book Value/Share HK$19.48</td>
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| Valuation Metrics  
(@11/27/15): |
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<tr>
<td>P/E (TTM) 7.3</td>
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<td>S&amp;P 500 23.2</td>
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<th>SINO LAND PRICE HISTORY</th>
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<td>2013 2014 2015</td>
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<th>THE BOTTOM LINE</th>
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<td>The company has managed its balance sheet from HK$15 billion in net debt five years ago to HK$15 billion in net cash today, providing it with long-term upside optionality, says Amit Wadhwaney. Patience is made easier, he says, by the fact that what he considers a conservative estimate of current net asset value is 45% above today’s share price.</td>
</tr>
</tbody>
</table>

Sources: Company reports, other publicly available information
High Definition

Imprecise and obfuscating language is, sadly, commonplace in the worlds of business and finance. Typically with the aid of lawyers, corporate and investment managers alike can render what they do in opaque and overly complicated terms. Why use one word when seven plus an appendix will do?

Such is the target of Jason Zweig’s biting wit in his new book, The Devil’s Financial Dictionary. Inspired by American satirist Ambrose Bierce’s The Devil’s Dictionary – which “scoured the artificial gleam off nearly every institution and pretention” of the late nineteenth century’s Gilded Age, he writes – Zweig offers pithy definitions of commonplace business and financial terms that he says “should not – quite – be taken as literally true.” Herewith a sampling, meant as food for the contrarian, and even a tad cynical, investor:

» Act, v. What a financial market supposedly does, as if it were a living creature with a sense of self and volition. Millions of traders are squaring off, and no one can sell unless someone else is buying. The stock market isn’t a unified force and doesn’t act in unison; it is a mechanism that enables people with opposing opinions to put a price on their differences. Investors should ignore any verbs used to describe how the market is “acting.”

» Active, adj. Portfolio managers are active when they seek to beat the market by identifying the best investments and avoiding the worst. To do so, the managers study the investments so exhaustively that by the time they understand them, the information has become outdated and they have to sell them. That takes most managers approximately one year and costs investors 1 percent to 2 percent of their wealth annually.

» Bonasus, n. A mythical creature described by the ancient Romans and often included in medieval bestiaries, the bonasus closely resembles a bull, but with its horns curled back toward its tail. Because the horns are only for show, as the Roman naturalist Pliny wrote, the bonasus has no way to deter predators and will run away as soon as it is threatened. When it becomes panic-stricken, the bonasus spews immense quantities of flaming-hot manure in its wake. As the next stock-market crash will show, the typical investor who believes himself to be a bull will turn out to be a bonasus. Do not stand too close behind him.

» Certainty, n. An imaginary state of clarity and predictability in economic and geopolitical affairs that all investors say is indispensable – even though it doesn’t exist. The unexpected will always occur – over and over again, until the end of time. And pundits will forever try to predict what will happen next. But if anyone could predict it, then it wouldn’t be unexpected. Thus, hating uncertainty is a waste of time and energy. You might as well hate gravity or protest against the passage of time. The only certainty is that uncertainty will never go away. Get used to it, or get out of the markets entirely and stay out.

» Confidence, n. A quality, similar to religious belief but grounded on much shakier evidence, that tends to be high when it should be low and low when it should be high.

» Downside Protection, n. A tactic put in place by a financial advisor to protect against whatever hurt the value of a portfolio last time. The portfolio will be hurt by something entirely different next time, however.

» Idiot, n. See Day Trader.

» Portfolio Manager, n. A highly trained and even more highly compensated professional who seeks to beat the market by buying the best securities and avoiding the worst, without venturing into the kind of originality that might jeopardize his or her paycheck.

» Regression to the Mean, n. The tendency of above-average results to be followed by below-average results and for extremely good outcomes to follow unusually bad ones; the most powerful force in financial physics.

» Rich, adj. Having as much as you want of all the things that money can’t buy.

» Stock-Picker’s Market, n. An imaginary set of circumstances in which shrewd and skillful investors stop competing against each other and are able to trade exclusively with an unlimited supply of morons. The justification for this belief is weak, even by Wall Street’s featherweight standards of reasoning.

» Trend-Following, v. The attempt to make money from trends by following them. If you could reliably identify trends, wouldn’t you be much better off anticipating them than following them? Yet the term “trend-anticipating” doesn’t appear to exist in the Wall Street lexicon. Perhaps that should tell you something.

» Wealth, n. A quality existing exclusively in the soul and mind that most investors erroneously believe can be measured best by the amount of money in their bank and brokerage accounts. 

For more information on The Devil’s Financial Dictionary, click here.
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