

Jim and Abigail Zimmerman on the Philosophy of Lowell Capital

We are pleased to share with you an exclusive interview with Jim and Abigail Zimmerman of Lowell Capital Management, based in El Segundo, California.

Jim is founder and portfolio manager; he works closely with his daughter Abby who assists in idea generation and other areas of the firm.

MOI Global: Please tell us about the genesis of your firm and the principles that have guided you since then.

Jim and Abigail Zimmerman: We have managed Lowell Capital and Lowell Capital Value Partners employing a proprietary strategy focused on companies with large, sustainable free cash flow yields and “Ft. Knox” balance sheets. Lowell Capital and Lowell Capital Value Partners have compounded capital in the 15+ years since 2003 at about 11% per annum after fees while holding a significant portion (20%+) of capital in cash. We try to take a low-risk approach to investing in public equities, especially in the small cap area.

Jim Zimmerman has over 25 years of investment banking and investment management experience in a variety of industries and has been involved with several billion dollars of investments. He has been a member of the exclusive, invitation-only Value Investors Club (VIC) for over 15 years, with over 50 detailed investment write-ups with an average return of 50%+ and almost all have been profitable. He has an extensive network of relationships with value-oriented investment groups and activists. He is a close follower of Warren Buffett and his investment approach. He runs the firm by taking a “Buffett” approach to small cap stocks.

His daughter, Abigail Zimmerman, works alongside him at Lowell Capital. She earned her B.A. in Business Administration at Loyola Marymount University in Los Angeles and has worked with Jim for the last several years. She assists in the generation of new ideas, administrative duties, research of small and medium cap companies, and detailed due diligence on potential investments.

The goal is one of absolute return rather than relative return, and we continue this long-term investment objective of compounding assets between 10 and 20 percent per year without great turnover, thereby realizing a minimum amount of realized gains and net investment income.

MOI: In choosing your investors and communicating with them, what considerations have you found most important?

Jim and Abigail: Our investor base generally includes high net worth individuals and some family office investors. Over time, we have also had some institutional type investors. We fit well with investors who have a long-term orientation. Our typical hold period is generally two to three years for our investment positions. Our focus is first on capital protection and second on capital growth through attractive risk-reward opportunities. We have performed well over many years and through several market environments and cycles. Our goal is to prudently grow investors’ capital over time by with attractive risk-reward opportunities. We seek to be

highly transparent with our investor base including detailed discussions of recent investment positions and our overall view of the market environment. Patience is essential for good long-term investment results.

MOI: How do you define your investable universe and how do you generate ideas?

Jim and Abigail: Our investable universe is generally North America, with some focus on Western Europe and Australia — all markets which have strong securities law and accounting standards. We are generally focused on smaller cap companies with market caps below \$1 billion which are under-followed and/or misunderstood and have limited coverage by research analysts and institutional investors. We try to focus on areas and opportunities that are ignored by other investors which can generate excess returns. We like investment opportunities where we can have direct discussions with senior management to understand their business and capital allocation strategies.

We have highly proprietary sources of investment ideas we have utilized over many years. Our discussions also allow us to build a relationship with management. We look at thousands of investment ideas each year to find just a handful that fit our strict criteria. Through our broad network, we can source new ideas as well as communicate with our extensive contact network of other value investors. We also source ideas through proprietary screens, periodicals, and extensive industry research.

MOI: What are your key stock selection criteria, and what types of businesses have you favored historically?

Jim and Abigail: One of the most important criteria is sustainable free cash flow generation, which is the foundation of our approach to investing. We look for businesses that can sustainably generate large amounts of free cash flow relative to their market values and enterprise values. We have found sustainable free cash flow is one of the most reliable factors in generating attractive long-term investment returns. We also look for businesses that have high returns on invested capital, or where operating income or free cash flow generated is significant relative to the tangible assets invested in the business (net working capital plus net property, plant, and equipment). Businesses with high returns on invested capital tend to generate large amounts of free cash flow.

In terms of risk management, we focus on companies with safe, “Ft. Knox” balance sheets, which often have large amounts of net cash relative to their market values. We believe this greatly reduces risk and gives our investments more time and flexibility to execute their business plans. We mitigate risk wherever possible and maintain low risk investments. We look for highly sustainable and reliable business models, especially those with recurring revenue.

In terms of types of businesses, we invest in simple and reliable business models that we can understand and which we believe can produce predictable results over many years. These have included software companies, IT services companies, business services companies, niche manufacturing companies, niche retailers, and some healthcare companies. We tend to avoid volatile industries such as oil and gas, biotechnology, natural resources, etc.

MOI: What sources of competitive advantage have you found to be most durable?

Jim and Abigail: We are always looking for companies that have a niche good or service that is unique and gives them a sustainable competitive advantage over time. They generally

provide a service that is unique or hard for competitors to copy and they are doing something different compared to their competitors. Many investments offer higher value-added services to their customers which make for a “stickier” customer relationship and more recurring-type revenues which we strongly favor. Some investments are uniquely positioned geographically near their customers which makes their goods or services hard to replace. One of our investment mantras is: “Skate to where the puck is going to be”, which reminds us to stay focused on where the business will be in two or three years.

MOI: When it comes to equity analysis, how do you assess the quality and incentives of management? Which CEOs do you admire most?

Jim and Abigail: We do extensive research with the companies we invest in including detailed talks with the management team. We seek management teams who will align with the incentives of shareholders. We like honest and intelligent management teams that are highly focused on driving shareholder value.

One CEO we like and admire would be Steve Sadler of Enghouse Systems in Canada. He is one of the best. Enghouse is a software company in Canada and Sadler is someone who excels at both organic growth with existing operations and inorganic growth with highly accretive acquisitions. He has built a powerhouse software company over time with excellent shareholder returns.

MOI: Would you outline the summary thesis behind one or two of your best ideas at this time?

Jim and Abigail: We will discuss two ideas: New Zealand Media and Entertainment (ASX: NZME) and Celestica (NYSE: CLS).

New Zealand Media and Entertainment

NZME operates as an integrated media and entertainment company in New Zealand. It offers its products through 39 print publications and 9 audio brands, 17 websites, and 19 real estate publications. Its principal brands include The New Zealand Herald, Newstalk ZB, ZM, Watch Me, nzherald.co.nz, and e-commerce platform Grab One. NZME owns the dominant daily newspaper, *The New Zealand Herald*, and [digital news website](#) in New Zealand; the leading radio broadcasting company (with 40% market share), and the #2 digital real estate listing company (One Roof).

NZME has three segments: Publishing, Audio, and One Roof. NZME is aggressively shifting its Publishing segment to a digital-first model, adopting a similar playbook successfully executed by the New York Times (NYT) over the past several years. It is also increasing its market share in radio broadcasting and in digital real estate advertising.

We were impressed with the resiliency of NZME’s business model during a very difficult pandemic environment, and its aggressive cost reductions and cash generation in response to the pandemic. In 2020, despite the pandemic, adjusted EBITDA increased 3% to NZ\$67 million and NZME generated NZ\$40 million in free cash flow. Digital subscribers increased sharply, and management confirmed that digital (about \$200 per year cost) and print subscriptions (about \$600 per year cost) were equally profitable to NZME. We believe NZME provides unmatched access and connections to New Zealand’s population of 5m people. We were also attracted to NZME’s “Ft. Knox” balance sheet and highly cash-generative business model.

We originally invested in NZME at about NZ\$0.65 per share in late 2020 with about 197 million shares outstanding for a market cap of about NZ\$128 million. NZME had net debt of about NZ\$55 million for an enterprise value of about NZ\$183 million at investment. We expected NZME could generate adjusted EBITDA of close to NZ\$70 million for 2021 so we believed NZME was trading at less than 3x adjusted EBITDA when we invested. Further, NZME's highly cash-generative business model was rapidly reducing its net debt and we expected NZME would be debt-free by year-end 2021. NZME's business model was not capital intensive, with capital expenditures of about \$10 million per year (versus adjusted EBITDA of NZ\$60 million to \$70 million per year).

We believed NZME could sustainably generate NZ\$40 million of free cash flow per year versus an enterprise value at investment of NZ\$183 million and that NZME was trading at a free cash flow yield of 20% plus on an unleveraged basis. We believed NZME's Publishing segment could produce stable results over time as it transitioned to a digital business model, like the highly successful transition of the New York Times (NYT). NZME digital subscribers were growing rapidly and were equally profitable with print subscriptions.

NZME recently completed the sale of Grab One, a non-core asset, for NZ\$17 million. As a result, net debt has been reduced to close to zero.

Further, we expect NZME to continue to generate strong cash flows in second half of 2021. We believe NZME will eventually undertake a significant dividend program to drive shareholder value. Additionally, NZME is focused on getting fair compensation from the global platform companies like Google (GOOG) and Facebook (FB) for displaying its proprietary journalistic content on their sites.

We believe as NZME further pays down debt, increases dividends, drives growth through its digital subscription strategy for its Publishing segment, negotiates with global technology platform companies like Facebook (FB) and Google (GOOG), sells non-core assets like Grab One, and grows its revenues and adjusted EBITDA, the market could put a stronger multiple on its business. We believe NZME could reasonably generate adjusted EBITDA of NZ\$75 million in 2022 and trade at a 6x multiple for a market cap of about NZ\$450 million or NZ\$2.25 per share, versus our entry price of about NZ\$0.65 per share and the recent market price of about NZ\$1 per share. Further, NZME's dominant media and entertainment position in New Zealand could make it highly attractive to a strategic or financial buyer.

Celestica

CLS is an undervalued Canadian electronics contract manufacturer based in Toronto. CLS provides hardware platforms and supply chain solutions in North America, Europe, and Asia. The Company offers a range of product manufacturing and related supply chain services, including design and development, engineering, supply chain management, new product introduction, component sourcing, electronics manufacturing, and testing. It also provides enterprise-level data communications and information processing infrastructure products, capacitors, microprocessors, resistors, etc. The Company serves a range of industries, including aerospace and defense, industrial, energy, healthcare, capital equipment, and others.

CLS has two segments including Advanced Technology Solutions (ATS) and Connectivity and Cloud Solutions (CCS). In 2021, we believe ATS will be about 40% of revenue and CCS will be about 60% of total revenue. The ATS segment includes aerospace and defense, industrial, health tech, and their capital equipment business. CCS consists of enterprise

communications, telecommunications, servers, and storage businesses. CLS's Hardware Platform Solutions (HPS) is within the CCS segment.

CLS's shares recently traded at about \$8.50 with about 127 million shares outstanding for a market cap of about \$1.1 billion. CLS has a "Ft. Knox" balance sheet today with net debt close to zero. The Company has a total enterprise value (EV) of about \$1.1 billion. LTM EBITDA is about \$314 million and we expect free cash flow (FCF) for 2021 to be \$100 million or more. CLS recently traded at about 3.5x EBITDA and a 10% unleveraged free cash flow yield.

We believe the market is underestimating the quality of CLS business despite its strong ROIC due to its low profit margins. We believe as CLS revenue continues to shift towards higher margin and longer lifecycle industrial verticals, its valuation multiples could increase. CLS is gradually shifting its business towards its higher margin ATS segment and HPS vertical. Further, CLS exited a low margin relationship with Cisco and the loss of these revenues has been obscuring CLS revenue growth at its core business segments.

CLS has a long-standing reputation in the aerospace and defense market and is one of the leading EMS providers for the vertical. The pandemic greatly disrupted the aerospace market. Despite this, CLS believes aerospace revenue has stabilized and will grow sequentially from here.

Electronic manufacturing services (EMS) businesses have tended to trade at low margins due to their low margins. However, most of their cost of goods sold are variable, with the majority of that being pass-through raw material costs, which is important in a rising cost environment. This has enabled CLS to consistently generate double-digit ROIC and strong cash flow despite low operating margins.

Further, there has been significant improvement in the EMS competitive environment over the past few years. Over the last few years, the EMS industry has placed a greater focus on margins and cash flow versus revenue growth, leading to a more disciplined pricing environment and, thus, higher ROIC's and margins.

We expect CLS to grow revenues in 2022 to \$6 billion or more with adjusted EBITDA of \$350 million and adjusted EPS of \$1.35 or more. We believe as CLS expands into its higher-margin and higher value-added segments and shows improved stability due to long-term, high value-added relationships with its customers, that CLS could trade for 6x adjusted EBITDA, which would result in a market cap of \$2.1 billion with net debt of zero or a share price of about \$16 per share, versus the recent price of about \$8.50 per share. Further, we believe CLS strong competitive niches could be attractive to a strategic or financial purchaser.

MOI: How do you think about the art of valuing a business? To what extent do industry-specific considerations or industry comparables play a role, and to what extent do you focus on "shareholder earnings" or free cash flow?

Jim and Abigail: In terms of valuing a business, we focus heavily on free cash flow generation which is generally already happening and may accelerate imminently. We don't want to have to look too far out into the future for free cash flows and prefer businesses which are currently generating free cash flow which is sustainable but being undervalued or underappreciated for some reason.

We like to compare our investments to the alternative of holding cash or risk-free bonds, like

U.S. ten-year treasuries near 1.5% currently. We are generally targeting investments that we believe have a free cash flow yield of 10% or greater and we look at this on an unleveraged basis, or free cash flow to enterprise value. We feel if we have an investment with a sustainable 10%+ free cash flow yield, as compared to the ten-year U.S. treasury at 1.5%, this provides a large margin of safety for our investments. We define free cash flow as cash from operations less maintenance capital expenditures, so literally the cash flowing into the company each year.

We don't really focus too much on comparable companies but rather on absolute returns where we believe we can make mid to high double digit returns over an extended period.

We like good businesses with low expectations. In terms of low expectations, our investments generally have valuations which are low, and this helps reduce risk. The market does not expect much from the business in the future or is worried about current earnings or free cash flow sharply declining. These may also be situations where a business is simply misunderstood or undiscovered. We strongly agree with Joel Greenblatt's quote: "Stocks are not pieces of paper that bounce around. They are ownership shares of businesses that we value and then try to buy at a discount. So that's value investing. Figure out what a business is worth and pay a lot less." This is what we aim to do.

MOI: How do you strike the right balance between being concentrated in your best ideas while remaining sufficiently diversified to keep downside risks under control? How does short selling fit into your portfolio management approach?

Jim and Abigail: We generally limit our investment in individual companies to about 5% to 7% of our capital at cost. We read and research thousands of investment ideas each year to reduce them down to 15 to 20 investments that have our required characteristics – "Ft. Knox" balance sheets, large and sustainable free cash flow yields, simple and understandable business model, sustainable competitive niche or advantage, management team focused on driving shareholder value, etc. Ideas that "work" can double or triple or more, while with ideas that don't work, we can generally get most of our capital back over time. We don't like to bet too much on any one company. Also, with a diversified group of investments, we tend to hold those investments that are working longer and give them more time to create shareholder value.

On short selling, here again, we try to minimize risk and generally keep our individual positions to 0.5% to 1% of capital at cost. We typically keep our short positions to 5 to 10 positions total and use them to provide downside protection to our overall portfolio, as well as to monitor how extreme market valuations are getting and how "frothy" the overall market may be.

MOI: You have achieved enviable investment returns while periodically holding substantial amounts of cash. How do you think about the right level of cash in the portfolio?

Jim and Abigail: Our cash levels are driven by the investment opportunity set we find in the marketplace and by our assessment of the overall risk-reward position of the market. We believe holding a significant portion of cash reduces the overall risk to our portfolio and positions us to take advantage of new opportunities as we find and research them.

Our investment results have been achieved with an average net cash position of 20% to 30%, although we have reduced our net cash position to about 20% in recent months based on the opportunity set of investments we have encountered. We avoid the use of leverage and, on

the contrary, generally maintain a significant cash position, and we believe this has reduced the risk to our capital.

MOI: Which one or two recent books have given you new insights into the art of investing?

Jim and Abigail: We recently reread a couple of classic books on investing. *Poor Charlie's Almanack*, about Charlie Munger, and *Margin of Safety*, written by Seth Klarman, a long time ago. Munger is a great source of investment insights and one of our favorite lines of his is: "you make money not in the buying or the selling but the waiting" - we think this is so true for successful investing. Klarman is obviously one of the greatest investors of all time and his focus on absolute investment returns and on not losing money is a great reminder for us in our work.