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Operating in the Grey Area

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Value investors tend to be an odd lot. On the one hand, they may find themselves attracted to assets that are out-of-favor, whether a company, industry, geography or asset class. At the time many of these potential opportunities may appear to be fraught with risk, perhaps justifying their low market valuations. On the other hand, value investors are often associated with a risk-averse nature, which can seem to be in conflict with the types of businesses they are attracted to. From a 30,000-foot perspective, value investors may seem inherently contradictory; sometimes interested in businesses that others have discarded as risky but at the same time being risk-averse.

Value investing often operates in the “grey area” where potential opportunity and potential impairment risk are more tightly bound than usual. In the heat of the moment, typically surrounded by negative sentiment and headlines, beaten down prices can sometimes be justified from a long-term perspective and sometimes not. For instance, in the 2000s a variety of companies from the New York Times to Kodak had significant price drops and traded at statistically attractive levels, at times less than 10x earnings.

In hindsight, the price drops were justified as digitization redefined the marketplace for such companies. Conversely, global markets have also been characterized by rolling bear markets in individual industries that accompany the normal cyclical patterns inherent in any marketplace. The key has been to sort out those companies affected by cyclical causes from those affected by structural ones.

At Centerstone, our goal is to provide equity-like returns over the long-term with minimal material capital impairments. In our experience, price and value tend to converge over time and we seek to avoid having that convergence at below our cost, i.e. a capital impairment. Our goal is to have zero impairments, but in practice it is difficult not to make any mistakes. Minimizing impairments or errors is crucial to long-term investment success, which is why so much of our analysis is oriented that way. Within our margin of safety framework, our approach evolves as lessons are learned and the landscape changes. For instance, for several years we have distinguished between cheap and undervalued as a consequence of the era of digitization. After all, Kodak was statistically cheap at $40, $30 and even $10, but the earnings power and intrinsic value[1] continued to deteriorate showcasing the difference between cheap and undervalued.

Recently, companies from industries such as retail, auto parts and grocery stores have suffered. A common thread among companies drawn into what has become the latest rolling bear market is the so-called “Amazon threat.” I am not downplaying the severity of Amazon’s influence but sometimes bear markets take the good with the bad. In this case, the “grey area” for value investors is not only quite large but also quite challenging to analyze because of the historical baggage of what happened to other companies displaced by digitization. With the knowledge and perhaps fear of the past, can one separate the good from the bad?

Are these businesses potentially undervalued securities or simply cheap but impaired businesses?

The Centerstone Playbook

Just in case you are tempted to skip to the end, as we say “the future is uncertain.” With that in mind, I do not have a definitive answer, but I can share our playbook. When looking at any business, our analytical framework has three pillars:

(1) balance sheet quality, (2) management quality and (3) business quality. In order of subjectivity, the balance sheet is least subjective and can be quantified. Management quality can partly be quantified as management teams tend to have a measurable history of capital allocation. Business quality used to be reliably measurable as well because the past was indicative of the future, however, times have changed and we have adapted.

Not only has online commerce blossomed, but demographics are changing rapidly along with long-standing consumer behavior. Our current assumption is that we should not completely rely on the past when judging the business quality of some of these beaten down companies. Instead, we spend a great deal of time on “what could go wrong” with the business than we did years ago. What filters through our process is a small selection of businesses among those beaten down names that we believe seem to have balance sheet strength, hidden assets, hidden earnings and/or other sources of strength that can help to offset what we believe to be manageable problems.

We understand there are outcomes where we could ultimately be wrong and therefore we seek to limit the aggregate exposure to this idiosyncratic risk[2] to a reasonable size. In the case of the Amazon threat, this aggregate exposure of six holdings in the Centerstone Investors Fund (CENTX) totals 7.47% and one holding in the Centerstone International Fund (CINTX) totals 1.51%, as of September 30, 2017.

Real-Time Experiment

Two examples of the companies we own in the midst of this “real-time experiment” are Target[3] and Ahold Delhaize[4]. In the case of Target, it is a company which owns the vast majority of its real estate and where the stores tend to be free standing. Over 20% of the company’s sales come from groceries and even in the best of times, grocery retailing is a tough business with razor-thin margins and an often-fickle customer base.

Demographic changes have meant that the average consumer continues upgrading to organic and fresh foods and is increasingly open to e-commerce to fulfill their grocery needs. Target’s e-commerce sales have been growing at double-digit rates (albeit a small portion of the business) and with the recent entry of Amazon into the traditional brick-and-mortar grocery space, concerns have only heightened over the future of all grocery retailing. At the same time, food deflation for the past 18 months has been a severe headwind—as food prices decline a store’s operating costs do not.

The fixed cost nature of retail means that food deflation has a magnified effect on operating margins and earnings. Currently, this is likely the greatest worry and Target has responded by taking the margin hit and repricing much of the typical customer’s shopping basket. Encouragingly, there are some signs that this headwind is fading but other risks remain. In particular, two German competitors have announced plans to roll out hundreds of low-cost “hard discount” stores, which may add to price pressures in many parts of the US.

Target's real estate ownership helps us make a case that the market has valued the core retail business below its intrinsic value. We believe the real estate is valuable based on publicly available information and is worth well more than half of Target's current market capitalization at the time of this writing. In that case, little value is ascribed to the operating entity. Valuation is further supported by the fact that the company throws off a dividend yield[5] of over 4%. In recent years there has been slight growth in the retail business as well.

At our average price the stock is priced to potentially deliver respectable returns, much of it in dividends. The company is conservative in its accounting as well, with earnings power well above stated GAAP (generally accepted accounting principles) earnings. Compared with the FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks, which need to spend up to half of their free cash flow in order to offset stock compensation, Target is considered a poster child of accounting conservatism.

Ahold Delhaize is a Dutch-listed company with significant operations in the US. It is the market-leading grocery retailer on the East Coast and operates under such banners as Stop & Shop, Hannaford, Food Lion and its e-commerce entity, Peapod. E-commerce grocery is more popular in dense cities like mine (New York) where route density economics can most successfully meet the biggest challenge of the online grocery business—last mile delivery cost. Outside of dense cities, online grocery is a difficult business due to its low margins and lack of route density. By analyzing Peapod and its peers, I believe the only way online grocers, which includes Amazon, can be successful is to focus on perishable items and limit their exposure to dense urban markets. Our analysis indicates that perishable items tend to have high enough gross margins to possibly offset a big chunk of the last-mile costs in that scenario.

In addition to the limitations of online grocery competition and Ahold Delhaize's own long-standing online presence, another positive factor for us is that Ahold Delhaize is the number one or number two player in all of its markets in the US. Notwithstanding the above I am under no illusions here—the Amazon threat is real as they could operate at losses for years in order to grow and therefore pressure the entire industry. However, I also see the grocery business as already competitive (online and offline), with sufficient local differences in shopping habits and with a natural limit to online market penetration due to last mile economics.

Both Target and Ahold Delhaize highlight the current dichotomy between online and "non-line" companies in many industries. Cash generating enterprises with conservative accounting managed by prudent shareholder-oriented management teams are in many cases being tossed aside by Wall Street for what they deem is a certain future where all business is done online forever. As much as Wall Street sees endless storm clouds for Target and Ahold Delhaize, it sees nothing but blue skies for online competitors. More likely, the outcome will be something in-between.

This "grey area" between the extremes is where we often find values. In the end, the potential value of a business is a function of the cash flows it generates over time. Our growing "Amazon threat basket" is a collection of cash-generative companies with good balance sheets, management teams and businesses— albeit not without their respective short-term issues. We believe over time that this basket may be a positive influence on portfolio returns but you never know when the returns will arrive as it can be gradual or sudden. As we have built out this bucket, the US allocation within the Centerstone Investors Fund (CENTX) has not contributed to positive performance, which is not unusual given that we tend to buy early. In fact, the non- US stocks and currency exposure have almost solely

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driven performance. Possibly then, there may be latent performance potential building within the portfolio, from a three-to-five-year view, provided we have chosen correctly. While we acknowledge we are walking a fine line, we believe we are most likely early, rather than wrong.

1. Intrinsic value refers to the price a knowledgeable investor would pay in cash to control an asset.
2. Idiosyncratic risk is the risk that is endemic to a particular asset such as a stock and not a whole investment portfolio.
3. 1.53% position in Centerstone Investors Fund as of June 30, 2017.
4. 0.03% position in Centerstone Investors Fund and 0.03% position in Centerstone International Fund as of June 30, 2017.
5. Dividend yield is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price.