

What Portfolio Implications Does the Asset-Based Approach Have?

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The asset-based approach, which we have spoken about at past MOI Global summits, functions well as a means of assessing a conservative value of a business to a potential purchaser of the company. It is also, in our opinion, of considerable importance in mitigating price risk (as a result of buying cheaply) in a longer-term context. However, we must emphasize that this approach is of limited utility as a timing tool for trying to buy “at the bottom.” Looking back through our years of investing, we believe that buying securities based on this valuation methodology has historically tended to diminish price risk in a longer-term context, but it has generally proven unhelpful as a guide to side-stepping transitory price declines in the short-term. To wit, buying cheaply mitigates, but certainly does not eliminate, the likelihood of experiencing price declines and significant stock price volatility along the way.

Another implication is that, again, investment time horizons matter. An asset-based investor such as Moerus would typically view any operating development through a long-term investor’s lens, assessing any earnings-impacting operating development quite differently than a typical earnings focused investor might. A long-term investor would typically assess the impact, if any, that the development had on the long-term intrinsic asset value of the underlying business. On the other hand, for the shorter-term, earnings-focused investor, the primacy of earnings and the information contained in the income statement or earnings release would dominate, prompting hair-trigger trading responses, which even small earnings changes (which may be immaterial in the long-term) can cause.

Example: Tidewater Inc.

An example of the potentially divergent interpretations of reported operating results is offered by the typical reaction to the reported results of Tidewater Inc., a company we spoke about at the 2019 MOI Best Ideas Conference. The company provides offshore service vessels and associated services to offshore oil exploration and production installations, which are currently experiencing significantly depressed levels of business activity. The continuing weakness of the level of business activity has been evident in the company’s reported results, which nonetheless showed gradual improvement in positive cash earnings, no small achievement in a fragmented industry in which many of its peers are at death’s door. Having executed a merger with a peer (Gulfmark Offshore) that had complementary operations, Tidewater has continued to broaden the geographic scope of its operations and has formed the dominant player in its industry, while acquiring Gulfmark’s fleet at what seems likely to be a significant discount to replacement cost. To us, this seemed like an astute piece of (inorganic) company building, albeit without visible near term earnings impact. Our take on the merger and earnings results has been generally positive in the context of the continued long-term building of the business value. But the majority of other investors, who tend to be earnings-focused and probably shorter-term in nature, seemed to view these events far more negatively, with an ensuing impact on the company’s stock price. In our opinion, the currently depressed levels of offshore activity that drove Tidewater’s results have long been known, and the company’s results for the past quarters therefore should not have been surprising. But from our perspective as a long-term investor in a business that we believe is building intrinsic value and strengthening its position for an eventual normalization in

business conditions, the near term earnings merely reflect noise that is irrelevant to the long-term operation of the business.

Emerging Markets

Nowhere is this dichotomy more visible, in our opinion, than in emerging markets. Normally considered to be the domain of growth investors, emerging market stocks accordingly seem to be subject to heightened sensitivity to changes in earnings estimates in both directions. Additionally, the reaction in emerging markets' securities prices to changes in earnings estimates/expectations is usually amplified by the relative illiquidity of the securities in such markets. The volatility resulting from a downward revision in earnings estimates, which in turn has often been amplified as a result of relative illiquidity, has historically proven to be a quite good source of attractively valued investment opportunities for us in developing markets, despite their reputation as a home primarily of growth investors. We have found this to be especially true in the area of asset-rich companies, where current earnings provide a poor yardstick for assessing value in our opinion.

Example: BR Properties S.A.

An example of this would be a company we spoke about in the MOI Best Ideas 2018 Conference: BR Properties S.A., a Brazilian company whose *modus operandi* has been to acquire a portfolio of very high-quality office properties, primarily in São Paulo and Rio de Janeiro, at unusually attractive prices from stressed or motivated sellers. The acquisitions of properties at uniquely attractive prices had been made possible by a severe economic downturn that resulted in a sharp rise in vacancy rates and a plunge in office rental rates in Brazil. Buying high-quality buildings cheaply in such an environment with low occupancy rates and depressed rents was unlikely to result in meaningful earnings contribution to the reported results or demonstrate earnings momentum in the short run. The earnings momentum would only get going when occupancy and rental rates stabilized at higher, more normalized levels (at which point in time a presumably generous or less-discounted valuation, mirroring a less depressed outlook, would make it a far less attractive investment opportunity in our view). In fact, acquiring high vacancy buildings in the midst of weak rental rates was likely to do just the opposite, making the company's income statement look worse as costs piled up while revenues remained elusive and depressed. Accordingly, earnings-focused investors steered clear of BR Properties, as its earnings were deemed to be low and disappointing (perversely endowing it with a stratospheric Price/Earnings multiple). From our perspective, however, the company's management has done a credible job building a formidable portfolio of prime office properties in a cyclically depressed market, which we believe would, in more normal times, command far higher prices than those at which they were then valued on the balance sheet. This, in our view, presented an opportunity which lay in plain sight for a long-term investor.

Not for Everybody

Of course, the long-term, asset-based investment approach that we implement at Moerus is not for everybody, or even for most. Quarterly earnings reports, momentum, and near-term outlooks are much more important for those who practice different approaches to investing/trading. For example, for very short-term oriented investors with very high turnover, who actively churn their portfolios, a quarterly earnings report, or management's guidance for the next six months might indeed be very

important. At Moerus, however, this is much less relevant to us other than as a frequent source of opportunity to find longer-term bargains that have found themselves in temporary disfavor.

Short-term outlooks, reported earnings and momentum take on much greater importance for another subset of investors: those who employ margin debt (financial leverage) in their portfolios. While margin debt can enhance returns when things work out, it also makes getting short-term variables “right” much more critical, because even temporary price declines, if sharp enough, could trigger margin calls and forced selling (often at the worst of times, when a security is depressed). Moerus Capital, however, does not invest on margin. Not doing so suits the Moerus investment approach quite well; when businesses become available at depressed prices due to temporary adversity, we’d much rather be the opportunistic buyer than the forced seller.

These are just two examples of the many market participants who focus mainly on the short run and particularly on earnings-related momentum. Because this perspective tends to predominate across much of the securities markets, our asset-based approach to valuation and our long-term investment horizon often cause us to view corporate and market events quite differently than much of, if not most of the market. The upshot: as in the Tidewater and BR Properties examples above, our approach to valuation and our long-term investment horizon might, and often does, lead to selection of securities that, while potentially rewarding over the long term, might experience considerable bumps in the road along the way, in the form of price volatility over the holding period. This volatility will often mirror what is, in our opinion, shorter-term earnings-related noise that, in the longer-term, might well amount to little true impact in economic terms, given the financial strength of the underlying businesses in which we strive to invest. Volatility can certainly be unsettling at times. But as we have often said, at Moerus we view volatility as “friend” rather than “foe,” as in our experience it has provided us with very attractive opportunities from a long-term perspective.

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