ValueWalk

Interview with Sandy Mehta, CFA – CEO of Value Investment Principals Ltd.

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Value Investment Principals Ltd. is a Hong Kong-based [with an office in India] investment advisory firm focusing on unique "deep value" stocks globally. Their clients include many savvy value investors globally. **Sandy Mehta, CFA**, has 30 years of investment experience, and has previously been a Portfolio Manager for a $15 billion "flagship" Global Equity Fund, been PM of two [international and domestic] 5-Star rated funds, and also founded a $200 million international Hedge Fund. He was the first analyst ever hired by legendary value manager John Rogers at Ariel, and also worked with Arnie Schneider and John Neff at Wellington Management Company. He is a Wharton MBA and a CFA.

The 6 stocks which Sandy mentioned in his last ValueWalk interview in July 2015 all did very well, being up anywhere from +20% to +90%. None were down.

Interview With Sandy Mehta, CFA

Q: Give us some details on your firm and investment style? How do you define value?

Sandy Mehta: Value Investment Principals [VIP] specializes in finding unique "deep value" stocks on a global basis. Our clients include some of the most prominent value investors in the world, and in fact many of them are often profiled regularly in your newsletter. Our valuation metrics are typically quite extraordinary, and this is our specialty. For example, we have had about a dozen stocks where net cash on the balance sheet is greater than the market cap, so investors are getting a quality underlying operating business essentially for "free". We have done really well with these net cash [and Net-net] type of ideas. Over the past 6 years, all of our stocks have had average dividend yields in the 5%- 8% range. Today, our stocks have an average dividend yield of over 5%, and including 20% of our current portfolio which have 5% plus buybacks this year, total return of capital to shareholders is around 7.5%. Single digit P/E's, price/books well below 1.0, EV/EBITDA below 4 or even below 0, are the sort of extreme deep value metrics we seek.

But it's not just about "throw away" valuation metrics. Two-thirds of our investments are "growth" companies, or at a minimum in growth sectors, and 50% are clear industry leaders. So this unique combination of deep value, growth, industry leadership and FCF/dividend yield is an intuitively appealing mix for most investors. Our investments are diversified by geography and market-cap; so we are typically 1/3 USA/Canada, 1/3 Europe/Japan, and 1/3 Asia/EM. And by market cap: 1/3 large-cap, 1/3 mid-cap, 1/3 small-cap. We like quality businesses, clean balance sheets, and strong FCF. We shy away from excessive debt, and only a fraction of our investments have been leveraged companies.

Q: How has performance been?

Sandy Mehta: Performance has been strong in general, and specifically last year. In addition to solid relative-to-benchmark performance, approximately half our stocks have been up 25% or more absolute, and one-fourth up 50% or more. In fact, just last week, one of our investments, **UK-listed Kennedy Wilson Europe Real Estate [KWE_LN]**, whose stock we picked up opportunistically following Brexit market dislocation in Q3 last year, received a takeover offer. Deep value stocks with strong FCF and underlevered balance sheets are fertile ground for takeovers and shareholder activism. Fully 1/3rd of our stocks over the past nine years have either received a takeover offer, or have been the subject of concerted shareholder activism efforts. Given the deep value metrics and extreme undervaluation of all of our ideas, we would not be surprised to see more of these companies being the targets of activists as well as outright buyouts going forward. [Please do see our full disclaimer on our website]

BTW, all six stocks I mentioned to ValueWalk when we last had an interview published, which was nearly two years ago on July 8, 2015, have all really done well, and provided returns of 20% to 90%, handily outperforming indices. I will mention those individual return numbers when we discuss specific stocks.

Q: What else makes your style unique within the value investing space?

Sandy Mehta: We are very risk-reward focused, and therefore, price sensitive. We like to catch stocks at multi-year lows in terms of our initial purchase price. The sell-side will always come to you with recommendation upgrades after stocks have already moved up 50%. For example, among the more well-known large-caps, we invested in **Toyota** below 2,800, **Microsoft** at 25.00, **H&R Block** at 16.11, **Suncor** below 30.00, **Corning** at 12.63, **Sony** 1,890, **InterActive IACI** at 20.30, **Hugo Boss** at 54, etc. Looking back over the past nine years, many of our entry points were close to multi-year lows. Extreme deep value, emergence of catalysts, receiving rich dividends while we wait – this enables us to pull the trigger. A low entry point increases risk-reward and sets up multi-bagger opportunities. And we have been able to consistently find one new deep value idea each and every month on average.

Q: What are some of your more recent "new money" buys today in the USA? Are you still able to find deep value with indices at highs?

Sandy Mehta: Yes, we still find at least one new idea every month globally, including the USA. The last time I spoke with you, back in July 2015, I had mentioned **USA ideas Kulicke & Soffa [KLIC]** and **Suncor [SU_CN]** – those stocks are up 90% and 30% respectively since then, much better than the overall market. I have two new names both of which are down more than 50% from recent highs, which is in sharp contrast to the overall USA in record territory. First is the clear leader in jewelry retailing in the USA, **Signet [SIG; US$4.5 billion market cap]**. As per IBISWorld, SIG controls 17% of US market share against Tiffany's 5.1%, which is the next largest player. Signet owns 3 of the top 5 retail jewelry brands in the US: Kay, Zales, and Jared. The stock is down over -50% from its highs during the past couple years. Globally luxury goods stocks [we have done really well buying **Hugo Boss** at the trough one year ago] are correctly viewed as being in a secular growth space and command huge premium multiples. Signet similarly was a growth investor darling trading at over 25x times earnings not too long ago. In fact, despite a sluggish environment the past one year, SIG's actual EPS has grown at 18.8% CAGR, and revenues at 11% CAGR, over the past six years. And despite weak comps this year, expectations are for both revenue and EPS to grow going forward. We expect minimal competition from online players such as Amazon and jewelry industry pure-play Blue Nile [NILE] which was acquired at a nice premium just six months ago despite producing very stagnant revenue/earnings the past several years. Signet trades at clear deep value levels at a P/E of 9x [a huge

discount to closest peer Tiffany's current 23x multiple and to SIG's own 5-year average P/E of 17x and median of 16x], 9.5% buyback in the last four years and 3% buyback in FY01/2018e, 16% ROE [last 5-year average], and 9% FCF yield on FY01/2018e. Retail experts Leonard Green also announced a strategic investment in Signet last year, which we view as a long-term positive.

Q: And another USA idea?

Sandy Mehta: The second stock I will mention is **Alliance Resource Partners LP [ARLP; $1.8 billion cap]** which is one of the highest quality players in the USA coal industry. As I speak with you, the company has just announced today that Q1 EPS has beaten expectations by 60% and revenues also were 6% ahead of the Street. The company just reaffirmed its 8.2% annual dividend/partnership distribution last week and the CEO is hinting today of resuming dividend increases. It should be noted that this huge dividend represents a 1.8x coverage ratio [i.e., 55% dividend payout], and in our conversation with management, this is much higher than the company's "normal" coverage ratio of 1.3x – 1.4x, implying that the company has significant headroom to raise dividends 30% without assuming any change in the IS/CF. Without getting into partisan politics and arguments for/against the merits of any policy, the Trump Presidency is widely expected to have a positive impact on several fronts for the USA coal industry. The entire coal industry has gone through a near-death experience over the last few years, with six companies [including the industry leaders] declaring bankruptcy, several more than once. For 2017, the Energy Information Administration expects coal to retake the lead and account for 32.5% of power generation against 30.4% in 2016**.** For 2017, the ARLP has guided for 9% growth in coal production to 37.9 mn to 38.9 mn range. ARLP has noted that meaningfully higher natural gas prices and a colder winter have prompted the company to expect increased coal demand for the first half of 2017 compared to last year. We believe management's guidance for 2017 may prove to be conservative and that there is an upward bias to revenues and earnings in 2017. There is improved visibility on revenues and earnings as ARLP has already secured coal sales and price commitments for 90% of total 2017 production target and 50% of the 2018 production target. It should be noted that ARLP has a long reserve life of 47 year, using the run-rate implied by the midpoint of the company's 2017 coal production guidance of 38.4 mn tons and the company's 1.8bn tons of reserves.

Q: Do you see rapid growth in your Asian ideas?

Sandy Mehta: The last time I spoke with you, I had mentioned Mainland Chinese market leader **Gree Electric [000651_CH; US$29 billion market cap]** and India's **Bajaj Holdings [BJHI_IN: US$3.7 billion cap]** – those stocks are up 65% and 50%, respectively, since then, much better than the overall market. We currently have more than a half dozen ideas in Asia where either net cash, or hard asset values such as land/property/securities investments, are about equal to or greater than the stock market cap.

A new name for us which we are quite excited about is **China Machinery Engineering Corp, or CMEC [1829_HK; US$3.1 billion cap]** which checks many of our boxes in terms of value, growth, FCF, etc. When we first got into CMEC over 6 months ago, the net cash position was about 100% of the market cap, today despite some stock appreciation we are still looking at 85% net cash to market cap on the balance sheet. CMEC gets 70% of its revenues from abroad as one of the larger Engineering and Construction [E&C] firms with over 30 years of operating history. In fact, it is a huge beneficiary of China's key strategic initiative such as One Belt One Road and Silk Road leading to strong orders for the company globally. CMEC is really a "flag bearer" for China around the world. CMEC is the sole bidder on 70% of its orders, thus ensuring healthy margins and ROE. CMEC received huge orders last year with a book-to-bill well over 2.0x and the highest level of new orders in the past five years, which is a big catalyst. The company recently reported EPS about 6% ahead of estimates, including a 3%

dividend increase. A rebound in commodity prices globally is a big positive for CMEC. The backlog has improved strongly to US$8.9bn [US$7.5bn in FY15] and signed contracts pending to be effective have jumped to US$15.2bn [US$12.2bn in FY15]. US$8.9 billion represent 2.6 years of confirmed/effective backlog, while signed contracts of $15.2 billion represent fully over 6 years of current run-rate revenues. The stock is extremely undervalued trading at 3.1x FY17 EV/EBITDA, 11.6% FY16 FCF yield and 8.4% FY17 FCF yield, and a ROE of 13.8% in FY16.

Bajaj Holdings in India [BJHI_IN; US$3.7 billion market cap] continues to look very undervalued, despite the overall Indian market having done well. Nobody really follows this company, so it remains an undiscovered gem. By owning BJHI, investors are getting exposure to two extremely high growth and underpenetrated Indian consumer businesses: motorcycles and finance/insurance. Since I have mentioned this name previously, I will not go into too many details here. BJHI is among the industry leaders in both businesses. They have grown very rapidly in their consumer finance business in particular, which remains very underpenetrated in India. We have already tripled our money in this stock, but even today net cash [no debt] + all investment securities = 240% of mkt. cap, 0.4 price/book, 9x P/E, and 20% ROE's. Even applying a 30% holdco discount [which is debatable given zero long-term capital gains taxes in India], there is still 70% further upside.

Q: What looks undervalued in Europe?

Sandy Mehta: Dream Global REIT [DRG-U_CN; US$ 900 million market cap] often slips through the cracks, as it is a German commercial property REIT with a sole listing in Canada until a few months, when it finally got a German listing as well. This stock has provided a 20% total return since we last spoke. Germany remains perhaps the only developed economy in the entire world which has not had a property boom and/or bust cycle in the past couple decades, although fundamentals are now steadily improving. Underlying economic trends are robust with an unemployment rate in Germany at a 25 year low of 3.9% while the vacancy rates across the "Big 7" office markets at record lows at the end of Q1 at 7.5% with strong demand for high quality commercial space. At the end of 2016, the Dream REIT's portfolio occupancy improved to 90% from 87.5% at the end of 2015. This represents the eighth consecutive quarter of occupancy growth and highest in the company's operating history. This, along with a healthy tenant retention of 81% in Q4, contributed positively to improved occupancy and portfolio rental growth. The REIT's weighted average interest rate on debt reduced to 1.85% at the end of 2016 from 2.49% a year ago as the company was able to refinance its existing loans at a lower rate as well as take new mortgage loans at a lower interest rates. Dream remains very undervalued with a solid 8% dividend yield [paid monthly and fully covered by FCF], 0.87x P/B vs. past 2-year average of 1.2x and high of 1.4x, and 11x P/AFFO. USA property stocks have done really well, trade at nearly 80% higher valuation levels than Dream, and Europe is at least two years further down the road in terms of monetary tightening.

One new name for us is **DAMAC Properties [Dubai/UAE listed DAMAC_UH; US$4.2 billion market cap]** which represents an extremely undervalued stock trading at extreme absolute valuation multiples as well as a steep discount to its peers and the overall market. The stock is trading at just 3.9x P/E on FY 2017 estimates [a 50% discount to its close competitor EMAAR], and 3.5x EV/EBIDTA [a huge 63% discount to EMAAR]. Furthermore, DAMAC's current 1.2x P/B provides reasonable downside protection in our view. In its limited stock trading history going back to 2014, the average actual P/B has been 1.7x while the high [as recently as last year] has been 3.2x. DAMAC also offers an attractive US$ equivalent [the local currency AED is firmly pegged to the US$] 6% dividend yield on a 9% FCF yield. Not unlike its distinctive and uniquely designed properties, DAMAC has high quality financial metrics today, with 45% net margins, 30% ROE's, and a clean net cash balance sheet. How many companies have 45% net after-tax margins [a 0% tax rate in Dubai is hugely attractive for

shareholders] after a period of challenging sales/pricing environment? Rising oil prices are a general catalyst for the entire region, as is its partnership with the Trump organization on a few golf resort properties. From a portfolio perspective we like the fact that Dubai and its property sector has withstood two severe downturns during the past decade, the 2008 global recession and the 2014-2016 plunge in oil prices. The company has good visibility for the next four years on its projects and revenues. We see 60% upside in this stock, which would imply only a 6x P/E multiple on the stock.

Finally, **Fondul Proprietatea [FP_RO; Romania and also London listed; US$3.3 billion market cap]** is one of the most undervalued closed-end funds globally, trading at a 26% discount to its marked-to-market NAV. This stock is up 30% since we last spoke nearly a couple years back. There's a 5.6% dividend yield fully backed by underlying dividend income, and the underlying investments are undervalued at 1x P/B, 11x P/E and 4.3x EV/EBITDA. The Fund, the target of several activist shareholders, is actually managed by Templeton, which has done a credible job. A couple months back, management announced a tender offer to buyback 640 mn shares [6.6% of the shares o/s] at RON 0.91 per share [a 11.79% premium to the pre-announced price] under its seventh buyback program which comprised a total share repurchase of 1,007 mn shares. Including this recent announcement, Fondul has bought back a staggering 31.5% of its issued share capital [for RON 2.8 bn] in the last three years and 42.2% [RON 3.8 bn] in the last four years. Including dividends and the buybacks, the company has returned RON 6.9 bn in the last five years which is 77% of the current market cap!

Thank you.

Value Investment Principals [VIP] is a leading investment advisory firm focused on unique "deep value" stocks diversified across geography/market cap/sector. We were founded 6 years ago, and our clients include many of the top value managers globally such as First Eagle, Royce, International Value Advisors, Ruane Cunniff, Barrow Hanley, Oldfield, Advisory Research, Columbia Wanger, Ariel, Artisan, etc. We look for extreme valuations, such as ten stocks we have recommended where net cash on the balance sheet is greater than the market cap, and one gets the underlying business for "free". In addition to undervaluation, 2/3rd of our ideas are in growth industries, and 1/3rd are clear industry leaders. With an average dividend yield consistently in the 5%-8% range for all our ideas over the past six years - the mix of value, growth, yield plus leadership is an intuitively appealing combination for most investors. Performance has also been strong, with over one-in-every-four of our stocks appreciating >50%.

Our CEO and CIO, Sandy Mehta, CFA, has 25 years of investment experience, and has previously been a PM for a $15 billion "flagship" global fund, been PM of two [international and domestic] 5-Star rated funds, and also founded a $200 million international hedge fund. He was the first analyst ever hired by legendary value manager John Rogers at Ariel, and also worked with Arnie Schneider and John Neff at Wellingon Management.