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Southeastern: The Exceptional Opportunity in Small-Cap Value

May 22, 2020
By Robert Huebscher

On April 9, 2020, Memphis-based Southeastern Asset Management announced that it was re-opening its Longleaf Partners Small-Cap Fund (LLSCX). It closed the fund to new investors in August 1997 to manage its size against any potential liquidity constraints that would limit the opportunity set and to avoid diluting its shareholders, given rising cash at that time. The fund remained closed to new investors for more than two decades over the course of various market conditions.

*I interviewed two of the fund's managers, **Staley Cates** and **Ross Glotzbach**, on May 18. I previously interviewed Staley in 2015, when we discussed Southeastern's methodology and approach to value investing. Please reference that interview for information on those topics.*

Bob: Why did you reopen the fund after 23 years?

Ross: First and foremost, it was the right thing for existing clients. It will lead to a better portfolio, both quantitatively and qualitatively. There are new stocks we want to buy. There are existing investments we want to add to. Historically, when the price-to-value ratio in our fund has been below 60%, it's been a great time to add. It's been below 50% at times over the last two months. We have a low price-to-free-cash-flow ratio, in the single digits, as well.

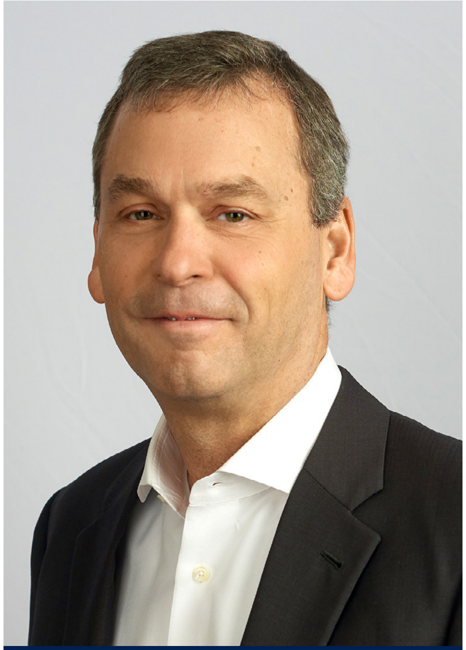
Another key thing about making this decision now is that not only is it good for existing clients, of which we are a very large one ourselves, it's when you get the best new clients. Small-cap value has not been a hot place to be in recent years. For people who join us now, we will be setting things up for a great long-term relationship, instead of having performance chasers come in at the top.

We designed this reopening in a thoughtful way. We are only targeting $2.5 billion of AUM. If we get there quicker with a performance bounce-back, that's great. We'll close again. We've shown over the years that we focus on doing the right thing for those clients who are already with us.

Bob: You did not open the fund following the dot-com or financial crisis market downturns. Why now and not then?

Staley: It's a function of better quality and better balance sheets compared to those two events. We are not sure why this is the case. Maybe it is because the financial crisis was more centered on all things financial, mortgages and derivatives. Maybe its focus was narrower. But for whatever reason, when we looked at our on-deck list, which we handicapped for the balance sheets we were looking at, the market caps and quality were not good enough that we felt compelled to open the fund back then.

This is so broad-based because of the pandemic. Maybe it's in combo with active and value underperforming for so long. We can't be sure why. We have an on-deck list with quality and balance-sheet strength, combined with great price-to-value. Otherwise, we wouldn't open it.


Staley Cates

Bob: As of March 31, the fund had approximately $2 billion in assets and 20 holdings—an average position size of approximately $100 million. Do you plan to increase the number of holdings, the position size or both?

Ross: We don't plan a radical change in what we're doing. We've always been concentrated. We've always been long term. When we can use something like this as an opportunity to upgrade the quality of the portfolio, we're going to do that. The 20 positions could look different depending on how things shake out. There's nothing wrong with going to 19 or to 21 at any given moment. But we definitely have some that we would like to add to, and we have been adding to, as well. Overall, we don't expect our concentrated long-term approach to change.

Staley: We've talked about still having that cap—$2.5 billion dollars makes sense, instead of indefinitely opening.

Bob: Please discuss a few examples of stocks that have emerged as attractively valued since mid-February, when the coronavirus crisis unfolded.

Ross: I will start off with one that we haven't talked about too much publicly. It's extremely compelling, and that is ViaSat. We always think of things in terms of business, people and price. On the business side, it provides satellite broadband to a variety of customers. Its most important business is with the government, where it has the best mouse trap in many places. These are often little mini duopolies or monopolies. It has been growing strongly in double digits. It has a strong backlog. This is a good, steady growing business that doesn't have much to do with the virus.

It also has a strong residential business, where often it is the only way that people in rural areas can get broadband. As broadband has grown in importance through this pandemic, that's another good place to be.

There are two things it has had in the crosshairs that brought it down over the last several months. First is that it had what it calls its "in-flight business," where it provides broadband on airplanes. It's far superior to GoGo, which a lot of people know. But with fewer planes flying and fewer passengers on them, that's going to knock that business out for at least a few years. But when we put that in our DCF model, it's a manageable impact. We think it will come out of this stronger.

One of the things that was holding back the stock, even before February, was the risk around these new low-Earth orbit constellations. They could be a new competitor. We were watching those closely.

As the virus has impacted the use cases for some of those ventures, it's also made money far less free than it was for those who want to launch billions of dollars in small satellites. We've already seen one of those competitors, OneWeb, go bankrupt. It will be interesting to see what happens to some of the other ones, but this is a very positive long-term development in the competitive landscape for ViaSat.

This gets to the people and what they'll do. Its CEO, Mark Dankberg, is an owner. It has had a little bit of insider buying. Baupost has a board-observer position and it has been a long-term shareholder. We feel good about the upcoming capital allocation at this company. When we add up all the parts, we get to a price over $100, and it's trading under $40. This is a deeply discounted growing stock that can come through this pandemic stronger in a variety of ways.

Staley: I'll talk about Hyatt. Because I'm old as dirt, I've followed a lot of hotel companies for Southeastern going back to Holiday Inn, Hilton, Marriott and Belmond. But Ross has done the most work on Hyatt.

Everybody is familiar with its flags. What's interesting about how the company is constituted is that it is a mix of franchise and management fees. That's more than half of its value, and it has a bunch of owned properties. What's unique is the two bullies of the industry, Hilton and Marriott, have turned their companies into pure-fee entities compared to Park and Host, which are pure plays on the owned properties.

> "Within its valuable overseas business, Hyatt has some incredibly high-quality, high-value per key properties in overseas gateway cities."

Part of the reason Hyatt falls between the cracks is because it's a hybrid. It's not a simple company to screen. Starting with the business quality, we love the fact that more than half the value is from fees. Even having invested in the past as very large owners of both Marriott and Hilton, we still believe that Hyatt's reservation system and points program are superior, but you can make the argument that the Hyatt fee stream could be worth even more because it should grow more off of a lower base. If you talk to hotel developers, which we do often, they not only have a lot of respect for the brand, but there are many more ways it can grow, even if it's not quite the same bully on the points and the reservation system.

Within its valuable overseas business, Hyatt has some incredibly high-quality, high-value per key properties in overseas gateway cities. In terms of its U.S. properties, the big ones are actually poised to do better than a lot of U.S. properties by their nature because the biggest territories are Orlando and central Texas, which includes San Antonio and Austin. Those properties will be drivable and the first ones back from the pandemic.

We look at trailing numbers as a proxy and reconcile that by looking out a few years, not assuming things come all the way back, but discounting back some level of recovery. Those are metrics you can compare to its public peers, both fee and owned peers. Hyatt has a value approaching $100 a share. It bought stock back in the $80s before the pandemic, telling you what it thought it was worth then. The stock's now around $50.

The Pritzker family controls it. We do discount our appraisal since we have non-voting stock, but they've been great partners. Mark Hoplamazian is the CEO. He's been there a long time, and he's done a great job.

Even if you project more debt for this year's difficulty, it still has debt-per-share in the mid-teens. This is an incredibly strong balance sheet going into and coming out of this pandemic.

We don't need a recovery in months for this investment to work. Hyatt has close to two and a half to three years of liquidity, because it was able to raise bonds even after the pandemic hit. It came into this with an industry-best position. We're interested to see what it can do that doesn't show up initially on a spreadsheet, while it is in defense mode. But we think it can shift to offense quicker than some others.

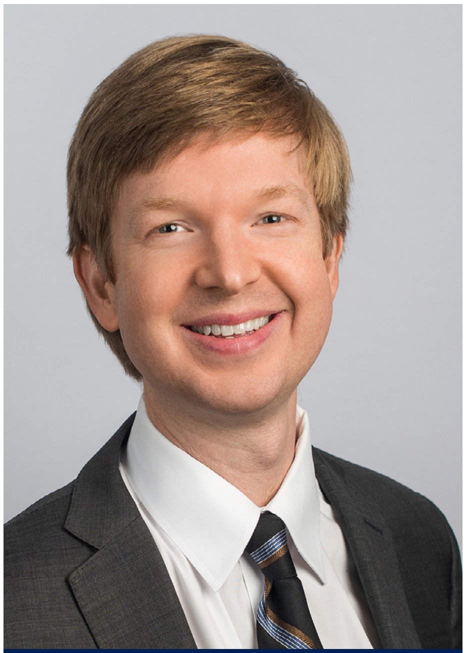
Bob: Value strategies have suffered relative to growth since the financial crisis, and have not provided defensive buffering during the recent volatility. Why has that been the case and what will cause that to reverse?

Ross: We're 13 years into the timeline of value's relative underperformance. We're a lot closer to the end than its continuation. But we need to acknowledge the reality that a lot of the parts of this crisis have really played out to the benefit of those stocks that were riding high going into it.

Sectors that we've been underweight include IT and healthcare. Those just got more important and have held up best, even in the downward market swings this year. Among some of the lower volatility-type stocks—the Steady-Eddies of consumer products and utilities—we were underweight as well. Those were all bottom-up valuation decisions going into this pandemic. We've updated those companies in our appraisals as a result of this. We still don't find them attractive. In many cases, they're less so because their values have not grown dramatically as a result of this. They have just hung in there better due to their perceived "safety".

We look at what we own from the bottom up. We think our fund is much more attractive than many of those growth strategies that have been working. But we're ready for the market, after this high-correlation panic over the last few months, to start sifting through the winners and losers. We think we've built a good bottom-up portfolio to come out of this pandemic.

Staley: We would have loved to have held our ground and performed far better going into the crash; we're not happy with how we did. However, that is a typical pattern during crashes because, when there's that flight to quality as correlations went to one, that's usually not when Mr. Market favors value or finds the economic truth. Once things settle down and you come out of that period, we usually come roaring back. That's what we're trying to lay the



Ross Glotzbach

groundwork to do.

Without opening a Pandora's Box of macro considerations, this is how macro affects a micro DCF. The free money since GFC has factored in several ways. With rates almost zero, it makes growth and thematic investments, where there's no time value of money, do well. It also leads to a "yield hog" mindset, where investors bid up stocks because of their yield, even if it makes them incredibly overvalued. That's not great for value.

After this crash, we may all look back and say that the government did the right thing. But whether we do that or not, it definitely continued the free money deal. It's hard to see that as permanent, but that still suppressed value returns. I don't think it will take a reversal of free money for value to come out of this okay. But it delayed some of our payback.

Bob: I realize that your investment process insulates itself from macro considerations. But surely the coronavirus has affected

your thinking. Have you made any changes in the fund, for example, based on a belief that certain sectors of the economy may be permanently impaired or that other sectors will be structurally stronger? For example, the fund has had exposure to real estate. Has your view on real estate changed in a structural way?

Ross: We've done a bottom-up review of every single company that we own across all of our different portfolios and strategies. We looked not just at the quantitative margin of safety and price-to-free-cash flow, but the qualitative factors that you mentioned. We don't want to stick to an old belief when things have changed. That said, given the sweeping coverage about these changes, we would caution swinging too hard the other way. We want to be right and get that right middle ground.

Real estate is an area where there definitely have been changes. The same is true of stocks tied to oil, balance-sheet-heavy banks and retail. Our portfolio had some exposure to some of those. It'll lead to some changes on June 30th when we file our next 13F. But overall, when we step back and look at what we have and the moves we've made, it has led to not just better quantitative, but better qualitative positions.

Bob: The S&P 500 is down 9.2% year-to-date. Yet, we live in a world where our lives are in danger, our economy has been crushed and the political landscape is uncertain. I realize that you are bottom-up investors and do not look at overall market valuations, but does that 9.2% correction adequately compensate investors for the greater risk premium that they should demand and for the degree to which corporate cash flows have been impaired?

Ross: You brought up the S&P 500. We think that's probably one of the most overvalued indexes as we look around the world. Even going into the pandemic, we thought the S&P 500 was trading richly. Non-U.S. and small-cap stocks were more interesting opportunities on a bottom-up, price-to-free-cash flow, and price-to-value-multiple basis.

> “When you have a fear of a correction, that's when it's great to know what you own and to know that you've partnered with great people who can make it through and go on offense in a variety of environments.”

You can definitely argue that there are large parts of the S&P 500 where investors are continuing to ride with what's been working or what feels “safest.” We'd refer back to the Warren Buffett adage about how you pay a high price for that cheery consensus, and the S&P 500 today is priced at a much higher multiple than our portfolios.

Staley: In a word, the answer is “no.” That decline does not compensate investors enough. But to add to what Ross said about where we're searching and buying, I would simplify this into multiples instead of how we always normally talk about price-to-value. This gets into owning things actively versus the index. I'm just using the S&P even though the Russell is our benchmark in small cap. But it's not that different, regardless of the U.S. index. Over our long history, if you took the composite of what we own, that might've looked like 11 times free cash flow, which is a surrogate for P/E.

The market would typically have been 15 or 16 times. You've heard us forever talk about roughly two-thirds price-to-value as a composite. That composite means a lot more than it does for individual stocks. As recently as last year, we were at more than nine to 10 times free cash flow in our composite. The market was 18 to 20 times, depending on the earnings estimate and the index. Now, it seems like the S&P would be lucky to earn $130 in the next 12 months. Yet, here it is almost 3,000.

Index investors are paying more than 20 times P/E. That has never worked in U.S. market history, and has not led to good long-term returns.

But our composite is down to seven or eight times. This explains why we have underperformed. Part of it was active, part of it was value, but it doesn't change the fact that we have these incredibly low historic multiples. Flipping that over, we see very fat free cash flow yields on businesses with durable cash flow. That's just a giant gap in what we own versus the index. That's the whole case for active versus passive. Fundamentally, that's why we think that our portfolio will be compensated for its risk, even if the S&P is not.

Bob: Related to my previous question, how do you respond to investors who believe it is a matter of time until the market corrects, and that such a correction could be extreme?

Ross: We would remind folks that we're bottom-up value investors. When you have a fear of a correction, that's when it's great to know what you own and to know that you've partnered with great people who can make it through and go on offense in a variety of environments. That's what our investor partners, who think and act like owners, can do at a time like this. If you own an ETF in order to have broader market exposure, that's when you don't know what you own.

Often it can lead to an emotional decision at the very wrong time. It means going to cash at the bottom because it feels like something that will give you short-term relief. We're talking to you on an up day. You let the fear of missing out run a little too wild, and then you jump in at the very wrong time. We want to avoid both of those extremes. We think we'll have the ability to do that.

Bob: Fund flows have favored passive products, especially ETFs, over the last five or so years. What guidance do you offer to advisors who are facing the decision as to whether to allocate to active or passive products?

Staley: We acknowledge there's a place for passive as well as active. We're not trying to be a one-trick pony, but because of the valuation measures we were talking about, we believe that this is just way more tilted in favor of active than its normal allocation, as compared to passive.

Ross: We haven't talked too much about just stocks versus bonds. Lots of Treasury bonds are yielding 1%. That's paying 100-times earnings for something that can't grow its earnings for a decade or more, at least on longer term bonds. That is very unsafe for the person who's focused on compounding their wealth over the long term. It's a radically different story than stocks, like the ones that we've carefully chosen at a 10% or higher yield, and that yield can improve from free cash flow growth.

Bob: Lastly, this is an incredibly challenging and uncertain time—perhaps the greatest in the careers of all investors alive today. What makes you optimistic?

Ross: Glotzbach: It is a hard time. We need to acknowledge the pain that this has caused on so many levels on the human side. But we have a resilient world with healthcare workers and scientists working to get us solutions to this crisis. Rough months are ahead, but there've been lots of challenges before that have been overcome. We don't have to bet on broader market things happening one way or another. We can drill down into what we own and who we partnered with at these companies to get a bottom-up look at a variety of scenarios in which we make it through and grow our long-term absolute returns.

Staley: The pandemic that led to the destruction of the economy is obviously on the top of everybody's mind. There is so much scientific talent and so many great minds on the case that the first reason for optimism would be getting to a vaccine. No matter how long that is in the scheme of things is not the important issue. It's finding it. There was a pandemic in the U.S. in the 1960s, and there have been SARS, MERS and other diseases we have overcome, even though it doesn't feel like it.

There is an aspect of this that feels like no one will travel again. If we all remember, it felt like that after 9/11. People did get back to traveling. During the GFC, there was systemic risk to the financial system, banking distress, stories of trapped cash and panicked CFOs. Those problems have been fixed, and the financial system is in a better place. Those are foundational reasons to be long-term optimistic.

Disclaimer

Average annual total returns for the Longleaf Small-Cap Fund and its benchmark for the one, five, ten year and since 10/26/98 inception periods ended March 31, 2020 are as follows: Small-Cap Fund: -30.62%, -3.56%, 6.00% and 9.01%; Russell 2000: -23.99%, -0.25%, 6.90% and 8.17%. Returns reflect reinvested capital gains and dividends but not the deduction of taxes an investor would pay on distributions or share redemptions. Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by visiting southeasternasset.com. The total expense ratio for the Longleaf Partners Small-Cap Fund is 0.93%.

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RISKS

The Longleaf Small-Cap Fund is subject to stock market risk, meaning stocks in the Fund may fluctuate in response to developments at individual companies or due to general market and economic conditions. Also, because the Fund generally invests in 15 to 25 companies, share value could fluctuate more than if a greater number of securities were held. Smaller company stocks may be more volatile with less financial resources than those of larger companies.

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P/V ("price to value") is a calculation that compares the prices of the stocks in a portfolio to Southeastern's appraisal of their intrinsic values. The ratio represents a single data point about a Fund and should not be construed as something more. P/V does not guarantee future results, and we caution investors not to give this calculation undue weight.

"Margin of Safety" is a reference to the difference between a stock's market price and Southeastern's calculated appraisal value. It is not a guarantee of investment performance or returns.

Free Cash Flow (FCF) is a measure of a company's ability to generate the cash flow necessary to maintain operations. Generally, it is calculated as operating cash flow minus capital expenditures.

Discounted cash flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF analysis uses future free cash flow projections and discounts them to arrive at a present value estimate, which is used to evaluate the potential for investment.

The price-to-free cash flow ratio is a valuation method used to compare a company's current share price to its per-share free cash flow.

An exchange traded fund (ETF) is an investment fund traded on stock exchanges.

The Global Financial Crisis (GFC) is a reference to the financial crisis of 2007-2008.

Price / Earnings (P/E) is the ratio of a company's share price compared to its earnings per share.

Yield is the income return on an investment, which is the interest or dividends received, expressed annually as a percentage based on the investment's cost, its current market value, or its face value.

The S&P 500 Index is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P is designed to be a leading indicating of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3,000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

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