Hidden Value Stocks

SMALL CAPS WITH LITTLE OR NO COVERAGE

from Value Walk

www.hiddenvaluestocks.com

COVE STREET CAPITAL

Interview Two

BEN CLAREMON

Cove Street Capital

Ben Claremon joined Cove Street in 2011 as a research analyst. He also serves as a Co-Portfolio Manager for the Classic Value | Small Cap Plus strategy.

Previously he worked as an equity analyst on both the long and the short side for hedge funds Blue Ram Capital and Right Wall Capital in New York, and interned at West Coast Asset Management in Santa Barbara. Prior to that, he spent four years with a family commercial real estate finance and management business.

Mr. Claremon was also the proprietor of the value investing blog, The Inoculated Investor. His background includes an MBA from the UCLA Anderson School of Management and a BS in Economics from the University of Pennsylvania's Wharton School.

To start, could you give our readers a bit of background on Cove Street and your three long-only investment mandates, Small Cap, Small Cap FOCUS, Small Cap PLUS?

Cove Street was founded in 2011 by Jeff Bronchick. Jeff was formerly the Chief Investment Officer of Reed, Connor & Birdwell. When that firm was sold, Jeff spun off with the rights to his investing track record. From the firm's founding, Cove Street has been focused on small-cap U.S. equities. Our founder has run a small-cap value strategy since the early 1990s, and small-cap was his first love.

But why focus on small-cap? First, we like to fish in ponds that are not as popular and well covered as are the large-cap lakes and oceans. We intentionally seek out securities that are underfollowed, under-loved, and underappreciated.

In other words, we are looking for market inefficiencies and the academic and anecdotal evidence would suggest that you are more likely to find substantial mispricings if you are willing to sort through a universe that is outside of companies that are household names and show up on the cover of the Wall Street Journal.

We see equity market inefficiency as a spectrum with the most inefficient side being, for example, frontier market private equity investments and the most efficient side (in

theory) being large-cap U.S. stocks.

While small and SMID cap U.S. stocks are not quite as ripe for undervaluation as are some more esoteric investments, we believe there are enough periodic inefficiencies to allow concentrated investors who employ a three-to-five-year time horizon to create a lot of value for investors.

Getting to your question regarding our specific strategies, each of the three strategies offers a different flavor of small-cap investing.

Our core Classic Value Small Cap strategy invests in securities with market caps under $3 billion and holds 30 to 39 stocks.

Our Small Cap FOCUS strategy is essentially a “best of” portfolio that holds 10 or fewer stocks—for investors who really believe in concentration.

Finally, our newest strategy—and the one I co-manage—invests in companies with a $1 billion to $12 billion market cap and holds 20 to 29 stocks. This strategy is more concentrated due to the increased liquidity available as you climb up the market cap spectrum.

Cove Street’s investment philosophy is designed around Graham’s hunt for value and Buffett’s pursuit for quality. How do you quantify these styles and to that end, what are the quantitative and qualitative factors you’re looking for in a potential investment?

Let’s start off by what we mean by Graham and Buffett stocks.

Graham stocks (named after the father of value investing, Ben Graham) consist of mediocre-to-decent businesses that are trading at substantial discounts to intrinsic value.

On the other hand, Buffett stocks (named of course after the Oracle of Omaha) are high-quality businesses that are getting more valuable each day and trade at a more modest discount to intrinsic value.

Within that framework, we code every security with a 1-to-4 score, with a one being a perfect Buffett and a four being a total Graham. To help frame this paradigm a little better, just think of a four as being a levered oil and gas driller and a one being Coca-Cola or American Express.

Within our Classic Value Small Cap and FOCUS strategies, we are agnostic in that you see a mix of Buffetts and Grahams because we are willing to take what opportunities the market gives us.

However, mainly based on my temperament and predisposition, our Small Cap Plus strategy leans more heavily on Buffett stocks.

Our deep research process is designed to decipher whether a company we are looking at is a Buffett or a Graham. The reason is that understanding the business helps set both your buy AND sell discipline.

Specifically, while you might be satisfied with buying a 90-cent dollar when investing in a Buffett, you might require a 50-cent dollar when making a foray into a Graham stock.

When a Graham stock hits your estimate of intrinsic value, you are likely to be a seller, whereas when a Buffett stock hits that threshold, you are more inclined to hold onto it—precisely because of the business’s compounding nature.

Finally, the scoring mechanism provides guidance on what to do when the investment moves against you initially.

For example, when a Buffett stock you own

As such, determining where a company fits within the spectrum often requires a lot of time and due diligence. The answer does not always jump out at you, and that is why we call former employees, canvas the competitors, liberally use expert networks, attend industry tradeshows, and visit the companies' plants and facilities. Only then can we be more confident in our assessment of the business.

goes down and is "on sale," you are likely to be excited to buy more. With a true Graham, that might not be the case.

In fact, you might be very hesitant to buy more on the way down. The recent COVID-related market downturn has only reinforced our belief that it helps determine what you plan to do—on the buy and sell side—before you invest rather than when the market is in the middle of a nosedive. (Or a rapid rebound for that matter.)

I should point out that most companies exist within a gray area that straddles Buffett and Graham. Our goal, as contrarian investors, is to unearth opportunities in which the market perceives a company with Buffett-like qualities to be a Graham, most often due to some short-term issues or a misunderstanding of the industry and end-market dynamics.

As such, determining where a company fits within the spectrum often requires a lot of time and due diligence. The answer does not always jump out at you, and that is why we call former employees, canvas the competitors, liberally use expert networks, attend industry tradeshows, and visit the companies' plants and facilities. Only then can we be more confident in our assessment of the business.

Of course, no business is static, so we continuously re-underwrite our investments, seek information that disconfirms our internal narrative, and engage a devil's advocate on the team whose job is to point out all of the flaws in the investment premise.

We aggregate all of the qualitative factors we glean from our diligence process and combine that with an analysis of margins, returns on capital, capital intensity, and other quantitative factors to come up with our 1-to-4 score.

When it comes to portfolio management, do you follow Buffett's style (concentrated) or Graham's (lots of bargain stocks)?

Regardless of the strategy, we wholeheartedly believe in concentration.

No one will ever mistake us for closet-indexers. We understand that not every asset allocator is comfortable with portfolios of 40 or fewer securities. And that is fine with us. We are not trying to be everything to everyone.

We simply do a lot of work that sometimes requires months or even years of research before we invest, and we display our conviction by concentrating on our best ideas. That leads to position sizes of 2.5% and 5% in Classic Value Small Cap and even 7.5% position sizes in Small Cap Plus.

Cove Street is also looking for behavioral anomalies/companies in transition. Could you highlight some examples of behavioral anomalies that might interest you?

When it comes to behavioral anomalies, we are looking for situations that other

investors dislike and for companies that may be undervalued for temporary or structural reasons.

Whenever we see companies that other investors cannot or will not own for any variety of reasons, we get excited. Accordingly, when we screen, we look for: post-bankruptcy companies; small-cap stocks spun from off large-cap conglomerates; securities that are either not an index or were kicked out of an index; and illiquid securities that are hard for other investors to get into and out of.

It is worth mentioning here that the firm planned to limit the total asset size from the very beginning. We have established and will absolutely stick to firm assets under management limits for all of the strategies, and thus we will close long before we get too big to invest in the smaller-sized opportunities that come across our desks.

Being small, nimble, and avoiding stringent rules regarding what we can and cannot own allows us to take advantage of situations where there is forced selling or a company is deemed untouchable.

As it relates to firms in transition, it really gets back to the gray area between Buffetts and Grahams that I described earlier. Specifically, businesses and industries change over time.

> ***Being small, nimble, and avoiding stringent rules regarding what we can and cannot own allows us to take advantage of situations where there is forced selling or a company is deemed untouchable.***

It is imperative to monitor how any of the preceding elements impact returns on capital and growth opportunities due to technological changes, industry consolidation, mergers or divestitures.

I think the U.S. airline companies provide an interesting case study that highlights what I am talking about. For as long as anyone could remember, airlines were these cyclical companies that were always going bankrupt, and they were often the butt of Buffett's jokes. A lot of consolidation happened, and pricing and capacity additions became more rational, and all of a sudden, Berkshire Hathaway was investing in airlines.

The narrative that developed was that the industry was no longer quite as cyclical and had established more pricing power. Well, Covid-19 has thrown cold water on that idea, and who knows if the airlines can survive with their current shareholder base intact? In general, if you are right in identifying a business for which the future returns and growth prospects are poised to improve and you can invest before the market truly appreciates the change, you can make a lot of money.

Therefore, that is what we are looking for, and we run screens for changes in management and capital allocation that could be indicative of a company or industry in transition.

The firm is looking for a margin of safety before investing. Can you give an example of the sort of margin of safety you'd be prepared to accept?

All of our investments have three pillars: Business, Value and People (BVP). When you say the words margin of safety, most people immediately think of some quantitative measure of intrinsic value that you have in mind.

That is absolutely one aspect of our analysis—the V in our BVP framework. But, the reason we spend so much time performing diligence on businesses and management teams is that those can also be sources of downside protection.

For instance, you might be willing to pay up for a decent business that is run by incredible people who have been successful in multiple industries or stock market cycles.

On the other hand, you might require a large margin of safety for a business that has high returns on capital and a moat but is run by people who have misallocated capital in the past.

So, the answer to how significant a margin of safety you require is: it depends!

In general, as mentioned above, we require a more considerable margin of safety for a Graham stock. That usually corresponds to a minimum 50% return over three years, incorporating conservative assumptions about the future. For a true Buffett stock with excellent management, that return hurdle will likely be less onerous.

You recently published a presentation titled, "Buy as Much ViaSat (VSAT) as You Can Stomach." How does ViaSat fit into your investing framework, and how did you first come across the idea?

Let me say first that it is sort of uncharacteristic for us to be so upfront about a specific investment opportunity. We just think this company is incredibly misunderstood.

If people are interested in a much longer discussion on ViaSat, I highly encourage them to go to our website and read the letter we published and listen to the interview that my colleague Eugene Robin and I recently did with the ValueWalk podcast. In that podcast, we spent the entire time on ViaSat, and we also created a detailed PowerPoint presentation to accompany the interview.

Answering your question directly, our founder has followed this company for decades. I believe there are letters from Jeff to the Board and CEO of ViaSat from the 1990s—when he first owned the stock. Coincidentally, my colleague Eugene worked at ViaSat before attending business school. (His parents worked there as well.) So, we have a long and intimate history with this company. We believe that gives us an edge in understanding and assessing ViaSat.

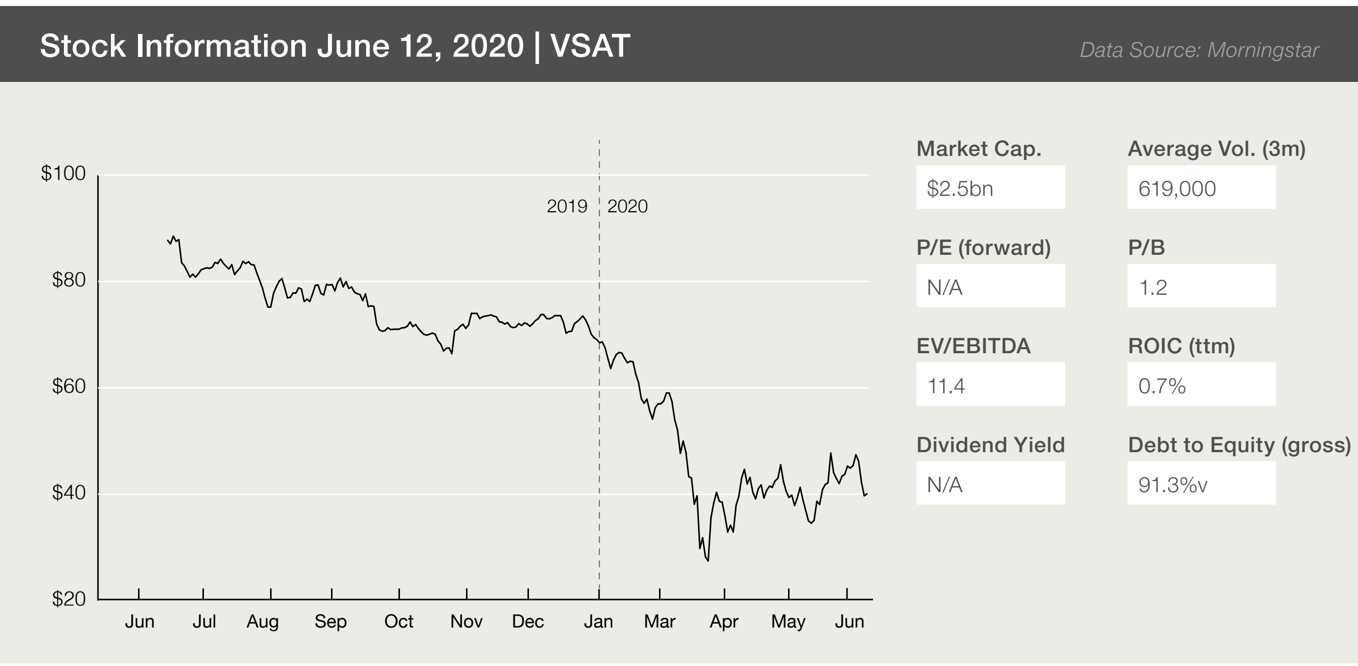
As it relates to our current investment, ViaSat checks several boxes. Let's walk through the business, value and people.

First, we would argue that people on both buy-side and sell-side analysts misunderstand the business, especially when it comes to the most important segment and the secret sauce of the company.

Specifically, people are far too focused on the commercial broadband business and the associated average revenue per user (also known as ARPU). As such, they miss the incredible defense business and the massive synergies there are between the Government Systems and Satellite Services segments.

Next, Mark Dankberg, the company's founder and CEO, has been a visionary within the satellite industry for decades. During his tenure, the company has revolutionized high throughput satellite technology and has achieved speeds that were unthinkable years ago.

This was validated by the fact that Loral, a competitor, had to steal ViaSat's technology to compete—and paid hundreds of millions of dollars in penalties as a result. In addition,



What is great about satellites is that they are pretty easy to value using a DCF, requiring a few assumptions about capacity utilization and pricing. When we do that analysis, it appears that the market is giving the company very little credit for the returns it will likely achieve on the capital it has spent on the ViaSat 3 infrastructure.

Mark has the willingness to invest for the long-run, and to both his credit and detriment, he has not cared too much about what Wall Street has thought about that in the short-run. We like people who are willing to suffer right now to achieve great things in the future.

As such, we believe we are in good hands with Mark at the helm, especially with Baupost—Seth Klarman's investment firm—being the largest shareholder and maintaining board observation rights.

Finally, ViaSat is a little bit hard to value, and that creates a barrier, which explains why we believe the stock is fundamentally and consistently mispriced.

The company has spent hundreds of millions of dollars on next generation satellites that have yet to be launched—and will be launched over the next few years. What that means is that the returns on capital look low and the balance sheet looks a little bit more leveraged than the company will be once the birds (a colloquial term for satellites) are up in the sky.

What is great about satellites is that they are pretty easy to value using a DCF, requiring a few assumptions about capacity utilization and pricing. When we do that analysis, it appears that the market is giving the company very little credit for the returns it will likely achieve on the capital it has spent on the ViaSat 3 infrastructure.

In more simple terms, at the current stock price, our research suggests that you are getting all of that for free. That is because, in our estimation, the high margin defense segment—the one that has been growing at a very rapid clip as the company establishes a deeper relationship with the various arms of the U.S. military—would be worth more than the current stock price.

So, it almost doesn't matter what value you put on the other two segments or the Capex that ViaSat has put into the new birds.

What first attracted you to the stock?

We started buying the stock in 2014 when the stock was in the $50s. At the time, we thought the stock was worth about $80.

Let's be clear: while the recent drop in the market has punished most stocks, this has not been an excellent investment. We have indeed bought and sold the stock intermittently, but several things have happened that have delayed our gratification.

We initially purchased the stock in anticipation of the launch of ViaSat 2, the company's first attempt to change the world's idea of what kinds of download speeds a geostationary satellite could provide. The bird was scheduled to be launched in Q1 2016. However, it was delayed until the summer of 2017, due to issues that had nothing to do with ViaSat.

Accordingly, investors essentially lost 18 months of cash flow from the satellite. Now, we are in a similar waiting period—as ViaSat and Boeing put the finishing touches on the next three satellites. The difference this time is that the opportunity is far, far more significant given the growth of the inflight WiFi market, the inroads that the company has made with the U.S. Department of Defense, and the proof of concept provided by the success of ViaSat 2.

Considering ViaSat's problems and potential, what's your long term price target for the company?

If you peruse the presentation on our website, you will see that we think the stock could be worth more than $130 overtime. Now, we are not going to get there overnight and that valuation requires many successful launches.

However, if you are buying the stock for less than the defense segment's value, a lot has to go wrong with the new satellites for you to lose money as a shareholder. We think there is a substantial margin of safety here, and if the ViaSat 3 satellites create anywhere near the value that the company expects, there is a significant amount of upside in the stock from here.

We've talked about one idea that you like, now could you give us one idea that's not worked out too well for the firm?

I would say the most painful mistake we have made over the last few years was buying Tupperware (TUP).

If people are not familiar with the company, Tupperware is a direct seller of household and beauty goods with a focus on emerging markets. For many years, Tupperware was a high return on invested capital business that generated cash, paid dividends, and was able to grow the top line consistently.

Admittedly, there were always concerns about the longevity of a direct selling model, simply because direct selling becomes less lucrative when a country develops a sophisticated retail infrastructure. However, even in the face of those issues, Tupperware's women empowerment message resonated with female sellers. Moreover, the total addressable market of potential sellers was so large that it seemed almost impossible for the company to not grow.

What went wrong?

What went wrong is that the company failed to modernize and innovate. Tupperware should have been perfectly positioned for a world in which "social selling" became so popular. What are Instagram influencers other than people who use their social cache to sell products? The problem is that Tupperware never built out the digital infrastructure to capitalize on the social selling trend, and by the time the company started to pivot, it was far too late.

Furthermore, we did several calls with former employees, and we heard a common refrain about the company's product set. The company believed that introducing a green water bottle to complement the blue version was consistent with product innovation. But the sellers saw through that. If you can't add compelling products, the sellers will potentially move on to another direct seller such as Herbalife.

This was a textbook example of a value trap. The stock always looked "cheap," but that was true at $80, $50, and $25. I haven't done the math recently, but I am sure it looks cheap around the current price.

> ***This was a textbook example of a value trap. The stock always looked "cheap," but that was true at $80, $50, and $25. I haven't done the math recently, but I am sure it looks cheap around the current price.***

> ***I am not saying it is easy to spend margin to reinvent a company in the middle of consistent growth, but the writing was on the wall that the company had to invest in digital and social if it was going to thrive in an Amazon-dominated world. The company did not and squandered a great opportunity.***

When did you finally realize you'd made a mistake?

We have this mantra that we are looking for companies that are getting more valuable every day. After a while, it became clear that although Tupperware had a great brand and a very formidable salesforce around the world, the lack of investment had permanently impaired the business model. As a result, the company was unequivocally not getting more valuable by the day.

So, despite the high free cash flow and dividend yields, we decided to move on. This was not a great investment, but our decision to invest the capital elsewhere has been validated as the stock has fallen meaningfully since we exited.

Did this situation lead to any changes in your investment strategy?

Consumer stocks are hard! But, we already knew that. Getting back to a common theme at Cove Street, the success or failure of a business will, most of the time, come down to management and governance.

In this case, Rick Goings, the former CEO, did a fantastic job growing Tupperware into a global brand. There is a statue of Rick outside of Tupperware's headquarters. (Always a potential red flag.) He is a hero for empowering a lot of women around the world—no question about it. But, maybe he was too concerned with being a Wall Street hero for always hitting his numbers and keeping margins high.

I am not saying it is easy to spend margin to reinvent a company in the middle of consistent growth, but the writing was on the wall that the company had to invest in digital and social if it was going to thrive in an Amazon-dominated world. The company did not and squandered a great opportunity.

Nothing about the Tupperware experience is going to change our philosophy or strategy. But, like with any mistake, there are lessons to be learned.

In this specific case, I would commend our investment process for unearthing a lot of potential issues at the company. We did a lot of great work, and we did not act on it fast enough. My personal takeaway is not to get seduced by a stock because it is cheap, and the historical returns are high.

We need to perform a realistic assessment of the incremental returns on invested capital, and if those are not commensurately high, maybe the business is not what it was in the past—and therefore is cheap for a reason.

COMPASS MINERALS INTERNATIONAL, INC. (CMP)

COVE STREET CAPITAL

Compass Minerals is a relatively unique business. Can you explain what it does?

Compass is a little wacky (a technical term), and frankly, that is why we like it. The company has three segments, but we see only two of them as core to the business

The primary division primarily mines and then sells de-icing salt to municipalities in North America and the U.K. For anyone who lives in a place where it snows a lot, you know how dangerous it is to drive on roads and walk on sidewalks that have yet to be salted.

Compass operates in a very consolidated market in North America, which is almost an oligopoly, with K+S (known for the Morton's brand) as the other major player.

Compass has a fair amount of pricing power given the industry structure and the mission-critical nature of the product (if you are a municipality in charge of keeping roads safe). Over a 30 year period that ended in 2016, the price of de-icing salt increased by about 3% to 4% per year.

"Compass has a fair amount of pricing power given the industry structure and the mission-critical nature of the product (if you are a municipality in charge of keeping roads safe). Over a 30 year period that ended in 2016, the price of de-icing salt increased by about 3% to 4% per year.

The downside of this business is that the company's salt volumes are driven by how many "winter events" occur during the year. Accordingly, in a year when municipalities don't use much salt because it doesn't snow, next year's pricing might not be as strong.

However, demand for de-icing salt is not correlated with economic activity, and thus, the business should be somewhat recession—and Covid-19—resistant.

I should note that there is some economic sensitivity on the consumer and industrial side of the salt business. But, overall, we believe this is a high margin, cash generative business that, because of the ever-present weather impact, might not make sense as a public company but would be perfect for a private owner.

The other major segment consists of a North American plant nutrition business that produces and sells sulfate of potash or SOP.

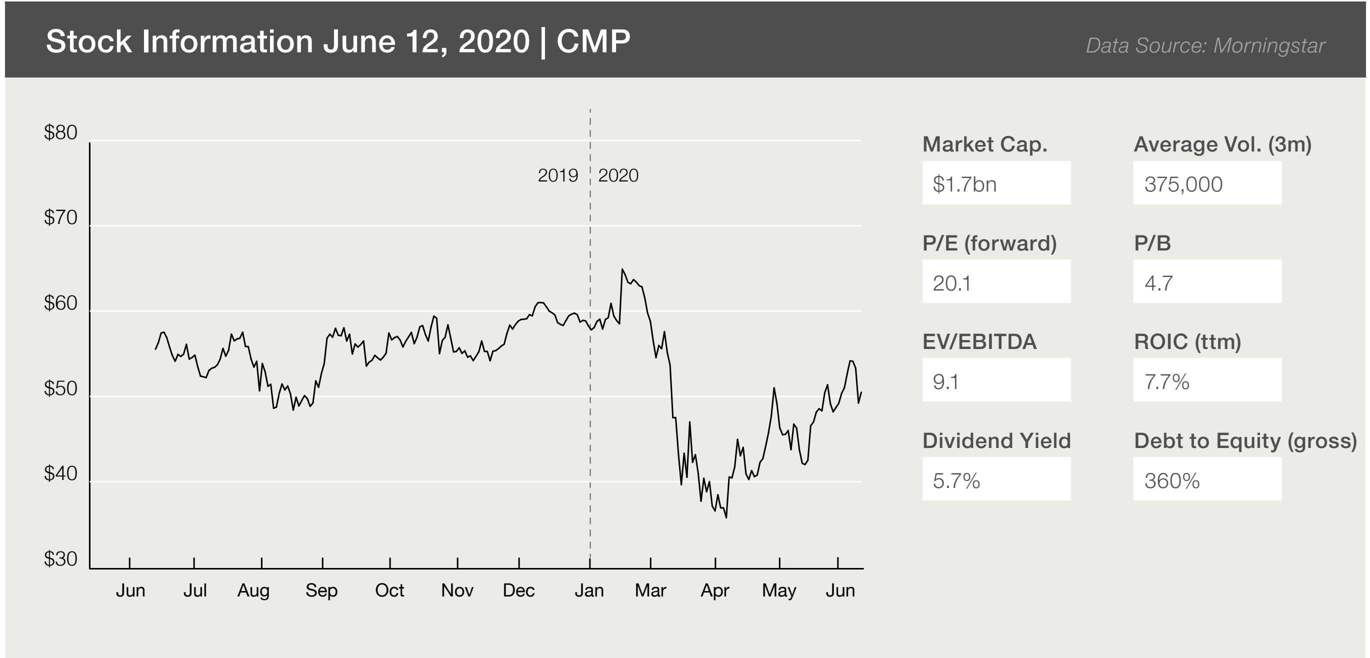
Some people may be familiar with muriate of potash (MOP) produced by large companies such as Nutrien. MOP is more of a pure commodity product, while SOP is a specialty fertilizer that receives premium pricing and is essential for growers of high value crops such as fruits and nuts.

Compass operates as a monopoly as it relates to domestic production. Some imports come into the U.S. from the E.U., but Compass is amazingly well positioned, given that the main plant is in Utah.

Similar to the Salt segment, the volumes of SOP are more tied to the agricultural cycle than to what is going on within the industrial economy.

Stock Idea One | Cove Street Capital

Compass Minerals International, Inc. (CMP)



While 2019 was a very, very tough year for U.S. farmers, 2020 is shaping up to be a much better year. Compass is already seeing an excellent rebound in volumes.

We will talk a little more about the South American plant nutrition business later on, but if you take a step back and look at the two primary segments, what you have is favorable industry structures, mission-critical products, pricing power, and volumes not dependent on broader economic cycles.

We believe these are unique assets that would trade at very healthy multiples, especially relative to where the stock trades—if they were ever sold, either together or separately.

If the company is so attractive, why is the market avoiding the business? On that topic, where does the stock fit into your behavioral analysis framework?

First, road salt is certainly not a sexy product. So, I guess that no buy-side or sell-side analyst is excited to find out that he or she will have the privilege of covering Compass. Also, there are no other US-listed competitors in de-icing salt or SOP, so Compass doesn't fit well into anyone's coverage list.

We have found over the years that being the only public company producing a specific product kind of makes you an orphan. That may be why there are only a handful of Wall Street sell-side analysts who cover it.

Next, this business is tough to model. Unless you can predict how much it is going to snow, it is impossible to forecast cash flows. As you can imagine, Compass is a challenging company to follow for an analyst who is focused on predicting next quarter's earnings.

We have found over the years that being the only public company producing a specific product kind of makes you an orphan. That may be why there are only a handful of Wall Street sell-side analysts who cover it.

Finally, the three businesses don't fit together. Some people may view that as a negative. We think the lack of fit and how separable all three firms are makes Compass more attractive as an investment.

You mentioned Compass's South American operation earlier. The group had been pursuing a strategic review of this division until recently. What does the future hold for this specialty agriculture business?

We have been floating the idea to the company to consider selling the South American business for a while.

The previous management team made the mistake of levering up to buy a company called Produquimica (PDQ for short), and we sensed that the old CEO didn't understand what he was acquiring.

The new CEO has taken his time with this business but seems to have come to the same conclusion. I am not suggesting that PDQ is a bad business, it just doesn't belong with North American road salt and SOP.

Excluding the impact of the depreciation of the Brazilian currency, PDQ has actually performed OK. So, it is not like Compass has destroyed what they acquired.

As such, when the M&A markets eventually open up, there are plenty of other companies that would be interested in owning a specialty nutrient business that offers unique products within a growing agricultural market.

Talking about leverage, Compass carries quite a bit of debt on its balance sheet. Net debt to EBITDA stands at 3.7x. Is this something that worries you?

Yes. We have had countless hours of internal debate regarding this topic. The previous management team spent a fortune on Capex at the company's primary salt mine in Canada (named Goderich, the largest rock salt mine in the world) and then bought PDQ.

That Capex has yet to yield even a fraction of the cost savings the company thought it could achieve, and F.X. headwinds have crushed PDQ.

So, the balance sheet is a little more leveraged than we would like. The funny thing is that Compass would not have a leverage problem if it didn't have such a high dividend payment. But, the management team appears to be committed to the current dividend. It is finding other ways to de-lever instead.

The primary mechanism was the sale of PDQ, a process that is unfortunately on hold right now. But, I think that divestiture would be an excellent catalyst for the stock once companies get over the Covid-induced shell shock and start thinking about expansion once again.

Also, the Goderich mine was run so terribly by the previous management that just basic blocking and tackling is leading to better margins and cash flows from the Salt segment.

That, combined with less Capex and the limited economic sensitivity of the de-icing salt and SOP businesses, should allow Compass to navigate safely through the current market.

How does this stock fit into your Buffett/ Graham style framework?

This is a Buffett stock that has been run poorly until recently. That is why the margins and returns over the last three years look so mediocre compared to the previous years.

We think that both the SOP and de-icing salt business have significant moats and operate

> ***If you give the company credit for some of the internal improvement measures it is currently working on—and apply slightly richer multiples—you can get mid-$80s without a lot of heaving lifting.***

within very favorable industry structures.

Accordingly, Compass should be able to generate consistently high returns that reinforce the Buffett-like nature of these businesses.

Let's talk about valuation. What's your current estimate of the intrinsic value/price target for the business?

This company is a little bit hard to run a discounted cash flow projection on. On the Salt side, you can look at the average number of yearly winter events and make some assumptions about the average volume. And you have a fair amount of information on price per ton of salt sold.

But there is no way to properly incorporate the years when it snows far less than average—or way more than average. As such, we use a sum-of-the-parts (SOTP) analysis as one aspect of our valuation.

The three businesses are absolutely separable, so we believe a SOTP value is a relevant metric.

For Salt and Plant Nutrition North America, we take five-year average prices per ton and five-year average production to get a reasonable estimate of through-the-cycle revenue. We then apply a run rate EBITDA margin to each and use an 11x multiple for salt and a 10x multiple for Plant Nutrition North America.

Let's not forget that these are 30% EBITDA margin businesses that have leading positions in markets that have high barriers to entry. We think these are pretty pedestrian multiples for these franchises.

From there, we take the value of what they paid for PDQ, subtract out net debt, take a deduction for the corporate expense, and come out with a conservative value of $70 per share.

If you give the company credit for some of the internal improvement measures it is currently working on—and apply slightly richer multiples—you can get mid-$80s without a lot of heaving lifting.

How does (or did) the stock fit into your Margin of Safety (BVP) framework?

Let's start by saying that the margin of safety has never included the people who managed Compass!

We think the new CEO is good but, before his arrival, the company burned a lot of capital, made an expensive off-the-beaten-path acquisition, and was wrong in all of their projections.

We think that the unique physical assets and the industry structures that Salt and Plant Nutrition North America operate within provide significant downside protection.

These are cash flowing businesses that may have periodic down years but also supply mission-critical products without much competition.

Are there any significant factors that would have a substantial impact on your long-term price target?

Compass Minerals International, Inc. (CMP)

Sunny winter weather is always a short-term problem for salt. Too much rain or unfavorable planting conditions are never helpful for the plant nutrition businesses.

However, we don't view down years as indicative of a permanent impairment in the business. The things we worry about are more issues at the Goderich mine (such as another strike or mine collapse), the company becoming over-levered and being forced to change its capital allocation, and poor execution when it comes to producing and shipping the products.

Any of these things are possible, but with the management change and the quality of the underlying asset base, we are sleeping much better now. If the company can only get a decent valuation for PDQ, the main risks would likely be off the table.

MACQUARIE INFRASTRUCTURE CORPORATION (MIC)

COVE STREET CAPITAL

This seems like a Ben Graham style sum-of-the-parts investment. Can you explain what first attracted you to the business and where it fits on your Buffett/Graham scale?

I agree that valuing Macquarie requires a sum-of-the-parts analysis, but I would quibble with the idea that these are Graham-like businesses.

Like some of Compass Minerals' assets, Macquarie owns several irreplaceable assets within its International-Matex Tank Terminals (IMTT) and Atlantic Aviation segments.

For instance, given the impossibility of getting the requisite permitting, no one could replicate IMTT's fuel storage assets in Bayonne, New Jersey. It would be tough to replicate Atlantic Aviation's airplane hangar and aircraft fueling infrastructure that it controls at various airports around the country.

> *Usually, I would be hesitant to be involved in a situation where the management team had consistently mismanaged the balance sheet. However, the company's decision to seek strategic alternatives for individual businesses—or the whole company—was what got me over the hump.*

Accordingly, I would argue that some of these assets have very Buffett-like characteristics. My perspective is that the assets by themselves would receive a one or two score, but management and the leverage on the balance sheet drag the score down a bit.

Usually, I would be hesitant to be involved in a situation where the management team had consistently mismanaged the balance sheet. However, the company's decision to seek strategic alternatives for individual businesses—or the whole company—was what got me over the hump.

What attracted us initially to Macquarie is the dividend cut that happened in 2018. Yes, many people run away from companies that are forced to cut their dividends, but, as we discussed above, Cove Street revels in the opportunity to look at companies that other investors have discarded for one reason or another.

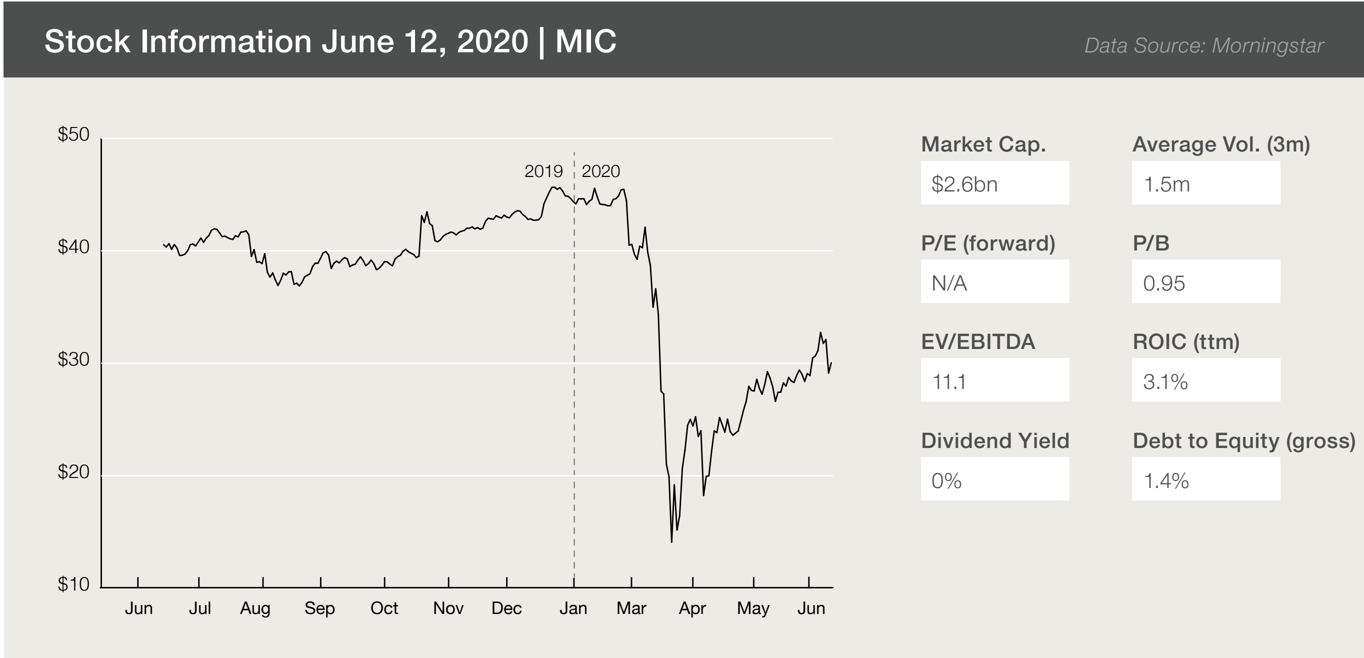
Additionally, our founder owned this company in 2009, when the stock was under $5. There have been some changes to the portfolio over that time, but in general, we were familiar with Macquarie's businesses.

Macquarie is currently in the process of selling itself. How much do you think the business is worth on a sum-of-the-parts basis?

Our contrarian thesis regarding Macquarie Infrastructure surrounds the fact that the parent company, Macquarie, plays in both public and private infrastructure assets.

Therefore, if anybody were in a position to understand what the value of Macquarie Infrastructure's businesses looks like to a

MACQUARIE INFRASTRUCTURE CORPORATION (MIC)



private infrastructure fund, for example, it would be Macquarie.

There are not necessarily perfect public comps for IMTT and Atlantic Aviation. However, a quick analysis of recent acquisitions of similar assets suggests that businesses like these can fetch much higher multiples in private markets than the public stock currently reflects.

On that basis, our sum-of-the-parts analysis of the business is as follows:

Atlantic Aviation could be worth 11.5x EBITDA, which is a discount to where peer Signature Aviation trades.

12x EBITDA for IMTT, which is right about where Buckeye Partners--not a perfect comp--was sold for.

10x EBITDA for Macquarie Hawaii.

That gets you about $45 after subtracting the debt and some corporate costs.

Macquarie is a bit of an orphan in the public market, just like Compass Minerals.

Often when analysts don't have a carbon copy comp, the potential for undervaluation exists. We think it is very telling that even to this day when just about every company we follow has postponed the process of seeking strategic alternatives (due to Covid-19 of course), the Macquarie management team continues to swear up and down that the best path forward for shareholders is for Macquarie to be sold in pieces or in one big bite.

We would be remiss not to mention that the parent company Macquarie owns close to 16% of the stock and will receive a portion of the upside in the form of a fee if Macquarie Infrastructure is sold. Talk about an alignment of incentives!

How long do you think it will take to unwind the portfolio of private assets?

This question is impossible to answer at the moment. A lot depends on when M&A markets open back up.

However, we don't think that Covid-19 has permanently impaired the value of any of Macquarie Infrastructure's assets. We

We don't think that Covid-19 has permanently impaired the value of any of Macquarie Infrastructure's assets. We continue to read that there are infrastructure-focused funds out there with billions of dollars of dry powder.

continue to read that there are infrastructure-focused funds out there with billions of dollars of dry powder.

So, we think there are willing and able buyers, combined with a Macquarie management team that is highly motivated to sell.

Talking of Covid-19, what impact has the coronavirus crisis had on Macquarie's assets? Has the crisis had a material effect on your estimate of the company's fair value?

There is no question that Covid-19 has impacted the Atlantic Aviation business. While the segment does generate revenue from hangar rental fees, a lot of the income comes from aircraft fuel sales. With flight volume down 80% or more, that part of the business has been hurt.

However, over time, we think flight activity will return, and Atlantic Aviation will still have what are called fixed base operations (FBOs) at 70 airports that don't face new competition because of how space-constrained airports are.

On the other hand, IMTT has been benefiting from some of the disruption in the oil markets. So, Covid-19 has not had a material impact on this operation.

Finally, concerning the Hawaiian gas utility that Macquarie owns, the decline in tourism in Hawaii has reduced demand for the segment's products. This is another trend that we see as temporary.

One could argue that especially as more middle-class Chinese people start to travel abroad over the next decade, Hawaii may become an even more popular tourist destination.

Overall, there are some puts and takes in the portfolio, but our estimate of what the three businesses could be sold for has not changed materially.

It's going to take some time for Macquarie to sell its various businesses, and it may take longer than expected in the current environment. With this in mind, does the company have enough liquidity to manage a prolonged wind-down process?

This is an important question and is what I worry about the most. The company has suspended its dividend to preserve liquidity. That was the right thing to do, given the drop in revenue at Atlantic Aviation.

On the other hand, Macquarie continues to invest growth Capex dollars in the IMTT segment.

So, the company has not entirely retrenched. Our research indicates that maintenance Capex is pretty low relative to the cash flow that the businesses will generate even in harsh conditions. Further, by moving around some debt pieces, Macquarie recently eliminated the leverage covenant associated with Atlantic Aviation—where the real stress is.

So, in the immediate term, Macquarie doesn't

really have any solvency or liquidity issues. Having said that, I don't want to gloss over this risk.

Looking at the cash flow statement for 2020 and incorporating the dividend the company has already paid, there could be a small cash bleed this year.

However, the nearest maturity is not until 2022. After drawing down some of the Atlantic revolver, Macquarie has about $1.1 billion in cash.

Further, while the environment could always get worse from here, as economic activity begins to pick up in Hawaii and demand returns for general aviation, growing cash flow will provide an even greater buffer.

But, if it is 2022 and air travel hasn't bounced back at all, Macquarie—like many companies—is going to be feeling some stress.

Leverage seems to be the most significant risk here. Are there any other weak spots you're keeping an eye on?

I think we have talked about several risks, but the primary one is that Atlantic Aviation has a fair amount of leverage tied to it and is suffering from a drop in general aviation.

Second, the management team could decide to postpone or cease looking for strategic alternatives, and the immediate catalyst would disappear.

Third, even if they do continue the sale process, the exit multiples for the assets could be far lower than we are anticipating. I should say: note the current stock price implies a fair amount of multiple compression—relative to our estimates—so we firmly believe that there is a large margin of safety embedded in the present valuation.

I should say: note the current stock price implies a fair amount of multiple compression—relative to our estimates—so we firmly believe that there is a large margin of safety embedded in the present valuation.

Lastly, this is a leadership team that has not covered itself in glory in recent years as it relates to capital allocation and balance sheet management.

While we think they are doing the right things now, there is the potential that they once again misallocate capital and permanently impair the business.

I believe that the final risk is somewhat unlikely, but it can't be ignored.

If any of these risks emerged, how would that alter your view on the company?

If any of the above risks were to play out, we would be forced to re-underwrite our investment.

In both Classic Value Small Cap and Small Cap Plus, we own a 5%-plus position in Macquarie. If we become less comfortable with the upside, capital allocation of business-level execution, our likely first step would be to cut Macquarie to a half position.

One additional thought that has crossed my mind has to do with Atlantic Aviation. Most "infrastructure" assets don't see revenue fall to the degree that it has at Atlantic. Investors pay high multiples for true infrastructure assets because of their perceived stability. It

is hard to see that in Atlantic's numbers at the moment.

As such, maybe that businesses won't get the same multiple it would have received if the business had been sold last year. But, even if we haircut the valuation we are still coming up with a $45 dollar value on an SOTP basis. We were originally getting a mid-$50s value and still think MIC could be worth that as aviation starts to recover from the current freeze.

> ***In both Classic Value Small Cap and Small Cap Plus, we own a 5%-plus position in Macquarie. If we become less comfortable with the upside, capital allocation of business-level execution, our likely first step would be to cut Macquarie to a half position.***

The opinions expressed above are those of Cove Street Capital, LLC and are subject to change without notice. Past performance is not a guarantee or indicator of future results. Consider the investment objectives, risks and expenses before investing.

The information in this presentation should not be considered as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that the security discussed in this report is or will be profitable, or references we make in the future will be profitable or equal the performance of the security discussed in this presentation. The report is based on data obtained from sources believed to be reliable but is not guaranteed as being accurate and does not purport to be a complete summary of the available data.

Terms of use

Use of this newsletter and its content is governed by the Terms Of Service described in detail at

https://hiddenvaluestocks.com/terms-of-service/.

Disclaimer

Any reference obtained from the documents posted on this containing references to products, process, or service does not constitute or imply an endorsement by Hidden Value Stocks, Inc. or its officers, directors or agents of the product, process, or service, or its producer or provider. The views and opinions expressed in this document do not necessarily state or reflect those of Hidden Value Stocks, Inc.

There are no warranties, expressed or implied, as to the accuracy, completeness, or results obtained from any information set forth in this newsletter. Hidden Value Stocks, Inc. will not be liable to you or anyone else for any loss or injury resulting directly or indirectly from the use of the information contained in this newsletter, caused in whole or in part by its negligence in compiling, interpreting, reporting or delivering the content in this newsletter.

Compensation

Hidden Value Stocks, Inc. receives compensation in connection with the publication of this newsletter only in the form of subscription fees charged to subscribers and reproduction or redissemination fees charged to subscribers or others interested in the newsletter content.