BROADVIEW ADVISORS

Articles

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Groundhog Day

Rick Lane, CFA

For small-cap core investors, the past fifteen months have felt about as fun and rewarding as Bill Murray's role in the classic movie *Groundhog Day*. We have experienced several periods where economic growth appeared poised to snap out of its doldrums only to fall back into a funk. A similar pattern has played out with interest rates. Using the U.S. 10 Year Treasury Note as an example, yields have increased only to fall again. We believe mildly rising interest rates would be very good for Broadview's financial sector holdings. Rising interest rates are also typically good for equity prices because they are associated with a strengthening economy and increasing corporate profits.

Why can't the U.S. economy seem to gain a firmer footing? Before weighing in on that topic, we note that while overall growth certainly hasn't been robust; it has not been nearly as bad as portrayed by journalists and politicians. Job growth has been averaging over 200,000 per month. Personal income grew 4.4% in 2015. Energy prices have been lower, providing consumers much needed relief. That said, there is still a fair amount of "slack" in the labor market. Uncertainty on the part of businesses and consumers is high and no one seems particularly happy.

In our opinion, this suboptimal economic growth is likely to continue for the foreseeable future. Not only is the U.S. in the latter stages of the economic cycle that began following the financial debacles of 2008, but it is also suffering from an unfriendly regulatory environment which acts as a drag on productivity. Furthermore, we believe U.S. exports are being negatively impacted by recessions in many of the emerging markets. Of course, the crushing decline in energy prices is taking a toll on the U.S. energy sector.

Interest rates in the U.S. fixed income market have been artificially suppressed by the increased demand from Japanese and European investors. Given the negative interest rate environments they face in their own countries, foreign investors are drawn to the "higher" interest rates in the U.S. even though in absolute terms our rates are also extremely low by historical standards.

Low rates are depressing the U.S. financial sector through compressed lending spreads. Compounding this misery has been the regulatory environment. Dodd Frank, the Consumer Financial Protection Bureau (CFPB), and a myriad of other regulations have squeezed earnings in a revenue-challenged environment. Higher capital standards have further magnified these challenges. U.S. financial institutions have had to reign in lending, particularly in certain arenas such as home mortgages. The overall effect is yet another retardant to overall economic growth.

Despite the aforementioned, the U.S. economy continues to advance. But the various impediments are not about to go away. While we are in the latter stage of this economic cycle, the Federal Reserve seems determined to extend this cycle indefinitely. So, until an exogenous event spoils the party or economic imbalances develop, the current economic condition could go on for a while.

Meanwhile, equity valuations are not cheap. This is particularly the case in the less cyclical sectors where investors, fearing the end of the cycle, have bid prices up to nosebleed levels. Therein lies the dilemma. Most "bargains" in the equity market tend to be in more cyclical sectors or the much maligned energy sector. Yet, given how deep into the current economic cycle we are, we believe one should be very careful about over-exposure to cyclically-sensitive businesses. The energy sector certainly intrigues the contrarian spirit in us, but trying to pick a bottom can be treacherous. Furthermore, much of the energy space is comprised of commodity businesses, lacking the barriers to entry we require of a portfolio company.

We have identified a few companies in the energy sector that meet our Five Pillar criteria. Two are Exploration and Production (E&P) companies, Gulfport Energy Corp. (GPOR) and Range Resources Corp. (RRC), and three are energy services companies, Patterson-UTI Energy, Inc. (PTEN), Superior Energy Services, Inc. (SPN), and U.S. Silica Holdings, Inc. (SLCA). Given the extreme volatility of this sector's stock prices, the positions currently account for about 5% of portfolio holdings. We believe these companies are leaders in their respective fields, possess solid balance sheets to weather the storm, have capable and seasoned management teams who have successfully lead their companies through prior downturns, have strong competitive positions in the industry, and, in the case of the two E&P's, have low-cost long-lived assets.

We believe there is a current inventory imbalance, which will work its way off over the next twelve months or so, allowing supply and demand to level off. Balance will likely stabilize prices for a period of time although the exact timing is impossible to predict. Worldwide demand for oil goes up roughly one million barrels a day on a base of about 95 million barrels per day. Especially important is the natural decline rate which measures the rate of decline of existing oil production without any additional capital spending (e.g. new oil rigs). Our work suggests the worldwide natural decline rate is somewhere around 2 to 4 million barrels per day. With industry capital spending plunging for a period of several years, a significant percent of the natural decline rate will not be offset.

Commodity market shortages and gluts are defined by small imbalances driving large price swings. It is hard to calculate how much oil and gas prices are currently being discounted in the valuation of energy stocks. The consensus is generally between $45 and $50 dollars. This is about $10 higher than what we are seeing as we write this. Equity prices never reflected $115/barrel oil at the peak, nor did they reflect the recent lows in the low to mid-twenties. This adds an element of complexity and imprecision to valuing companies in the energy sector. We do feel the intermediate-term opportunity is sufficiently large to warrant wading into high quality companies, but very carefully.

When measuring overall energy holdings in our portfolios, it is important to note we own a handful of banks with exposure to energy companies, referred to as "energy banks," including Hilltop Holdings, Inc. (HTH), IBERIABANK Corp. (IBKC), Legacy Texas Financial Group, Inc. (LTXB), and Zions Bancorporation (ZION). Collectively these banks comprise approximately 5.5% of the portfolio. These energy banks generally have between 4% and 8% of their loan portfolios in energy-related loans and tend to have geographical concentrations in oil producing regions as well. Places like Houston will feel the pain of low energy prices in other economic sectors such as commercial real estate. Therefore, energy banks trade with energy prices, but with less volatility. These could be considered "safer ways to play" the recovery in oil and gas.

With respect to the rest of the portfolio, overall we believe we are positioned conservatively with respect to economic sensitivity. We believe we have been careful and disciplined about valuations in a market where many sectors are extremely overpriced (driven by the zero-interest-rate environment). We also have exposure to sectors of the economy that still have more of their respective cycles left to play out. Residential housing is a good example of where we think substantial upside is still possible, assuming no near-term recession. For this reason, we have invested in Vulcan Materials Co. (VMC), Summit Materials Inc. (SUM), and MGIC Investment Corp. (MTG). In our opinion, the recently enacted multi-year federal highway bill should benefit certain of our portfolio holdings, specifically Astec Industries, Inc. (ASTE), Vulcan Materials, and Summit Materials. We are all painfully aware of the sorry state of our roads and highways, so this is certainly good news for all Americans and for investors in Broadview products.

Consumer Sector Review

Faraz Farzam, CFA

After a difficult 2015, Broadview's consumer investments rebounded sharply in the first quarter of 2016. Our best performing stock was accessories and luggage retailer, Tumi Holdings, Inc. (TUMI), which was acquired by Samsonite International in a $1.8 billion deal valuing the company at $26.75 per share, a 35% premium to the stock price.

Our largest consumer position, Hibbett Sports, Inc. (HIBB), which we discussed in detail last quarter, reported better than expected results driving a modest relief rally, although the market continues to keep the valuation in the penalty box. In a related development, industry peer TSA Stores, Inc. (Sports Authority) filed for Chapter 11 bankruptcy. They announced they are liquidating all 450 of their retail stores as the company failed to make interest payments on debt in excess of $1 billion.

In contrast, Hibbett is financially solid in our opinion. The company has no debt, significant cash on the balance sheet and, despite ongoing investments in its business, generates free cash flow. Although Hibbett and Sports Authority have little geographic overlap, the implications of Sports Authority's filing are very positive for Hibbett. Sporting goods retailers depend on product availability from branded partners such as NIKE, Inc. (NKE) and Under Armour, Inc. (UA) which make up almost three-quarters of Hibbett purchases. With Sports Authority withering on the vine, well financed and well run partners like Hibbett become increasingly important channels of distribution for NIKE and Under Armour with their compelling product lines.

In our conversations with Hibbett management, we find that both NIKE and Under Armour are also investing in Hibbett. Last fall, NIKE opened an office near Hibbett headquarters in Birmingham, AL solely to service the company. Similarly in May, Under Armour plans to open an office near Hibbett headquarters solely to service the company. We continue to believe that Hibbett is one of the most compelling businesses in our portfolio trading at a rock bottom valuation.

Mobileye N.V. (MBLY)
Aaron Garcia, CFA

This quarter we initiated a position on Mobileye. This investment reflects an evolving investment theme regarding autonomous driving automobiles. While we are still many years away from stepping into a car that can drive you to work, automobile original equipment manufacturers (OEMs), tier 1 suppliers, and large technology companies are all feverishly pursuing solutions to enable this future technology. We believe Mobileye will be one of the key suppliers of image sensing and processing chipsets for the automobile industry during this transition.

In our opinion, the company is the current market leader in vision technology, specifically autonomous emergency braking (AEB). AEB is considered the next largest safety feature in global automobiles with a market adoption potential similar to airbags. Mobileye's disruptive vision solution is more accurate, more functional and lower cost than other technologies. It has become the gold standard of AEB at this time.

While autonomous driving technology is certainly a future initiative for Mobileye, it is too nascent to confidently incorporate into the valuation. However, OEMs award technologies several years out and Mobileye's recent wins (91% win rate in vision/radar based contracts over the past three years) position it well to grow both revenue and earnings, while continuing to develop more advanced applications.

Mobileye went public mid-2014. Analysts universally loved the name and forecast 80-100% market adoption of the Advanced Driver Assistance Systems (ADAS) market by 2020, which would imply many billions in revenue (potential for 100 million units at $100-200 average suggested price). According to a Deutsche Bank report issued in August 2015, Active Safety Technologies such as AEB is expected to gain fitment on the vast majority of Developed Market vehicles and a significant portion of developing market vehicles over the next 10-years. Unsurprisingly, the analysts continued forecasting eye popping numbers in more and more bombastic reports as the stock marched from its IPO price of $25 to a high of $64. While valuation is always an impediment to our investment discipline, we could not find fault with the company's market leading technology and nearly 100% win rate. Fortuitously, the currently volatile equity markets presented an opportunity to initiate a position near the IPO price, even though we were a year-and-a-half closer to the revenue ramp and earnings growth from AEB. We project $2.50 per share in earnings by 2019 driven by $1.1 billion in revenue, which represents contracts already in hand as of 2015. A 25x multiple implies $62.50/share which does not include an option value on future ADAS technology.

Allscripts Healthcare Solutions, Inc. (MDRX)
Aaron Garcia, CFA

Allscripts is a healthcare information technology company that specializes in clinical and financial systems that help healthcare organizations improve their clinical, financial, and operational results. The company provides these services to a diverse client base which includes physician practices, hospitals, post-acute care facilities, medical research hospitals, and life science companies. Key services include electronic health records (EHRs), hosted services, clinical decision support, financial reporting & billing, and population health management solutions.

The healthcare IT sector has enjoyed several years of strong revenue growth post the 2008 recession. During this period of economic distress, the government passed the Health Information Technology for Economic and Clinical Health (HITECH) Act, which spurred the adoption of information technology solutions by the healthcare industry. Allscripts benefited from this adoption curve and was able to grow revenue rapidly, both organically and through acquisition.

It is worth noting that Allscripts is perhaps the most acquisitive company in the industry. The company rolled up several large companies, Mysis and Eclipsys most notably. While this allowed the company to grow rapidly and establish a large software user base, integration of multiple software platforms was challenging and led to a sub-optimal user experience. These issues compounded into disappointing financial results at the company and the stock pulled back from a high of $30 per share to a low of $9 per share.

New management was hired to right the ship in late 2012. Since then, the company has accelerated R&D spending, refocused the sales force, and simplified the product offering by integrated its various software platforms. These investments have borne fruit. Bookings have accelerated. Client satisfaction and retention has improved. Additionally, the company has moved into population health software, which has a massive green-field opportunity as the healthcare system transitions to a pay-for-performance model. The company has also made strides in interoperability that has helped cross selling into its customer base.

The stock has recovered from its lows of 2012 and traded at $13.21 at March quarter-end. Despite this, we believe the stock price does not reflect all of the improvements that the management team has made. Going forward, we believe revenue growth will outperform based on the improvement in bookings and the growth of the company's population health solution. In 2016, the company is forecasting revenue growth of 4%, which is somewhat affected by a 2-4% decline in non-recurring revenue. This piece of the business is getting smaller (23% of revenue in 4q15) and will be less of a headwind to revenue growth in 2017. Given the improvement in the margin profile, we believe 2017 could demonstrate meaningful improvement over the 2016 numbers. In our opinion, $1.00 in earnings for the company is not unreasonable over the medium term. Our private market value is $20 per share.