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Staying Disciplined in a Momentum Market

Faraz Farzam, CFA

The second quarter of 2015 proved to be another challenging quarter for the Broadview investment strategies relative to their benchmarks. According to data from Evercore ISI, momentum stocks, or shares with the most price appreciation in the last two to twelve months, are rising three times as fast as the S&P 500® Index. This has only happened two times in 24 years of data, 2007 and 1993.

This frustrating landscape was captured best by Greenlight Capital's David Einhorn lamenting in his Q2 letter, "in today's market, the best performing stocks are companies with exciting stories where accountability is in the distant future." The market seemed to shrug off global macro-economic headlines, such as the much discussed crisis in Greece dubbed the "Grexit." Although a deal has ostensibly been reached by Greece and her creditors, we suspect there is more drama yet to unfold.

In other global macro developments, Iran and the P5+1 (includes Germany and the permanent members of the U.N. Security Council, namely the U.S., Russia, China, France and Britain) announced a historic deal surrounding Iran's nuclear ambitions that will lift economic sanctions in exchange for Iranian concessions on enrichment and inspections. In roughly 12-18 months Iran will be able to substantially increase its oil exports, which should continue to keep oil prices, and thus gasoline prices, in check.

Improving domestic economic indicators led to a sharp increase in 10-year U.S. Treasury rates in continued anticipation of the Fed's first rate hike later this year. This was a positive catalyst for our regional bank stocks, an area where we have been increasing our exposure. Despite strong returns from our regional bank investments and technology names, our consumer discretionary investments reversed last quarter's strong results. Most, but not all, of this poor performance was due to a sharp correction in our largest position, MDC Partners Inc. (MDCA). Aaron Garcia will expand on this topic in the following paragraphs.

Ironically, in our last quarterly discussion we expressed enthusiasm for consumer discretionary stocks due to falling energy prices, the strong dollar, and gains in overall wages and employment. Although all of these favorable conditions persist and we continue to believe the environment remains favorable for consumer names, the second quarter was nonetheless difficult. We caution investors that one quarter (90 days) is never enough time to make or judge true investments. We are confident in the long term outlook of our positions. Rick Whiting makes the case for two of our consumer names below, Winnebago Industries, Inc. (WGO) and Brunswick Corp. (BC).

The most salient example of the momentum nature of the current market, as we discussed last quarter, is captured in the hyperinflation of biotechnology stocks. The total return on the S&P Biotechnology Select Industry Index (SPBIO) is up 35% year-to-date and 450% since the March 2009 lows. The Russell 2000® Index continues to be driven by "Biotech Mania." This is an area where our investment process simply does not apply. At some point, the piper will come calling. Until it does, we caution that our performance may suffer due to our lack of exposure to these "lottery ticket" stocks should the momentum in biotech persist.

Although the current market environment does not favor our investment style, we will continue to adhere to our rigorous process of buying durable business franchises at opportunistic prices. One such company with a durable business franchise, Kforce, Inc. (KFRC) is discussed by Rick Lane. When the tide turns, as it invariably does, the market should reward our time-tested investment discipline.

MDC Partners Inc. Class A (MDCA)

Aaron Garcia, CFA

Regular readers of our commentary know that MDC Partners has been one of our largest investments for several years. The company has a unique mix of advertising agency assets that focus on digital advertising and cutting edge creative work. While smaller than other holding companies, MDC has successfully attracted very coveted agency partners through its partial acquisition strategy which leaves equity upside for junior partners and top creative talent. MDC has also been successful at taking these agencies to the next level through resource allocation and talent development. The corporate strategy has borne fruit; organic revenue growth has been in excess of 2x the industry and margins have begun to accelerate as the digital revenue is more profitable.

In the first quarter earnings release, MDC disclosed that it is cooperating in an SEC investigation. In response to the SEC investigation, the company has revamped its expense management policy for senior management. CEO Miles Nadal has also reimbursed the company $8.6MM related to his personal use of the corporate jet. We cannot know with certainty what the SEC investigation will bring in terms of penalties against the company and senior management; however, we do believe that these issues are most likely contained to the CEO and that the company's financials are not at risk. This was confirmed by the company's independent auditors who 1) did not issue a qualified opinion of the financials; and 2) believe there is no risk of restatement after an exhaustive review of the books. The company has taken several proactive steps to beef up corporate oversight at both the board level and the senior management level. Unfortunately, the price of the stock declined about 30% in the quarter likely due to the SEC investigation.

While any SEC action brings a measure of uncertainty, we believe that the unique holding company structure insulates the revenue generating agencies from the disruption of the investigation. We immediately reviewed the investment fundamentals of the company and believe there is significant unappreciated value in the stock at this time. Even in the event of a CEO removal, we believe the agency assets have a private market value in excess of $40 a share due to comparable take-outs of similar companies.

Our investment discipline also requires competent management at the helm of a portfolio company. This investment pillar is obviously under review as we await the findings from the SEC investigation. At this point, we are inclined to await further clarity on his status at the company and believe there is an adequate bench of talented managers underneath him. Also, the agencies continue to operate at a high level and surpassed expectations in the first quarter. We think that if he was removed, the board would face significant pressure to review strategic options which would likely be a value generating event.

These investigations are hard to weather as an investor. However, our investment philosophy provides some measure of conviction. In particular, the company's discount to private market value is in excess of 50%. We believe that there is significant upside to the stock upon a conclusion of the SEC investigation. We await further clarity from the company in the current quarter and will continue to update our investors as to the status of this investment.

Winnebago Industries, Inc (WGO) & Brunswick Corp. (BC)

Rick Whiting

The U.S. consumer is emerging from a long winter. We have seen evidence of this, first in the auto sector where the SAAR (Seasonally Adjusted Annual Rate) of auto sales is running above 17 million units in 2015 and is expected to surpass its prior peak of 16.6 million from 2006. Also, the housing sector is confirming a renewed capacity to spend. Data from housing starts, remodeling activity, home prices and the big box improvement centers is encouraging.

Our expectation has been that once the consumer had regained a footing, we would see a broadening in the range of spending. We believe this is not just by the number of items but with a willingness to purchase higher ticket items. This led to our investment in Winnebago Industries Inc., the maker of recreational vehicles, where our thesis has largely played out as expected. Typical of our investment profile, Winnebago offered an iconic brand, solid management and, in our view, a seemingly bullet proof balance sheet. The downturn offered an exceptional opportunity to buy into the company at attractive prices, but required patience as the consumer righted himself. The consumer has come back. To be sure, there have been stops and starts. However, with dealers who survived the downturn properly chastised, inventories have remained consistent with demand and profits at Winnebago have recovered nicely.

Similar to any road trip however, there have been detours. While none of these company-specific items derail the thesis, they do shroud the full value of a consumer recovery from the standpoint of peak operating margins and profitability. The company has embarked upon an ERP (Enterprise Resource Planning) implementation that, while necessary, is rarely without risk. Much like a home remodeling project, ERP implementations often come with myriad gremlins in the form of cost and timing. Further, Winnebago is headquartered in Forest City, Iowa, and that has posed a serious challenge to the company as the pool of available qualified labor has been insufficient to fully accomplish all that a rebounding market provides. In the end, while we feel that we have timed the cycle right, the capacity constraints, labor and cost challenges and ERP risks have led us to question if there were more powerful ways to profit from the second half of a consumer recovery story and we have reduced our position in Winnebago.

We have deployed some of our investment dollars in Brunswick, the dominant builder of boats and engines for the marine market. Like Winnebago, Brunswick is home to iconic brands: Mercury Marine, Boston Whaler, Sea Ray, Lund, Lowe and more. We believe they have an exceptional management team and strong balance sheet. They too are in the mid-cycle upswing of selling to revitalized consumers.

Unlike Winnebago, Brunswick had much more heavy lifting to do during the downturn. The deftness with which management rationalized manufacturing, cleaned up product lines, introduced innovative designs and positioned itself for a sunnier day have been remarkable. Our pathway to understanding the potential profitability of a peak cycle and probability of actually seeing that profitability materialize seem much stronger at Brunswick, given the rapidity and thoroughness with which they have addressed their business challenges.

The markets have certainly been volatile. As Faraz alluded to above, there are many macro issues that buffet stocks on a daily basis. While that may fray nerves, it also creates opportunities. We have used the market's frenetic trading patterns as opportunities.

Kforce Inc.

Rick Lane, CFA

Kforce is a professional staffing firm focused on technology and finance & accounting. They provide both temporary staffing and permanent placement services to the technology and finance & accounting segments. Kforce also provides government contracting services in the fields of technology, intelligence, financial management and accounting. Based in Jacksonville, Florida, the company operates out of 63 offices with locations in all 50 states.

We have been involved with Kforce on several occasions over the years, but the current iteration is by far the most interesting. The company has greatly narrowed its focus on its two main businesses, pared expenses, sold off several companies, and set very ambitious revenue and profitability goals. Simultaneously, the staffing industry is enjoying both cyclical and secular tailwinds.

Rolled together, we believe the company could earn north of $2.00 per share this cycle. Applying a 15x multiple yields a $30 baseline target with definite upside to that if certain factors play out.

In early 2012 Kforce began divesting non-core businesses, selling a clinical trial business for $50 million. Last summer, they sold a health management information system business for $119 million. Each time, sale proceeds were used to buy back stock. Once the current program is finished, the company share count will have shrunk from about 40 million to roughly 28 million. Given our estimated free cash flow generation of over $100 million over the next few years, Kforce will likely be in a great position to buy back another meaningful amount of stock.

Management has also ramped up its staffing recruiters to drive revenue. Many of the newer recruiters are approaching tenure where their productivity really starts to ramp. Interestingly enough, notwithstanding management's focus on growing its core businesses, they also thoroughly reviewed expense structures to drive efficiencies. Management has put a stake in the ground of 7.5% operating margins at $1.6 billion in revenue. This equates to about $2.50 per share in earnings.

For perspective, we see 2015 revenue at about $1.35 billion and operating margins at just under 5%. Clearly these are stretch goals, but further share buybacks are not factored into this equation, nor are potential accretive acquisitions. As we stated previously, even if they just get to $2 in EPS (earnings per share), we believe that would support a $30 stock with definite upside.

Certainly staffing is a cyclical business. We are probably in the mid-part of the cycle; however, the secular tailwinds could make this a super-cycle. Increased health care costs mandated by the Affordable Care Act, combined with a very tepid economic cycle, have rendered most businesses cautious with respect to full-time hires. Even though we are only mid-cycle, temporary staffing penetration is setting new all-time highs at about 2.09% of the U.S. labor force. As well, the offshoring and outsourcing trends of the last cycle, which hurt staffing, have reversed in this cycle. We see staffing penetration continuing to gain share. We believe Kforce is poised to outperform a strong underlying industry.

Definitions:

S&P 500® Index - An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors.

S&P Biotechnology Select Industry Index - represents the biotechnology sub-industry portion of the S&P Total Stock Market Index.

Russell 2000® Index - measures the performance of the 2,000 smallest companies in the Russell 3000 Index which comprises the 3,000 largest U.S. companies based on total market capitalization.