BROADVIEW
ADVISORS

THE BROADVIEW | SUMMER 2018

Articles

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“Softly, Softly Catchee Monkey” Revisited
Rick Lane, CFA

In our previous publication, we referred to the African proverb “Softly, softly catchee monkey,” the moral of which is “patience gains the day.” We felt value and core stocks were overlooked in a market hyper-focused on growth stocks. We understood patience would be necessary for the value in our holdings to surface. This process may have started as the market has broadened beyond just the well-known FANG stocks (which we are not invested in and includes Facebook, Inc. (FB), Amazon.com, Inc. (AMZN), Netflix, Inc. (NFLX), Alphabet, Inc. (GOOGL), the parent company of Google). Small capitalization stocks in general have “caught a bid.” It is nearly impossible to predict which type of companies the market will focus on in the short term, hence the discussion on patience. We continue to believe that there is value in our names and sooner or later the market will recognize that.

Currently, the economy and corporate earnings are strong. Looking forward, tariff issues, rising inflation, and rising short-term interest rates present headwinds. The Fall elections will be very important as well. We generally view equities as fairly valued, but certainly not cheap. There are exceptions which have been left behind in the recent stock market increases.

As we have cautioned previously, we are very deep into this economic cycle. This cycle has a particularly long duration. We are essentially at full employment. The Federal Reserve is raising short-term interest rates and driving a flattening yield curve. We are wary of an inverted yield curve developing where short-term interest rates rise above long-term interest rates. This is an historically important economic indicator and very often signals an economic downturn, generally fifteen to twenty months from the point of inversion. Considering all the above, we believe investors need to be vigilant of late cycle indicators and cognizant that at some point in the not-too-distant future an economic downturn is likely. As such, we will continue our disciplined approach to investing, being particularly mindful of the valuation and cyclicality of our investments.

Technology Sector Review
Faraz Farzam, CFA

Fundamentals for the technology sector continue to accelerate as the software industry is the main beneficiary of Information Technology (“I.T.”) spending on cloud-based architectures. Although valuations are no longer cheap, we believe fundamentals are quite robust. Areas of caution include U.S. dollar strength as many software names have significant international exposure. Although the strength in the U.S. dollar creates foreign currency translation risk, we believe most technology companies with dominant competitive positions will likely not see much risk from cheaper foreign vendors.

Software’s strength has come at the expense of semiconductor and semiconductor capital equipment industries. Fears of cycle peaks have put the brakes on these stocks over the past six months. Although we are selectively evaluating opportunities in semiconductors, we are parsing through these laggard names for attractive valuations.

National Restaurant Association Show
Rick Whiting

McCormick Place in Chicago hosted the National Restaurant Association show in May of 2018. McCormick Place has 2.6 million square feet of exhibit space. It was full, from-stem-to-stern, with food industry participants. During our visit we focused our attention on the equipment suppliers to the restaurant industry, both public and private. We met with a host of innovative companies, managements, engineers and customers in a setting dedicated to the challenges and opportunities of an enormous market place.

Let me provide some context from the National Restaurant Association 2017 Restaurant Industry Outlook. The restaurant industry had 2017 sales of $799 billion and employed 14.7 million people. That revenue number is roughly equivalent to 4% of U.S. gross domestic product and represents 48% of what we as U.S. consumers spend annually on food. These numbers are spread across a myriad number of categories including fine dining, fast causal, quick serve, corner pizza place, home delivery and take-and-go, to name a few. There is no single solution for the kitchen side of every restaurant. However, some of the challenges kitchens face are universal. The customers (you and me) are fickle with rapidly evolving sets of expectations which currently include locally produced product, vogue food categories and dietary interests (e.g. gluten free offerings). The kitchen, therefore, needs to be flexible and capable of evolving with the menu. Further, every restaurant faces cost pressures. Primary among these are labor cost, energy cost, rents (particularly in dense urban areas) and food costs.

The equipment suppliers are front and center in a dynamic reinvention of the "back of the house," i.e., the kitchen, to address these cost pressures. This is most prevalent in the fast casual and quick serve segments. The goal is to think of the kitchen as a manufacturing space where productivity per employee is maximized, work flow is channeled, energy efficiency is embraced, footprint is reduced, and waste is minimized. As in so many other applications, this is where technological innovation is at the forefront. The kitchen is no longer an assortment of components that stock the counter tops, but a group of systems and subsystems that can dovetail in functionality, have flexibility in cooking styles and temperatures, offer speed and energy efficiency and are capable of "talking" to the manufacturer to report component performance to avoid down time for repairs.

Amongst the many companies we visited, all have embraced the trends and challenges discussed above. We feel that one restaurant equipment supply company in particular provides exposure to the most rapidly evolving sectors of the restaurant industry (quick serve and fast casual) and has an excellent distribution network. We believe that this restaurant equipment supply company is not only at the front of the pack in innovation and technology but has highly integrated sales and engineering teams to sell system solutions as opposed to individual component offerings. Historically, the growth rate for the restaurant equipment suppliers has been very steady. Macro-economic trends such as full employment and rising wages coupled with the challenges outlined above may spur increased spending in the industry. While that would be a "best case" scenario, we are increasingly convinced that this restaurant equipment supply company should continue to gain market share.

Regional Bank Mergers & Acquisitions
Rick Lane, CFA & Sam Koehler, CFA

Over the past several years, a trend of rapid market consolidation has emerged in regional banking. After one bank is sold in a market, it often generates a whirlwind of activity as acquirers fear losing out on limited market opportunities. This often creates a bidding war for the few banks that remain. Recent acquisition activity in the Southeast is a prime example. While we were not invested in these banks, the attractive growth prospects in North Carolina, South Carolina and Georgia drove larger banks to acquire many smaller banks, often at valuations attractive for the sellers. This culminated in a few large acquisitions. Nashville-based Pinnacle Financial Partners, Inc. (PNFP) acquired BNC Bancorp (formerly BNCN) to create a bank with assets of more than $20 billion and Pittsburgh-based F.N.B Corporation (FNB) acquired Yadkin Bank (formerly YDKN) to create a bank with $30 billion in assets. Atlanta experienced a similar craze recently with banks like privately-owned BrandBank being acquired by Renasant Corporation (RNST) and State Bank Financial Corporation (formerly STBZ) being acquired by Cadence Bancorporation (CADE). This activity has accelerated due to the passing of the Crapo Bill (Economic Growth, Regulatory Relief, and Consumer Protection Act S.2115), legislation aimed at rolling back some of the Dodd-Frank Wall Street Reform and Consumer Protection Act regulations on small banks.

We have written in the past about the growth prospects of Colorado banks. Two of the remaining independent banks in Colorado were acquired in the second quarter of 2018. Following the recent pattern, these acquisitions took place in rapid succession.

Looking forward, we see Texas as a likely area of additional future regional bank consolidation. There have already been several banks acquired in Houston. We believe there are still some Texas-based banks with solid prospects for independent growth that would also be attractive to potential acquirers. In Dallas, for example, corporate relocations, attractive demographic trends, and low tax rates have made it an attractive market. If additional banks are acquired, it may create a bidding war for the remaining targets just as we have seen in other markets.

Portable Storage
Aaron Garcia, CFA

We have taken an interest in the portable storage industry of the industrial sector. There are several attributes that we look for: leading market position in a fragmented competitive landscape, strong end-market demand, highly recurring rental revenue, and a very profitable margin structure. After spending time with the management team of a portable storage company, we were encouraged by this investment opportunity. While mobile offices do not have the same unit economics as portable storage, we believe the portable storage company has several compelling opportunities to accelerate revenue growth and enhance margins.

In our opinion, the portable storage company is a leading market supplier of modular space and portable storage solutions in North America and the company has a particularly strong position in mobile offices. Currently, the modular space industry is experiencing a strong economic environment for their services driven by commercial construction, accelerating inflation, and strong end-markets. Further, we believe the portable storage company is enhancing their growth with additional offerings for their mobile office customers by providing convenient products and services such as office furniture, appliances, and technology solutions for the interior of the office, and steps/ramps, fencing, and window and door security for the exterior of the office. These solutions may provide a revenue and margin uplift and increase the convenience to the end user for a small monthly fee.

The portable storage company recently acquired a privately-owned provider of mobile offices. We believe this acquisition will be accretive as there is significant geographic overlap of the two companies' field offices and enticing cost synergies. We believe the portable storage company's operating synergy projections are conservative and the revenue opportunity has a multi-year tailwind. Despite the portable storage company's position in the market, we believe much of the industry is fragmented, and that should create further M&A opportunities down the road.

Despite these positives, the portable storage company has a complicated capital structure with relatively high leverage following the recent acquisition. Although the leverage increases the risk profile of the investment, we see the potential for rapid deleveraging if the management team executes its integration plan successfully. We believe that portable storage companies can handle significant amounts of debt. However, should the economic backdrop deteriorate, the portable storage company's investment profile become markedly riskier.