Sparinvest

Letter to Shareholders | Q1 I 09

Value Equities

Headlines

- Quality Companies
- Valuations
- Earnings Cyclicality
- Asset Deflation
- M&A Markets
- Back to Basics

Dear Shareholder,

2009 started more or less like 2008 ended, with very little faith in the future of the financial system, and a global recession spreading like ripples in the water. Companies have been downgrading their outlooks and raising concerns about near-term earnings. As the stock markets have been telling us for some time, the world is in a serious recession. A big question is, "How long will it last?" It's not our style to try to answer this. However, in times when most news about the real economy is very depressing, we think it's important to remember that in past recessions in the US, the stock markets have tended to bottom out well before real economic data turns positive.

Looking at our portfolios, we would argue that a deep recession is already largely priced in. Cyclical stocks have been priced down almost as if there is no tomorrow – but in recent weeks, we have seen tentative indications that the market is waking up to the fact that most cyclical companies will live to see another day. However, we are not overly optimistic people and our investment style is not about calling turning points in the market. We prefer to focus on the fundamental qualities and the valuations of our investments, viewed over the long term.

Quality Companies

We talk a lot about balance sheet strength. Many of the specific issues we focus on are now gaining attention: the risk of write downs to goodwill and other intangible assets, or obligations such as pensions or lease payments, which place a burden similar to debt on corporate finances. Our portfolios' balance sheets are very conservative when compared with wider stock indices. Our holdings have lower levels of debt, pension and leasing obligations and a significantly lower proportion of their assets in intangibles, like goodwill. Ironically, with such negativity surrounding all equity investments, it can be hard to see how companies with strong balance sheets are actually benefiting. The fact is that these companies not only have the greatest chance of surviving this crisis but, among the survivors, they will have the greatest capital strength to assert themselves and exploit opportunities.

Valuations

Meanwhile, our portfolios are trading at extremely low valuations. Average valuations for the funds can be seen in the individual fund updates. However, if we take Sparinvest Global Value as an example, and aggregate the data from each individual holding to present the fund as, effectively, one stock, we get a price-to-book ratio of 0.6 times, and an EV/EBITDA (one measure of the price you pay for the earnings power) of just 2.8 times. For the MSCI World index, the same methodology gives a price book of 1.5 times and an EV/EBITDA of 5.6 times.

When we mention low valuations, we know we're in danger of sounding like a broken record. It's important to be careful. At the moment, everything looks cheap. Stock indices seem to trade at half of their historic average earnings multiples, whether you look at trailing 12 month earnings or expected earnings.

Naturally, valuation measures should always be taken with a pinch of salt. A company that looks cheap can quickly lose its glamour. Earnings estimates can be cut – as is happening now – and asset values can fall. Accounting practices can make companies look cheaper than they really are, by massaging asset values or earnings levels. People talk about 'botox earnings' – the cosmetic 'enhancement' of net income, which makes companies look cheap on P/E ratios. This strikes a chord with us, as our qualitative process is all about cutting through headline numbers and finding investments that are genuinely good value. We look at earnings, assets, cash flows (and proxies for cash flow) and the sustainability of the business model. In all of this we consider the long term and make conservative assumptions.

Nonetheless, as value investors with a focus on cheap assets and earnings, there are two problems which we face: earnings cyclicality and the risk of asset deflation.

Earnings Cyclicality

At this point, we expect substantial weakness in earnings and cash flows to continue for an extended period. But this is not necessarily a reason to be pessimistic. In our opinion, one- or two-year earnings estimates are not really the best measure of a company's worth. We always try to ascertain the long-term, sustainable earnings power of companies, and we look for companies that offer low valuations and high earnings yields based not on estimates for the next one to two years, but on that long-term earnings power.

This approach allows cyclical companies to enter the portfolio and, when a period of economic growth is replaced with stagnation or decline, it will of course be a while before such companies revert to long-term earnings levels. For short-sighted market participants, cyclical companies are out of favour right now, as no-one knows the length and depth of the recession. It is at times like these that the balance sheet strength that we focus on comes into play, allowing stronger companies to wait for better days. In mature industries, from banks to airlines and autos, those companies that can survive the next couple of years should revert to long-term earnings, and perhaps benefit from less competition once the recession ends.

Whatever the reason – whether due simply to the very existence of business cycles and economic fluctuations, or to statistical 'reversion to the mean', or to corporate restructuring – this approach of focusing on long term earnings levels seems to have worked historically.

Asset Deflation

For value investors who invest in asset-rich companies, asset deflation is toxic. A classic value approach is simply to buy assets below book value: paying fifty cents for assets – perhaps real estate or natural resources – with a book value of one dollar. Similarly, we have often found attractive investments in companies with 'hidden assets', which are stated on the balance sheet at well below their true realisable value. During periods of inflation, the realisable value of assets increases. But in a deflationary environment, asset values decline and it is obvious that asset values – whether for real estate, raw materials, machinery or financial assets – have declined a lot recently. However, we draw comfort from two factors. Firstly, when we buy asset-rich companies, we always try to do so at a considerable discount to their realisable value, giving us a large margin-of-safety should that value fall. Secondly, we are long-term investors and, just as asset values have decreased in value now, so they will rise again if the companies survive the current crisis. This is especially true of productive assets, whose market values tend to fluctuate along with short-term earnings.

In addition to straightforward asset deflation, the current crisis throws up other short-term negatives for asset-rich companies. For instance, in a normalised credit environment a company with short-term liquidity needs can use its assets as collateral for bank loans, or indeed sell them off to raise cash. The present environment doesn't leave much room for such companies - no matter how much asset value is on their books. This brings us back to the importance of strong balance sheets – we believe that companies with limited financial liabilities are least likely to be forced into a corner. They will be the survivors.

M&A Markets

If the tight credit markets have limited the options to sell or leverage assets, they have also weakened the global M&A market. This is reflected in low enterprise multiples: as mentioned above, the aggregate EV/EBITDA for Sparinvest Global Value is now 2.8 times – a level at which no sane business owner would consider selling his company.

Industrial buyers would usually take advantage of recessions like this to go 'bargain-hunting' for the long-term. But this time round, the difficulties in the financial markets have made even relatively strong companies reluctant. In such turbulent times, why stick out your neck and take on debt in order to expand?

Consider Japan in the 1990's. Companies were shell shocked by the collapse of the bubble and determined to be conservative. They cut debt and held back on investment and acquisitions. In Japan, it took long periods of zero interest rates and government spending before corporate investment took off again. Where are we now? Interest rates have come down, and the recent G20 meeting showed most governments are not reluctant to spend. But recovering from such conditions does not happen overnight.

Back to Basics

So we don't expect either a speedy return to normalised credit conditions or a sudden rush of M&A activity. However, acquisitions will pick up again. Japan offers proof of that – in the past year, it's been Japanese companies that have stood out as active acquirers, making use of their cash piles to go shopping overseas. So, gradually, buyers will emerge to reinvigorate the M&A market. For our funds, over a third of investment exits have been due to M&A activity and our current portfolios hold plenty of ripe targets.

So, recent markets have not been kind: cyclical stocks have been punished for earnings deterioration, asset-rich stocks hurt by fears of asset deflation and buyers who would usually swoop in to take advantage of these conditions have been holding back. But we must remember that for the true value investor, tough markets are no reason to worry and can, in fact, provide an opportunity. As Benjamin Graham would argue, investing for the long term allows the investor to exploit market prices when it suits him, and largely ignore them when it does not.

In dark days of falling markets, it is more important than ever to get back to basics and remember the simple idea of Graham and Dodd: most of the time, the investor is better rewarded if he forgets about the stock price and focuses on the company, its assets and its operations. We remain convinced of the strength and long-term potential of our investments. We are confident that their balance sheet strength and robust business models will allow them to reap the rewards as the survivors of this recession. We are sure that the value premium exists in the long run. We believe we are reaching a point where common sense and true ownership of a part of real companies, with real assets and earnings, will become more important to all investors and lead value investors to solid returns.

Yours sincerely,

Jens Moestrup Rasmussen
Lead Portfolio Manager
8 April 2009

Sparinvest Value Team

Jens Moestrup Rasmussen
Lead Portfolio Manager

David Orr
Equity Analyst

Kasper Billy Jacobsen
Lead Portfolio Manager

Jeroen Bresser
Equity Analyst

Per Kronborg Jensen
Portfolio Manager

Trine Uggerhøj
Equity Analyst