



## Value Equities

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### Our Value Equity Funds

Fund	ISIN code
Ethical Global Value	LU0362355355
European Value	LU0264920413
Global Small Cap Value	LU0264925131
Global Value	LU0138501191

Detailed information is available in the relevant Fund Update.

- [sparinvest.eu](http://sparinvest.eu)

*Dear Shareholder,*

In October 2009, we wrote that for every positive headline about improving economic conditions, there was another pointing to the risks that remain. One year on in October 2010, it feels largely the same. However, there is no reason to despair: these conditions offer good opportunities for value investors.

We previously wrote about the concerns over sovereign debt levels and the need for deleveraging at the personal, corporate and government level. Concerns about a double dip have not gone away. Overall, indicators of economic and industrial strength have picked themselves up from the troughs of early 2009, but they remain well below pre-crisis levels, and every so often a nasty number spooks the markets. The global economy picked itself up after the shock of the credit crisis, and is on the road to normalisation – but (again, as we have written before), it is going to be a long journey, and not always a smooth one.

So, the world is on the mend, but it is not out of the woods yet. This suits us. Back in September 2008 to March 2009, the crisis triggered a panic in the stock markets in which, effectively, the entire ocean of equity dropped. From April 2009 to March 2010, there was basically a relief rally, in which stocks generally rebounded – but not on a very selective basis, and with little regard to individual corporate quality. Since March 2010, various top-down concerns have put the markets under pressure again, but it has not been blind panic. We are starting to see signs of something more selective. Some of the sectors – such as banks – which did so well in the relief rally, are feeling the strain now, as the reality of the regulatory issues facing them starts to kick in. We think that perhaps a focus on quality is starting to emerge.

As always, day to day, we have been keeping a close eye on our existing investments, and searching the markets for potential new investments.

Looking at our existing investments first, what we see gives us great confidence for the future. As we have previously written, our holdings have responded to the pain of the past two years by taking dynamic steps to restructure their cost bases, and adapt to the currently harsh economic conditions. This gives us confidence in their ability to withstand it if conditions remain tough, and confidence that as conditions improve, they can reap massive benefits.

### **Valuations**

As always, comments and data on each specific fund can be found in the individual Fund Updates. Generally, the value equity funds are performing healthily so far in 2010, with solid double-digit gains. Importantly, despite these gains, the portfolios remain deeply undervalued.

Let's consider Sparinvest Global Value as an example. As a rough indication of the valuation, we amalgamate the holdings into one theoretical company. This company has a price-to-book of just 0.97 times, compared to 2.06 times for the MSCI World index. Looking at earnings-based multiples, many of our holdings have strong operating leverage: as the overall economic environment gradually improves, they are well placed to see healthy increases in earnings levels. While the price-to-earnings ratio for 2010 is 14.8 times Bloomberg estimates, it drops to 11.8 times for 2011. Meanwhile, EV/EBITDA, which is a useful indicator of the price of companies relative to their raw earnings power, is just 5.0 times 2011 estimates, compared with 6.6 times for the MSCI World. The aggregate balance sheet is strong, with net-debt-to-equity of just 29% (versus 52% for the MSCI World), and intangibles-to-equity of only 18% (versus 52% for the index).

These levels strike us as low both in absolute and historical terms, offering good potential for healthy long-term performance.

### **Contrarian Opportunities**

Meanwhile, in terms of new investments, we continue to find plenty of attractive opportunities in the markets. Across the value equity funds, we made eleven new investments in the third quarter, and it is notable that seven of these were in the United States. In recent years, our global funds have had relatively little exposure to North America. We are not top-down investors, and our

small weighting there has never been due to strategic or macro considerations. However, when we screened global markets in recent (pre-crisis) years, we simply did not find large numbers of compelling investment opportunities in North America, in terms of valuation. Unsurprisingly, the equity markets of the past two years have pushed valuations of many companies down to more attractive levels. As value investors, we are always prepared to be contrarian.

Note that two of our new investments in the past quarter have been in oil services: Noble, an offshore-drilling company, and Tidewater, an operator of supply ships. These are both companies which we had analysed in depth in 2009 and, while we had been satisfied as to their long-term quality and strength, we had found valuation marginally too high for our funds. The tragic events in the Gulf of Mexico in early 2010 have had a severe impact on this sector, and the after effects will be felt for some time. Regulation of the industry is set to tighten: improving safety and reducing the environmental impact. However, the long-term necessity of these offshore services remains strong, and in both Noble and Tidewater, we saw companies whose share prices had come to levels well below their long-term worth.

However, this willingness to be contrarian does not simply mean jumping headfirst into any stock that has suffered in the market, and now looks cheaper than it did before. It goes without saying that all new investments go through our rigorous analytical process and, of course, we do not invest unless we are satisfied as to their balance sheets, earnings power, and the overall quality of the company.

### **Quality**

But what do we mean by 'quality'? It is a word that can mean many things to many people. A key requirement for us is that the company should not have excessive financial leverage: we discussed the reasoning behind this in our last letter. But of course, quality is broader than any one quantitative factor. It is also a question of the earnings model, the competitive landscape and the company's market share, the management track record, the asset strength, and so on. These are some of the various qualitative factors that we consider in great depth before making an investment.

This does not mean that we only invest in the world's 'best' companies, or those with the biggest brand names. For one thing, the best-managed company with the biggest product in the most promising sector, with the strongest track record, most stable profit margins and

unshakeable balance sheet – well, that company simply doesn't exist. And usually, companies that come close to it are already extremely expensive.

Of course, when market conditions or temporary factors bring such leading companies down to attractive valuation levels, where we can see a significant discount to their long-term value, then we are more than happy to exploit the opportunity. Indeed, many of the stocks we have bought in recent months would fall into this category. But, we are also comfortable buying what Benjamin Graham called 'secondary companies'. This does not mean 'bad' or 'low quality' companies, but was defined by Graham as *"one that is not a leader in a fairly important industry"*. We are prepared to buy market leaders in less glamorous industries: fork-lift trucks, electrolytic capacitors, car seats, and so on. We are also prepared to buy companies that might not be the number one player in their area, but which have a strong track record of earnings generation, have solid asset backing, and – most importantly – have market prices well below their intrinsic value.

When you buy companies at low valuations, it goes without saying that whether they are 'leading' or 'secondary' companies, they are unlikely to be perfect. It may have revenues under pressure due to a tough macro environment; costs may be rising due to materials price increases; management may have made a poor strategic move. Or they may simply be good companies overall, but with one or two small areas that could be improved. These aren't inherent reasons not to invest.

One must analyse the risks thoroughly and consider the worst-case scenarios. We are rather downbeat when we evaluate a company, and we do not optimistically assume that it can transform itself overnight in a world-beater. We make sure it is a company with a durable business model, and financial strength – because this financial strength gives companies flexibility to invest, to restructure if needed, to survive tough periods. We conservatively assess what we think the company can achieve, and if it still looks cheap based on that, we invest. Of course, if the company does achieve significant growth, or effective restructuring, or some other form of improvement, then the intrinsic value simply increases – and so does the upside potential of the investment.

It is this strict focus on conservative assessment of intrinsic value that allows value investors to find compelling investments of great diversity. Value investing is not all about investing in the world's leading companies, or investing purely in defensive stocks, or indeed in cyclical stocks. It must always boil down to valuation. When

markets give us the chance to buy solid companies at large discounts, we do so.

## Transitional Times

This talk of 'quality' links to an issue we often discuss: mergers and acquisitions. In our last letter, we stressed that 'M&A' is not just about headline-grabbing acquisitions which double a share price over night (although we certainly don't mind it when this happens to our holdings). It can also be about more low-key mergers, which can build significant corporate value, but over a longer time. A further consideration is that for some companies, the mere possibility of a takeover bid can be a catalyst for positive developments. This kind of effect is naturally rather hard to quantify, but it certainly exists.

Consider the current M&A markets. After the slump during the financial crisis, deal numbers are increasing again. (In our own portfolios, we have recently seen a takeover at Gewiss, an Italian maker of electrical equipment. Having bought shares at EUR 2.9 in November 2009, we received EUR 4.2 per share in August 2010. There is also a pending takeover in Roto Smeets Group, a Dutch printing company, and Deutsche Bank is showing its interest in Deutsche Postbank).

So, the market is returning to life. But it certainly remains in a transitional phase. As buyers reach for their wallets, of course they will do their best to get a bargain, which means a risk of lowball bids. But that risk is not necessarily a bad thing. Any bid, even a low one which shareholders might reject, gives a clear sign to management that others see significant value in the company – and this frequently serves as a catalyst, motivating management to take the necessary steps to crystallize that value.

Another phenomenon of these transitional M&A markets is that of the weak trying to buy the strong. We have been long-term investors in Hochtief, the German construction and civil engineering company, whose crown jewel is its majority stake in Australia-based Leighton Holdings. Hochtief has been subject to takeover bids in past years, and in September, one of its previous suitors returned. Spanish construction firm ACS (Actividades de Construcción y Servicios), which already owns 29.9% of Hochtief shares, has made an offer valuing Hochtief at around the current share price. What is interesting is ACS's motivation. It is a large player in the industry, but it is highly indebted – it has net debt to equity of close to 300%. Hochtief, meanwhile, has only 8% of net debt to equity with a strong underlying business. Clearly, consolidating Hochtief into its accounts would improve

ACS's balance sheet dramatically. Hochtief's management and board have recommended that shareholders reject the current bid, and certainly we agree that the current bid grossly undervalues Hochtief.

So, industrial buyers are regaining confidence. We are seeing bids for our holdings. Some of these – like Gewiss – are at attractive prices, while others – like the current bid for Hochtief – still do not reflect the long-term value of the company. But in general, we see these as very encouraging signs. What we see now is basically the early stages of a new cycle of mergers and acquisitions, and crucially, as has been the case historically, the holdings in our funds are getting attention.

### Conclusions

Of course, although we are fairly satisfied with the progress of our funds so far in 2010, we can't say that it has been a bumper year for equities. Indeed, there still seems to be a fair amount of caution out there towards equities as an asset class.

This is nothing new. After any period in which equity markets have a rough time, their popularity as an asset class drops. Benjamin Graham, the father of value investing, wrote that:

*"After the great market decline of 1929-1932, all common stocks were widely regarded as speculative by nature. (A leading authority stated flatly that only bonds could be bought for investment)."*

This swing of sentiment is human nature, but it does go a bit against the commonsense principle of 'buy low, sell high'. To the value investor, the aftermath of a painful year or two for equity markets is exactly when you should be hunting for new equity investments.

For Graham, there was nothing inherently speculative about buying equities. An investment operation is: *"one which, upon thorough analysis promises safety of principal and an adequate return"*. This is what we stick to at Sparinvest: we analyse stocks carefully, and if we find that they offer safety of principal, and an adequate potential

return, we invest. Indeed, that is what we have been doing throughout the tough markets of the past two to three years: finding attractive investments at compelling valuations, which will generate strong investment returns. Equities as an asset class will always move in and out of favour. Graham's advice would be that the intelligent investor is the investor who takes advantage of these swings: if they take a good stock to a bargain price, buy it.

We feel extremely positive about the outlook for our funds. Performance so far this year has been encouraging. Our holdings are showing their strength at the operational level. And yet the stock markets continue to offer us many compelling new investment opportunities, which we are confident will drive solid long-term performance.

### Jens Moestrup Rasmussen

Lead Portfolio Manager  
12 October 2010

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