Value Investor INSIGHT
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Lying in Wait

Atlantic Investment Management's Alex Roepers, Kristian Gevert, Andrew Black and Daniel Griffith explain why they strictly narrow their opportunity set, how they scale in and out of positions, why they decided to stop shorting, and what they think the market is missing today in Wesco International, Rexel, Eastman Chemical, Aker Solutions and Niterra.

INVESTOR INSIGHT

Alex Roepers
Atlantic Investment Management

Investment Focus: Targets out-of-favor mid-cap companies that can benefit from value-enhancing activism and might in time attract a financial or strategic buyer.

After earning his Harvard M.B.A. and working in corporate development for two European industrial firms, Alex Roepers in 1988 decided to take his mergers and acquisitions experience and apply it to public equities in launching Atlantic Investment Management. "M&A taught me useful things about analyzing and valuing businesses," he says, "but also to dislike illiquidity and paying premiums."

The lessons learned have paid off nicely for Roepers' investors. Atlantic's long-only Cambrian Fund has since inception in 1992 earned a net annualized 12.7%, vs. 10.2% for the S&P 500. Targeting a narrow opportunity set he considers quite fertile today, he sees upside in such areas as chemicals, electrical-product distribution, energy services and spark plugs.

You've kept your circle of competence relatively narrow since starting your firm in 1988. Describe what that means and the rationale behind it.

Alex Roepers: We focus primarily on industrial manufacturing and services firms with market caps averaging in the $5-6 billion range. The range around that from $2 billion on the low end to $20 billion on the high end tends to work for us because we want to do private equity-type due diligence, with access to top management and the ability to become a significant minority shareholder with potential influence in how the company is run. We avoid small caps because we want good liquidity, and we avoid larger caps because we want direct dialogue with top management. Midcaps are also more likely to attract private equity and strategic buyers.

A good record is built by avoiding major losses and if you run a highly concentrated portfolio – our flagship Cambrian Fund usually holds only eight to ten names – you have to be aware of idiosyncratic risks. For that reason we've determined by elimination what our universe should look like. We don't do high tech, software and biotech because we don't believe we're able to credibly analyze the technological obsolescence risk. We eliminate companies that lack adequate transparency, including banks, insurance companies and brokerage firms. We avoid areas with high product-liability risks, like tobacco and pharmaceuticals, and where the risk of government interference is too high, like utilities or cable companies.

That leaves us with industrial-related companies and some that sell consumer products and services. From there our second level of screening focuses us on companies with predictable and reliable cash flows and strong balance sheets, which generally means interest expenses are covered at least four-fold by reliable levels of EBITDA. Strong balance sheets give flexibility to management in allocating capital, whether to further pay down debt, reinvest in organic or inorganic growth, do share buybacks or increase dividends. These screens tend to exclude all deep cyclicals and companies that are commodity dependent. All in, the universe of companies we follow globally is roughly 1,000, with 500 in North America, 300 in Europe, 200 in Japan.

With this universe, we're lying in wait for the targets that we know well – and in many cases have followed for decades – to fall into our lap from a valuation standpoint. Something may happen specific to the company or there's a dislocation in the industry or overall market, and the stock may start to become interesting. We have well-defined valuation ranges where we're looking to scale into a stock, typically 7-8x EV/EBIT, 5-6x EV/EBITDA or 8-10x P/E. Based on valuation, we're usually keeping close track of 30 of the most undervalued and interesting names we don't own yet in each of the regions in which we invest, the U.S., Europe and Japan. Some may not get cheap enough, but very often they do and we are ready when that happens.

We could imagine there have been many times over the years where you get pushback on not investing in what are classically considered technology companies. Have you thought about expanding your field of play?

AR: I really haven't even been tempted. It's just a different part of the market that for us is difficult to analyze. By and large, that whole space is trading at growth multiples that don't interest us. I will note that our companies benefit from all kinds of new technology which helps them better develop, manufacture, distribute and sell their products. But for the most part, they are not subject to the type of obsolescence risk borne by the primary sellers of technology products and services.

Kristian Gevert: One of our recent portfolio additions is MTU Aero Engines [Frankfurt: MTX]. Few things in the world are as high tech as making aircraft engines, so tech is clearly a central element of companies in our universe.

MTU Aero is also a good example of the type of situation we try to capitalize on, where a company we understand hits a pothole that causes a value dislocation. It is a supplier and partner to aircraft engine manufacturers such as Pratt & Whitney and General Electric. It's a business with a healthy secular growth outlook, consolidated competitive sets, high customer switching costs, and healthy levels of recurring maintenance, repair and overhaul revenues.

Given the R&D intensity of the aero-engine business, the manufacturers typically enlist their big suppliers as risk and revenue-sharing partners on large programs, one of the most important of which for MTX is its partnership with Pratt & Whitney to supply the hugely successful Airbus A320 family of aircraft. Late last summer Pratt & Whitney announced it had discovered shortcomings in its own manufacturing process that required a comprehensive overhaul of approximately 1,200 engines. While MTX is not at fault, as an 18% risk and revenue-sharing partner in the engine consortium they have to share in the cost to remedy the situation.

The opportunity for us came as the market in our view dramatically overreacted to the potential impact on MTU Aero. We concluded that a reasonable worst-case financial impact for it would be around €700 million after-tax over a few years, against a loss in market capitalization on the news that grew to roughly €3 billion. We also believed even this scenario could prove pessimistic, given the potential benefit to MTX from stronger demand for the older engines it supplies and from incremental maintenance and repair work it might get as a result of the P&W engines being taken out of service.

ON AVOIDING TECH STOCKS:

I really haven't even been tempted. It's just a different part of the market that for us is difficult to analyze.

The share price has turned around fairly quickly. It fell 25% to below €160 following the notice of the recall, but now at nearly €220 is back to where it was. We recently scaled out of the position.

We're curious about the timing of your purchase last summer of a stake in oilfield-services provider Weatherford [WFRD]. It was three years into a post-bankruptcy turnaround effort when you got involved. Why then?

Daniel Griffith: The company was not alone in its industry in over-extending its balance sheet through what turned out to be too many expensive and not well integrated acquisitions in a race to scale. We were watching the company closely under the new CEO, Girish Saligram, and thought he was doing the right things to restructure, upgrade customer relationships, and fix what was a bloated and inefficient operating structure.

The key trigger for us was the continued progress in restructuring the balance sheet and once net debt to EBITDA improved to below 3x, we started to intensify our research. We ultimately concluded the market wasn't recognizing the strides the company had made to put itself on solid competitive and financial footing, and the extent to which it could benefit from what we believe will be healthy multi-year growth in development and production spending by multinational oil companies.

The stock still trades at a substantial discount to peers, which we think will narrow as the market better recognizes the dramatic improvement in operating profitability, in the balance sheet, and in the company's more sustainable ability to generate free cash flow. Our base case target for the stock assumes a 7x EV/EBITDA multiple on our 2025 estimates, which would result in a share price of around $145. [*Note*: WFRD shares closed recently at around $104.]

You mentioned typically wanting to have a say in how the companies you own are run. Why is "constructive activism," as you put it, important to your process?

AR: We're typically coming into companies after they have underperformed for some time. We'll work hard to understand why that happened, whether the issues are fixable and, if so, what specifically needs to be done to get the operating performance – and ultimately the stock price – back on track. We want to have that roadmap in mind as we go deeper into due diligence, getting close enough to management to develop the conviction we need that they have a credible plan for improvement and that they are likely to execute it well. We may see many levers to pull, but almost always they include operational improvements to drive higher profitability as well as better-defined and articulated allocation of free cash flow.

While we will push our agenda, we also want to maintain our ability to trade relatively freely in the stock. We dynamically size our positions as share prices fluctuate and believe that has been a key element of our alpha generation. We don't want to give that up by being on the board or otherwise tying our hands when it comes to trading.

Something I'd add here has to do with mistakes we've made. One mistake, as I'm sure you've heard often from investors, is pushing the limits of what we'll accept in terms of financial leverage. The margin of error is smaller and the downside larger. That's why we err on the side of more conservative balance sheets and waiting long enough in cases like Weatherford and Wesco International [WCC], which we'll talk about soon, until they've cleaned things up enough. We might miss some of the upside by waiting, but that's okay if we're entering a more solid company with a still-compelling risk/reward.

Related specifically to activism, we've learned to tread increasingly lightly in situations where we conclude we have to call for replacing the CEO. We've run into problems when that's happened and we felt, given our activist role, that we had to stick around even if things weren't playing out as we had expected. That's been painful a few times in the past so we have been avoiding CEO-change situations.

You've pared your firm's product offering over the last two years to exclude long/short strategies. Why?

AR: Especially in the five years prior to the pandemic, with zero interest rates and a surge in growth stocks, it was challenging for us to create alpha with our short books. Eventually we agreed with client feedback that shorting had become an unnecessary anchor to performance. While we continue to believe that fundamentally driven long/short equity strategies can create compelling risk-adjusted returns over time, we've decided we should focus on our core strength of investing in undervalued, high-conviction mid-cap names in the U.S., Europe and Japan. We've been exclusively long-only for the last two years.

Describe your broader investment case for Wesco International.

Andrew Black: Wesco distributes electrical products such as wiring, cables, switches and transformers, primarily focused on longer-cycle non-residential construction markets. Its transformational acquisition of Anixter International in 2020 made it the #1 player in the North American market and continues to drive significant operating cost savings and ongoing market-share gains. At the time we thought the deal made a lot of sense from a strategic standpoint, but as Alex alluded to earlier we didn't like the balance sheet leverage associated with the transaction.

We waited and watched as the company integrated Anixter, reducing $300 million in annual operating expenses and taking advantage of an expanded product offering to cross-sell to a broader customer base. The resulting improvements helped the company drive net debt to EBITDA to 3x at the end of 2023 – from 5.7x immediately after the acquisition – and that was the catalyst for us to get really interested.

Wesco is now well positioned to capitalize on a number of secular growth themes, including increased electrification, heavy investment in factory automation, semiconductor capacity and data centers, and greater spending on utility, broadband and energy infrastructure. Federal stimulus plans in the U.S. call for a little over $1 trillion in related infrastructure spending over the next several years. Even if only a portion of that is spent, which is entirely possible, the investments should provide a tremendous tailwind for non-residential construction, playing very well to the company's diversified product portfolio.

INVESTMENT SNAPSHOT

Wesco International
(NYSE: WCC)

Business: Broad-based distributor of products and solutions for primarily Electrical & Electronic, Communications & Security, and Utility & Broadband end-market customers.

Share Information (@2/28/24):

Price	**146.04**
52-Week Range	121.90 – 195.43
Dividend Yield	1.0%
Market Cap	$7.44 billion

Financials (TTM):

Revenue	$22.39 billion
Operating Profit Margin	6.0%
Net Profit Margin	3.4%

Valuation Metrics (@2/28/24):

	WCC	S&P 500
P/E (TTM)	10.8	23.0
Forward P/E (Est.)	10.0	21.2

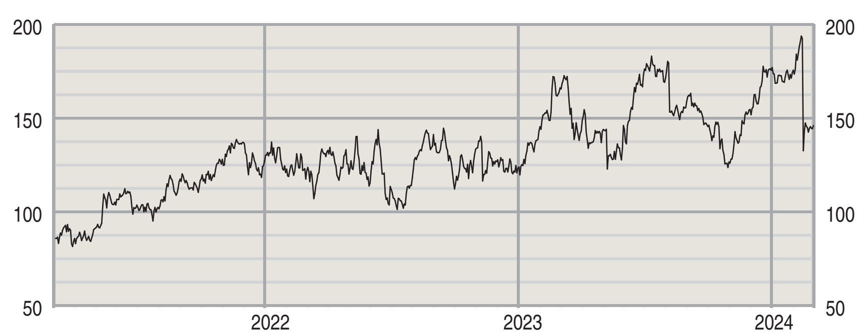
Largest Institutional Owners (@12/31/23 or latest filing):

Company	% Owned
Leonard Green & Partners	12.6%
Vanguard Group	9.5%
BlackRock	7.8%
Peconic Partners	4.8%
Dimensional Fund Adv	3.5%

Short Interest (as of 2/15/24):

Shares Short/Float	2.1%

WCC PRICE HISTORY



THE BOTTOM LINE

The company as a distributor is positioned to capitalize on secular growth themes such as electrification, heavy investment in automation, semiconductor capacity and data centers, and greater spending on utility, broadband and energy infrastructure, says Andrew Black. At 9x EV/EBITDA on his 2025 estimates, the shares would trade at around $240.

Sources: S&P Capital IQ, company reports, other publicly available information

The stock fell sharply earlier this month after a big earnings miss. How are you looking at valuation from today's price of around $146?

AB: As we've seen in several distribution companies, a mix of supply-chain constraints and inventory destocking has caused weaker results over the past several quarters. Many analysts are concerned that WCC's margins will fall back to historically low levels following the recent period of inflation. But we believe with the integration of Anixter and additional cost discipline that operating margins – on a much bigger revenue base – are structurally 250 or so basis points higher than the historical 3-4% range. Our 12-to-18-month price target is $240 per share, which is 9x EV/EBITDA on our 2025 estimates. That would be at the higher end of the historical valuation range, which we think will be justified given the increased profitability and reduced debt profile. Fortunately, we had trimmed our position heading into the earnings report and were able to repurchase shares on the weakness.

We also don't think sell-side estimates include the full beneficial impact of all the cash flow the company will generate that can be returned. Wesco launched an inaugural dividend in the first quarter of 2023 and have authorized a share-repurchase plan of $1 billion, which is 13% of the current market cap.

Is your thesis similar for France-based electrical parts and supplies distributor Rexel [Paris: RXL]?

AB: The end-market and geographic mix is somewhat different but the company is exposed to many of the same positive secular themes. European exporters are suffering somewhat because the Chinese economy is suffering, but that is being offset by the significant buildout in infrastructure related to energy and power, telecom and broadband, automation, and electrification in general. Close to 50% of the business is in Europe and 35% in North America. Like Wesco, Rexel has a highly diversified product portfolio and customer base, but one difference is that it has more exposure to residential end markets, which make up about 20% of sales.

The company also made a key strategic acquisition in buying Mayer in 2021, the #4 player in the U.S. with notable strength in the eastern half of the country. One thing we think confused the market – which sparked us to look into the stock closely – was that just as they were announcing this big U.S. expansion they turned over top management at the corporate level in naming an outsider, Guillaume Texier, as CEO. That created uncertainty and, understandably, a loss in confidence.

In fact, new management has driven margins higher, we think sustainably, through cost synergies from the acquisition and otherwise, reconfiguring the product mix to emphasize higher-margin lines, streamlining logistics, and upgrading the digital customer platform. The magnitude of the improvement is similar to Wesco's, as operating margins are now running above 6%, up from 3-4% pre-2021. There's also skepticism here on their ability to hang on to that margin improvement, which we don't believe is warranted.

The balance sheet has not been an issue, with net debt to EBITDA well below

INVESTMENT SNAPSHOT

Rexel
(Paris: RXL)

Business: Operating through 1,950 branches in 19 countries, distribution of a wide array of mostly electrical products to residential, commercial and industrial customers.

Share Information
(@2/28/24, Exchange Rate: $1 = €0.92):

Price	**€23.66**
52-Week Range	€18.08 – €25.77
Dividend Yield	5.0%
Market Cap	€7.05 billion

Financials (TTM):

Revenue	€19.15 billion
Operating Profit Margin	6.0%
Net Profit Margin	4.0%

Valuation Metrics
(@2/28/24):

	RXL	S&P 500
P/E (TTM)	9.2	23.0
Forward P/E (Est.)	9.3	21.2

Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
Cevian Capital	23.2%
Pzena Inv Mgmt	5.1%
Norges Bank Inv Mgmt	5.1%
Vanguard Group	3.1%
Dimensional Fund Adv	2.9%

Short Interest (as of 2/15/24):

Shares Short/Float	n/a

RXL PRICE HISTORY

THE BOTTOM LINE

New management that arrived in 2021 has driven profitabilty sustainably higher, says Andrew Black, through cost cutting, reconfiguring the product mix to focus on higher-margin items, streamlining logistics, and upgrading the digital customer platform. The stock today trades at a 25% discount to his 12-to-18-month price target of around €32.

Sources: S&P Capital IQ, company reports, other publicly available information

2x. That gives the company significant flexibility to pursue its balanced capital allocation strategy of dividends – the current yield is 5% – share repurchases, and additional bolt-on M&A.

At today's €23.70 price, how inexpensive do you consider the shares?

AB: Speaking to how much the company's performance has improved, the stock has nearly doubled over the past three years but the valuation is flat to down, with the shares still trading at a single-digit P/E. We think the risk/reward remains quite compelling. Our 12-to-18-month price target is around €32 per share, 9x EV/EBITDA on our 2025 estimates. That's also near the top end of the historical range, but we think that because the business and balance sheet have improved there's a good chance it will return to that level.

AR: We can say this about a number of our portfolio holdings, but I would argue especially in the case of Rexel that the balance sheet strength here and the character of the business make this an excellent takeover candidate for private equity. If the valuation doesn't improve, we wouldn't be surprised – possibly prompted by Cevian Capital, the company's largest shareholder – if a private-equity firm made a bid.

What's driving your interest today in Eastman Chemical [EMN]?

KG: The company is a supplier of chemicals used in a wide range of end products – cars, paint, pet food, crop protection, kitchen appliances, you name it. The business is clearly tied to the global economic environment, but supply-chain issues made 2023 a particularly bad volume year for the sector and for Eastman.

As happened in other industries, inventory levels for chemicals were very high coming out of Covid. As the pandemic waned and the economy was relatively stagnant coming into 2023, there was a significant change in the mindset of customers from carrying just-in-case levels of inventory back to just-in-time levels. That resulted in considerable destocking during the year, which reduced capacity utilization, fixed-cost absorption, and therefore reported earnings. We believe the destocking has already eased significantly and should be over across most of the company's verticals by the end of the first quarter.

We're also excited about the prospects for Eastman's new initiative around plastics recycling. It just started up the first of three what it calls polyester renewal facilities – this one in Kingsport, Tennessee – which essentially deconstruct waste plastic into its monomers and reassemble it all into virgin-quality raw material. That is a real step-up in plastics recycling technology that management and we think will generate considerable high-margin new business from customers looking to improve the sustainability of their products. Management expects each renewal facility at scale to generate $150 million in annual EBITDA – $450 million in total – a not-insignificant amount on an EBITDA base last year of around $1.6 billion.

How do you see this translating into share upside from today's $86.50 price?

INVESTMENT SNAPSHOT

Eastman Chemical
(NYSE: EMN)

Business: Chemical producer operating through segments focused on Additives and Functional Products, Advanced Materials, Chemical Intermediates and Fibers.

Share Information (@2/28/24):

Price	**86.49**
52-Week Range	68.89 – 91.38
Dividend Yield	3.8%
Market Cap	$10.14 billion

Financials (TTM):

Revenue	$9.21 billion
Operating Profit Margin	7.6%
Net Profit Margin	9.7%

Valuation Metrics
(@2/28/24):

	EMN	S&P 500
P/E (TTM)	11.5	23.0
Forward P/E (Est.)	11.3	21.2

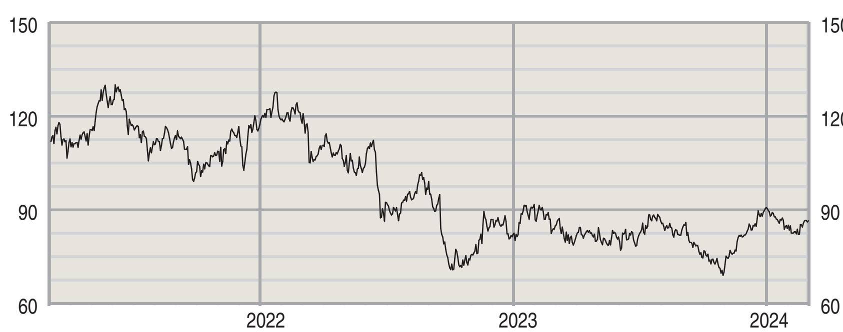
Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
Vanguard Group	12.7%
BlackRock	7.1%
J.P. Morgan Asset Mgmt	4.3%
State Street	4.1%
Putnam	3.7%

Short Interest (as of 2/15/24):

Shares Short/Float	1.5%

EMN PRICE HISTORY



THE BOTTOM LINE

Kristian Gevert expects improvement in the company's operating performance and its share price from two catalysts, supply-chain normalization after the ups and downs of Covid and the launch of a series of innovative plastics recycling facilities. His price target for the shares on his 2025 estimates is around $133, a 55% premium to the current price.

Sources: S&P Capital IQ, company reports, other publicly available information

KG: Assuming the recycling initiative succeeds, we see mid-cycle earnings power of more than $10 per share. On this basis the company trades at a less than 9x normalized P/E. Assuming a peer-group multiple of 9.5x EV/EBITDA – in the range of what Eastman has achieved in the past – we see upside to around $133 per share in 12 to 18 months.

Do you have an activism agenda here?

KG: We don't pursue an activist agenda in all of our core holdings. Mark Costa, Eastman's CEO, and his team have done a great job of investing in the business, pruning the portfolio of businesses intelligently, and returning unneeded cash to shareholders. They've been disciplined in buying back shares and have reduced the share count by around 20% over the past couple of years. We're very supportive of management in this case and don't see a need at the moment for taking a more activist stance.

Returning to another energy-services firm, why are you high on the prospects for Aker Solutions [Oslo: AKSO]?

DG: There are three main parts of the company. The largest core business, accounting for half our estimate of 2025 EBITDA, does engineering and fabrication of offshore oil and gas platforms, offshore wind farms and carbon-capture facilities. Second, the "Life Cycle" segment, producing roughly 15% of estimated 2025 EBITDA, provides maintenance and modification services for existing offshore installations. The remainder of the business, and what we consider the undervalued gem, is Aker Solutions' 20% ownership stake in a recently launched joint venture with Schlumberger [SLB] and Subsea 7 [Oslo: SUBC] called OneSubsea. This JV manufactures, installs and operates subsea infrastructure systems globally, competing with large global competitors like Baker Hughes and TechnipFMC.

Activity continues to grow at a healthy pace in offshore oil and gas exploration, field development and renewables development, and the company in recent years has been disciplined in adding new projects to its backlog. One near-term catalyst for the stock is that a significant number of projects are reaching the delivery stage or key milestones, which should lead to dramatically increased profitability in the core renewables and field development business. We expect that unit's EBITDA margins, in the low single digits in recent years, to increase to 8-10% in the next year or two.

We also believe the combination of capabilities with Schlumberger and Subsea 7 in the OneSubsea joint venture makes sense and that that business will benefit from its expanded scale and global reach. The payments Aker is expected to receive through 2025 for its contribution to the JV represent close to 25% of the current market cap. We're in active discussions with the company about the best deployment of this excess cash. There's no debt and they have increased the dividend and instituted some share buybacks, but on the latest earnings call management indicated they want to hold on to much of the excess cash and just earn a yield on it. We are urging for more value-accretive uses of that cash.

INVESTMENT SNAPSHOT

Aker Solutions
(Oslo: AKSO)

Business: Global provider of offshore design, development, engineering, construction and maintenance services to producers of both traditional and renewable energy.

Share Information
(@2/28/24, Exchange Rate: $1 = NOK 10.58):

Price	**NOK 35.12**
52-Week Range	NOK 33.14 – NOK 50.00
Dividend Yield	5.6%
Market Cap	NOK 17.14 billion

Financials (TTM):

Revenue	NOK 36.06 billion
Operating Profit Margin	1.0%
Net Profit Margin	32.5%

Valuation Metrics
(@2/28/24):

	AKSO	S&P 500
P/E (TTM)	178.8	23.0
Forward P/E (Est.)	8.0	21.2

Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
Folketrygdfondet	5.0%
JPMorgan Chase	3.2%
Vanguard Group	2.0%
UBS Asset Mgmt	1.3%
Goldman Sachs Asset Mgmt	1.2%

Short Interest (as of 2/15/24):

Shares Short/Float	n/a

AKSO PRICE HISTORY

THE BOTTOM LINE

Though its shares have been hurt by weak natural gas prices and recent management missteps in articulating capital-allocation plans, Daniel Griffith thinks the company is poised to capitalize on increased activity in offshore energy exploration and field development. At an historically modest 5x 2025 estimated EBITDA, the stock would trade at NOK 80.

Sources: S&P Capital IQ, company reports, other publicly available information

The shares, now around NOK 35, have performed poorly since the formation of the OneSubsea JV. Is the market less optimistic about that initiative than you are?

DG: The weakness in the stock is in part due to the latest messaging with respect to capital allocation, and also reflects falling natural gas prices in Europe and the associated expectation of reduced development activity. But on either a sum-of-the-parts or consolidated basis we think the shares are highly undervalued. At even 5x our 2025 estimate of full-company EBITDA – the stock has traded as high as 9x in the past – the shares would trade at above NOK 80. If we value the "remainco" and the JV stake separately on what we'd consider mid-cycle earnings, we come to about the same estimated value per share.

From Europe to Japan, what do you think the market is missing in spark-plug maker Niterra [Tokyo: 5334]?

KG: The company specializes in ceramics technology also used in products such as automobile sensors and semiconductors, but 50% of the business is selling spark plugs, where it is the global leader with just under 50% market share. The U.S. is its #1 market overall and 80% of revenues are generated outside of Japan, which has been a benefit in recent years due to the weaker yen.

The concern here, of course, is what the rise of electric vehicles will do to the business. Until last year the company's name was NGK Spark Plug, and a generalist fund manager might look at this and decide to pass immediately because the company's primary reason for being appears to be going away.

Such a first-level look misses a couple of things. One is that even in an optimistic EV-adoption scenario we assume the global aftermarket sale of spark plugs is going to grow at least until 2040. That's important because close to 90% of the company's spark-plug revenue comes from the aftermarket, not original-equipment sales. As the global car park slowly turns over to EVs, Niterra is adopting a perfectly rational last-man-standing strategy, which allows it to grow market share and benefit from increased scale and pricing power. Run-rate operating margins are now well over 20% and the business generates strong free cash flow. We expect those metrics to continue to remain healthy.

Regulators would take a close look, but Niterra is currently in discussions about taking over the spark-plug business of its largest domestic competitor, Denso. That would be an enormous win, and even if it doesn't happen, the company has already benefitted from Denso customers switching to Niterra in order to secure supply with a company committed to the market.

As for the rest of the business, 30% of total revenues come from the sale of sensors, mostly for vehicles but less tied to internal combustion engines, and another 15% are technical ceramics used in semiconductor and healthcare applications.

I would also mention that the company has been spending heavily in recent years on a variety of "new businesses" using ceramic technology. We are not counting on any of that hitting it big and would argue that they should narrow their ambitions to fewer technologies that are closer to the company's core competencies. That said,

INVESTMENT SNAPSHOT

Niterra
(Tokyo: 5334)

Business: Manufacture and sale of spark plugs, sensors and technical ceramic products used in the production of internal-combustion-engine vehicles and semiconductors.

Share Information
(@2/28/24, Exchange Rate: $1 = ¥149.95):

Price	**¥4,538**
52-Week Range	¥2,534 – ¥4,619
Dividend Yield	3.5%
Market Cap	¥916.69 billion

Financials (TTM):

Revenue	¥599.22 billion
Operating Profit Margin	19.7%
Net Profit Margin	12.6%

Valuation Metrics
(@2/28/24):

	5334	S&P 500
P/E (TTM)	12.3	23.0
Forward P/E (Est.)	10.8	21.2

Largest Institutional Owners
(@12/31/23 or latest filing):

Company	% Owned
Meiji Yasuda Life Ins	8.4%
Dai-Ichi Life Ins	8.3%
Nomura Asset Mgmt	3.8%
Vanguard Group	3.5%
Mitsubishi UFJ Trust & Banking	3.3%

Short Interest (as of 2/15/24):

Shares Short/Float	n/a

5334 PRICE HISTORY

THE BOTTOM LINE

While the company's core business will be challenged over time by the rise of electric vehicles, Kristian Gevert believes the market is overstating both the speed and magnitude of the impact on it as it pursues a "last man standing" strategy. Despite very strong share performance of late, the stock remains his firm's largest holding in its Japan-only fund.

Sources: S&P Capital IQ, company reports, other publicly available information

some of the development efforts underway are interesting and could certainly be optionality on the upside.

Have you been constructively active here?

KG: Our discussions have focused on two areas. One has been investor communications, part of which involved the name change but more broadly has been about helping investors understand the staying power of the business and its improving ability to generate free cash flow. The second part has been on capital allocation, including the magnitude of the new-business spending but also emphasizing the importance of returning capital to shareholders through share buybacks and dividends. Management has been receptive and has taken concrete actions on all of that.

How attractive do you consider the shares at today's ¥4,540 price?

KG: The shares have done extremely well, particularly over the past year, so are starting to bump up against our latest fair-value estimate. We're maintaining our position – it's still the largest holding in our Japan fund – because the valuation at less than 11x estimated forward earnings doesn't appear stretched to us and we believe that the coming fiscal-year-end earnings report is likely to result in our increasing our 12-18 month price target.

AR: This is another case where I'd highlight the attractiveness of this business to a private-equity buyer. Such a buyer could come in tomorrow and probably pay ¥6,000 per share, reduce the loss-making investments, sell off the third-party equity holdings on the balance sheet, and then earn a very attractive return as the company throws off a ton of cash flow. If one or more of the new projects hits gold, all the better. We think we win either way.

You explained earlier scaling into positions. Is the process similar in scaling out?

AR: Yes, it's the same basic process. We are unwilling to hold stocks, even if they're performing well, once they go through our sell range, which on average means 10-12x EV/EBIT, 8-9x EV/EBITDA and 13-15x P/E. Even in what seems to be a buoyant market, we're well below those levels today. Our top-ten holdings in our global fund on average trade at 6.5x EV/EBIT, 5.3x EV/EBITDA and 9x P/E.

To give an example, we've invested multiple times over the past 20 years in Rheinmetall [Frankfurt: RHM], the largest German defense contractor. We had a position in it at below 6x EBITDA and 10x earnings in late 2021, and then the war in Ukraine started and the German government and others across Europe decided to do a 180-degree turn on their defense spending. That benefitted the company, and the stock has increased from €90 or so to €420 in the last two and a half years. Here we have actively traded the position to right-size it and capture gains from time to time. But the operating performance has improved so much that despite the surge in the share price, the valuation isn't out of hand. It's currently out of our top-ten holdings, but we still own a small position.

ON ACTIVISM:

We've learned to tread increasingly lightly in situations where we conclude we have to call for replacing the CEO.

AR: Another fairly recent sale for us was Ralph Lauren [RL], which is an example of the type of high-quality consumer name that can interest us. It's rare that we venture outside of our industrial areas, but this is a business we know well and if you can buy it at 8x EBIT and a forward P/E of 10-11x – as we did shortly after the Ukraine war began in 2022 – it was a no-brainer back then below $100 per share.

Despite the macro concerns, the company was focused on further expanding the brand's reach into womenswear and accessories and also driving sustainable top-line growth through introducing higher-quality, higher-priced items that refreshed the product portfolio. They were consistently able to beat and raise margin and sales targets and we exited last August with a nice gain at around $130 per share, roughly 10x EBIT.

Are you kicking yourself with the stock now trading at $184 per share?

AR: Not at all. We have a valuation discipline with the objective to constantly field the most compelling risk/rewards in our chosen universe. We used the proceeds from RL to allocate to what we thought were better opportunities, and our funds have done as well or better than RL shares since we sold it, with lower valuations and better risk/rewards. If you adhere to a strict valuation-based sell discipline, you just can't worry about things running up after you sell them.

To the extent you think about the macroeconomic environment, how would you say your views there are influencing the outlooks for your portfolio companies?

AR: There are always a lot of things to worry about, with interest rates, with economic growth, with geopolitics. I would say we're generally positive on the outlook for the U.S. economy, with continued good employment and wage growth. That has informed our willingness to have somewhat higher exposure to more economically sensitive names.

At the same time, we expect interest rates to come down later this year as inflation abates. That should be a positive for economic growth and ultimately could give rise to a new boom in M&A. We probably need to get past the U.S. election and see some improvement in the global geopolitical hot spots before we see a significant uptick in deals, but an increase in M&A activity would be a positive development for fundamental bottom-up value investors. Companies with strong business franchises trading at historically low valuations have great appeal to both corporate as well as private-equity buyers. VII

	2024*	2023	Last 4 years* Annualized	Last 4 years* Cumulative
Cambrian Fund (U.S. Equity)	**+2.71%**	**+28.01%**	**+27.88%**	**+167.41%**
Cambrian Global ($-based)	**+3.59%**	**+31.94%**	**+20.64%**	**+111.82%**
Cambrian Europe (€-based)	**+4.59%**	**+31.94%**	**+17.76%**	**+92.31%**
Cambrian Japan (¥-based)	**+15.35%**	**+25.38%**	**+21.53%**	**+118.15%**

The above results are for Class E Series 1 for all funds, except Cambrian Fund which is Class A Series 1, as of March 12, 2024 (*YTD and 4-year). Results are net of all fees and expenses, including 1.0% management fee and 15% annual incentive allocation, and are based on audited results through 2023 and unaudited results thereafter. Performance results of Cambrian Europe represent the performance of the original Cambrian Europe from December 2006 to March 2016, then the long-only positions of Quest Europe from April 2016 through June 2023, and then the results of the new Cambrian Europe beginning July 1, 2023. Performance results of Cambrian Japan represent the performance of the original Cambrian Japan from April 2007 to August 2015, then the long-only positions of Quest Japan from September 2015 through June 2023, and then the results of the new Cambrian Japan beginning July 1, 2023. This information has been prepared solely for informational purposes and does not constitute an offer or solicitation. Any such offer will be made only by means of the Private Placement Memorandum for the relevant fund. Past performance may not be indicative of future results.

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