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Atlantic Investment Management

30 years of excellent returns

Alex Roepers, Founder and CIO, Atlantic Investment Management



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30 years of excellent returns with disciplined, focused value investing in public equities

By HAMLIN LOVELL

Since 1992, Atlantic's flagship Cambrian US equity strategy has made 4,271% net of fees, against 1,013% for the US equity market. Cambrian has annualised at 19% gross; the difference in net annualised returns is 16% versus 10% for the market. At half the market exposure, Atlantic's hedge fund strategy has kept up with the S&P 500, annualising at around 10% since 1993. The gap in holdings is far greater. The six or seven stocks in Cambrian US would be just over 1% of the five hundred

S&P 500 stocks, but Atlantic casts its net wider than the S&P 500. Its Cambrian Global fund typically has 18 positions, well under 1% of the world equity universe. Atlantic filters its global investment universe down to about 1,400 mid-cap value stocks in specific industrial sectors (500 in the US, 300 in Europe, 250 in Japan and 350 in Asia ex-Japan), but only owns around fifty of them at any time, across all of its global and regional vehicles. Atlantic belongs to a rare breed of highly concentrated equity managers, but is distinguished, in addition to its exceptional long-term performance, from its few peers by a resolute commitment to liquidity.

In early 2018, Atlantic's 30,000-foot view is that "despite the strong equity market run in 2017 and early 2018, overall equity market valuations have not reached the extremes seen during the internet bubble, but that a transition back to value stocks should occur," says Founder and Chief Investment Officer, Alex Roepers. Valuations have become bifurcated between market leadership coming from richly valued technology stocks (including Facebook, Amazon, Netflix, Alphabet/Google, Microsoft, Apple, Nvidia) in the US and Baidu, Alibaba, Tencent in Asia, while much neglected value exists in some other sectors. The auto sector has its own valuation dislocations, with stocks, namely Tesla, feeding off the electric vehicles narrative commanding very high valuations while some auto suppliers' share prices discount negative growth or even zero terminal value, according to Roepers. Broad indices of value stocks (such as the Russell 2000 Value) are full of traps for the unwary however, which is why the rigorous Atlantic process applies multiple stages of quantitative and qualitative filters and analysis to pinpoint its stock picks.

A global manager

Atlantic's small number of holdings is not due to geographic restrictions. Atlantic's main focus is the US, Canada, Western Europe, Japan, and Asia Pacific and select emerging markets in Asia. A global perspective, coming from around 500 company visits each year, helps to inform constructive dialogue with management around capital allocation, capital structure and messaging. For instance, Director of European and North American Equity Research, Kristian Gevert, can benchmark Japanese auto component makers' revenues and R&D spending, when returning to his native Germany and visiting eight or nine companies a day, in cities such as Cologne, Dusseldorf, Leverkusen, Paderborn and Lippstadt. CFA charterholder Gevert, who joined Atlantic in 2006, formerly spent seven years on the sell-side after an MBA at New York's Columbia Business School. Covering European industrials and capital goods at Credit Suisse, his research was twice top ranked by *Institutional Investor*.

Asia has been growing in importance, partly as its number of listed companies is actually swelling by thousands – while the tally is static in the US and Europe – but also because Asia now makes up 40% of global GDP. "Asian companies are key customers and competitors for the companies Atlantic invests in, so it is imperative for any investment firm to be there. Japan is huge as a mid-cap industrial, consumer services sandbox," says Roepers. Atlantic's Director of Asian Research, Kenichiro Yamada, and his team are finding overlooked value throughout Asia. Although Chinese benchmarks are skewed towards large cap growth, mid cap value is a neglected but ripe sector. Meanwhile, in markets such as Japan

Luxembourg UCITS launch

Atlantic's existing vehicles are domiciled in British Virgin Islands' vehicles that have been in place for over 20 years, and remain popular with many US client types. Atlantic is finding that some potential clients, outside the US, cannot allocate to these BVI offshore vehicles while some existing non-US clients have indicated a preference for switching into a so-called onshore vehicle. In 2018, Atlantic anticipates launching a Luxembourg-domiciled, UCITS-type structure offering access to the Cambrian Fund (US companies – long-only), Cambrian Global (global long-only) and a European long-only (ie the long book from Atlantic's highly successful Quest Europe long/short fund) strategies. Atlantic will be the investment manager partnering with the Value Investment Management Company, or VIMCO, who will be the management company of the Luxembourg vehicles. The custodian bank is VP Bank, which has branches in Zurich and Luxembourg. The minimum investment size is expected to be USD 250,000 or USD 1 million depending on share classes.

and Korea, Yamada finds many value opportunities with "improving corporate governance as an upside catalyst". At times, it is more difficult for Atlantic to locate value in India's relatively expensive market, though even there, the firm has identified several value stocks. "In addition to our extensive travel in the region, our New York offices are in fact a good location for Asia, because so many company roadshows pass through New York," points out CFA charterholder Yamada, who has an MBA from Berkeley and worked for Kayne Anderson Rudnick Investment Management and Industrial Bank of Japan, before joining Atlantic.

Filtering the funnel

Atlantic filters the global universe of 18,000 listed stocks in several stages, down to about 1,400 value, mid-cap stocks in specific sectors (500 in the US, 300 in Europe, 250 in Japan and 350 in Asia ex-Japan), but only owns around fifty of them at any time, across all of its global and regional strategies.

The first filter is size and liquidity. Atlantic doubts it can obtain an informational edge on the largest 600 stocks worth more than USD 20 billion. Atlantic is not prepared to take on the liquidity profile of 11,000 stocks with market capitalisations below USD 1 billion. Atlantic typically owns between 1% and 7% of invested companies and liquidity criteria are

to own a maximum of 30 days' trading, assuming 25% of average daily volumes. This is designed to align portfolio liquidity with fund liquidity, and to stay nimble in terms of trading around and exiting positions.

Of 6,000 mid-cap stocks, many do not match the second criterion: a private equity mind-set in seeking out predictable, reliable cash-flows. Atlantic avoids technology, as "even your own R&D department can destroy you. The risk of technological obsolescence is too great." Roepers has seen this over decades.

Atlantic eschews other sectors that can be a popular hunting ground for some value investors, such as pharmaceuticals, healthcare, utilities and tobacco, due mostly to political and product liability risks. A lack of transparency and potentially huge leverage means financials, including banks, brokers, and insurers are off limits for the long book but may become short candidates. These excluded sectors reduce the mid-cap universe to around 4,000 stocks.

A further 2,500 stocks are rejected based on their earnings patterns and valuations. Atlantic certainly does own stocks with varying degrees of earnings cyclicity but insists on 'all-weather' earning power throughout cycles to rule out intermittent loss-makers. Atlantic's valuation criteria further whittle down the shortlist. Roepers feels that many value investors have fallen prey to style drift and are starting to countenance higher valuations while Atlantic is steadfast in seeking free cash flow yields of 10%. "We look to buy at a multiple of 5-6 times EV/EBITDA, 7-8 times operating profit or EBIT, or a P/E ratio of around 10 or 11 times. This provides a great margin of safety if we are wrong about the company – as we get bailed out by free cash flow generation over time," Roepers explains. Atlantic is not often wrong; the manager's 'hit rate' has been about 80%, with unprofitable exits mainly taking place during market routs such as 2008.

These valuation metrics are designed to limit downside to about 10%. Forecast upside needs to be at least 50% over a 12 to 18-month timeframe, driven by both earnings growth and mean reversion to the company's own historical valuation and/or comparable peer group valuations. The base case is that Atlantic may exit at 8-9 times EBITDA, 12 times EBIT or a PE ratio of 13-15, which is still below the average market multiple today. "This is a time-tested and proven formula which works with high probability," underscores Roepers.

The companies emerging from this funnel are subject to many more layers of in-depth analysis. Gevert argues that "our analysts – spending 50% of their time following just two companies each – become as expert as private equity owners, know as much as



Left to right: Rossana Ivanova, Senior Equity Analyst; Kenichiro Yamada, Director of Asian Equity Research; Toni Bujas, Equity Analyst; Kristian Gevert, Director of European & North American Equity Research; Kenji Kobuse, Senior Equity Analyst; Michael Meek, Senior Equity Analyst; Peter Hanford, Senior Equity Analyst.

anyone other than insiders, and are certainly more knowledgeable than sell side analysts, who have historically focused their energies on large cap and mega cap stocks.” (In Europe, the MiFID 2 regulations, starting in 2018, are widely expected to further reduce sell side coverage of mid-cap stocks). “Our analysts talk to competitors, customers, suppliers and analysts, to get a deep, almost private equity-like perspective on public markets,” he explains.

Once candidates have been identified, Roepers sees three avenues for realising value. They are corporate action, activism and takeover. Atlantic wants to see potential for all three catalysts to work, so will generally avoid companies that cannot be taken over.

Corporate action

Atlantic seeks to quietly help management improve their own performance, via routes including operational improvements, financial engineering, working capital management, corporate governance, and investor relations. Atlantic is distinguished by Roepers’ early career in industry, manufacturing and corporate development, in hands-on roles that engendered operational advances, such as automation. Roepers’ first job was at Universal Investments, where he worked for two years before going to Harvard Business School for his MBA. “Universal was then automating circuit-boards and could not keep pace with explosive demand growth amid the 1980s PC boom,” he says. Roepers also worked at Dover Corporation, the conglomerate that Universal was part of, where he began his career in corporate development, ie the buying and selling of companies. After Harvard, he joined privately held Thyssen Bornemisza Group, which then had 80 subsidiaries spanning 40 industries, and within six months Roepers became Head of US Corporate Development, which made up half of the company. “I have been inside conglomerates, helping optimise portfolios, making divestitures, acquisitions, IPOs, restructurings and optimising the capital structure,” he points out.

Activism

If Atlantic’s recommendations are not enacted fast enough (or at all) – or are simply not working – activism is the next course of action. Roepers had first-hand experience of the 1980s activist investment heyday associated with leveraged buyouts, junk bonds, and hostile takeovers (which he recalls as far more aggressive than the current wave of activism). Roepers’ own style of activism is much less public and is more often friendly, but to describe Roepers as exclusively discreet and friendly, oversimplifies. Roepers’ first overtures seem to fit the stereotypically Dutch image of seeking consensus, coalition governments and ‘Polder politics’. But Roepers, a US citizen now for over 10 years, can be partisan when needed.

“We are intense and proactive. We always start off being pro-management but may sometimes, after all efforts with current management fail, go to the board to push our agenda, including a change in management.” But going for the jugular is never the first port of call because the mere threat of taking matters to the board can sometimes galvanise CEOs into action. Atlantic rarely goes public with its activism campaigns and will not take board seats, however, for the pragmatic reason that Roepers is allergic to anything that might render the portfolios illiquid. Many activists – and possibly most of them – become basically illiquid due to one or more of: the size of their stakes; holding board seats which result in restricted trading, making public utterances, or proxy contests. “Very few managers running concentrated, activist, books stay liquid enough to trade around positions,” argues Roepers. Atlantic has initiated about eighty activist campaigns in the past 25 years, most of which required some public disclosure, including 13D filings. For example, during 2017, Atlantic held 13D positions in Owens-Illinois and Diebold Nixdorf. Atlantic has not instigated its own proxy contests however (but might of course vote in proxy contests initiated by others). Sometimes, other activists get involved in Atlantic investment’s core positions, but they may have a different agenda. Atlantic recently was supportive of Swiss-based Clariant’s offer for US chemical maker Huntsman, while another activist was opposed to the deal.

Atlantic is called out for the success it has achieved with activism in Japan, where Roepers admits that the *modus operandi* is softer than in the US. “We have been investing in Japan since 2004, constructively engaging with managements behind the scenes and visiting scores of companies. One example is water purifier and chemical company Kurita Water [6370 JP], which is a strong cash flow generator with excessive net cash on its balance sheet. After we steadily engaged with management, the company carried out one of the largest share buybacks in Japan, in terms of percent of shares outstanding,” says Yamada, who grew up in Japan. Atlantic also successfully pushed car lamp maker Koito Manufacturing [7276 JP] to significantly increase its dividend.

Takeover

If neither corporate action nor activism work (and sometimes if either or both of them do) management may be replaced as firms may eventually get taken over, which is another reason why Atlantic focuses on mid-caps. “Mega-cap mergers, between companies worth USD 30-40 billion, usually take place at small premiums, as these are mostly stock-for-stock deals. Mid-cap takeovers of firms valued at between USD 2-10 billion can easily command premiums of 40-50% as

these are mostly competitive cash deals with private equity firms and/or strategic buyers competing,” Roepers observes. A recent portfolio target was Harman International Industries, which was bought by Samsung, with the acquisition completed in March 2017.

Though a takeover bid may often force Atlantic to take profits, meeting the initial 50% share price upside target does not force Atlantic to exit; some of Atlantic’s best investments have come close to being ten-baggers over many years. Japanese auto lamps maker, Koito, is one such example where Atlantic has had its investment go up eight-fold over the past six years. From the start, Koito was good value which benefitted from the weaker Yen policy but importantly it also tapped into a secular growth story of auto makers shifting from halogen to more energy-efficient LED lamps. Unlike some value investors, Atlantic is not a ‘buy and hold’ investor because Roepers stresses that “actively trading around positions is a key tool for creating additional alpha. You lose this important tool if you have given up your liquidity in a position due to overt activism.” Atlantic will often top slice positions on upwards spikes and add aggressively to them on downward lurches.

Short book and Tesla

Atlantic’s hedge fund strategy short book has not contributed much to absolute profits since inception 25 years ago, but it has certainly smoothed the ride, making solid attribution in down years for the markets and sometimes the shorts have made money in up years for equities. “Our short book has been profitable in 11 of the past 25 years while the S&P 500 has only had four down years,” says Roepers. Shorts are subject to strict risk controls. Position sizes will not exceed 2% at market at inception, and if shorts appreciate by 25% they are stopped out with a three-month cooling-off period pending potential re-entry of the position.

In late 2017, Atlantic has been short the leadership of the Nasdaq index via the QQQ ETF and also has numerous single name shorts. Atlantic has contributed an article to *Barron’s* entitled ‘Tesla: Reality Check’ setting out the Tesla short thesis. Roepers “does not believe that Tesla has the manufacturing capacity to meet its target of one million autos by 2020, and thinks it could take at least five or six years for them to obtain the wherewithal.” The timing of expanding capacity at the Fremont facility is uncertain and the Shanghai plant is not likely to be up and running until 2021 at the earliest. Falling short of the output target is also one reason to question the 25% gross margin target. Atlantic believes Tesla’s gross margins will stay below 20%, due to R&D and administrative costs, and loss-making retail and charging station units. Further, Atlantic has raised corporate



Pictured Kristian Gevert, Director of European and North American Equity Research

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— KRISTIAN GEVERT

governance questions and is critical of Tesla’s investor communications. Tesla is rather opaque in not providing a granular segmental breakdown amongst its products and units. Atlantic judges that cash burn rates and working capital requirements will force Tesla to raise more capital – and could lead to liquidity issues. The big picture is that over 100 branded battery electric vehicles are coming to market over the next few years and Atlantic views them as having better prospects. Yet Tesla’s enterprise value of more than USD 500,000 per 2017 vehicle produced is 50 times greater than VW or GM, according to Atlantic. But even if Tesla attains its output and gross margin targets, a relatively high valuation multiple of 20 times would imply a share price of USD 140 or more than 50% below current levels, according to Atlantic’s analysis.

Auto suppliers

The mirror image of Tesla’s overvaluation is undervaluation of firms perceived to be losers from EVs. Roepers outlined the investment case for three auto suppliers.

There are good reasons why German-based Schaeffler [SHA:GY] is misunderstood. It has only been public for two years, and is 75% owned by the founding family. Yet Schaeffler enjoys strong market power in niche areas of auto components: boasting high margins and market shares in automotive drivetrain, engine and chassis systems, (and in bearings for industrial applications). Roepers thinks that Schaeffler is ascribed a low valuation partly because it is perceived to be a pure play on the Internal Combustion Engine (ICE) which is supposed to

become obsolete, according to the current narrative surrounding the advent of electric vehicles (EVs). However, Schaeffler is a key supplier with higher content/vehicle than on ICE’s for hybrid vehicles, which Atlantic expect will soon become the largest category of autos. Atlantic is helping the company with messaging and expects the stock, which currently offers a dividend yield of 4%, should benefit from earnings growth, dividend growth and an overdue re-rating from a P/E of 7-8x to one of 11-12x. Atlantic’s price target of EUR 22 is 50% above current levels but only requires a multiple of ten times estimated 2018 EBIT.

UK-based GKN’s [GKN:LN] driveline division also has a 40+% market share in constant velocity joints and all-wheel drive systems used in both ICE cars and EVs. As most of the rest of GKN’s business is in aerospace, there has been speculation of a break-up or takeover by a private equity company or a strategic buyer, such as Berkshire Hathaway. Atlantic has publicly promoted the investment case for GKN, including at the September 2017 Legends4Legends hedge fund conference in Amsterdam and the November 2017 UBS Hedge Fund Conference in London, putting out an estimated sum of the parts valuation that could reach GBP 6 per share. “Even if we are only half way right, there is 50% upside,” said Roepers, who stated that at just six times EBITDA and a single digit P/E ratio, GKN’s downside was limited and that the share price weakness would prove transient. Further Roepers noted that GKN’s pension fund deficit of GBP 1.3 billion could benefit from higher interest rates. In GKN’s case, a 1% increase in interest rates would reduce the liability by GBP 700 million. Accounting

for the late 2017 share price weakness, and thus a buying opportunity for Atlantic and anyone heeding their call, was GKN’s botched management succession, with the board deciding a few months ago to remove the CEO-elect who was deemed to have his fingerprints on inventory accounting problems that are still being investigated. In early January, GKN received an unsolicited takeover bid from the well-respected and well-managed UK-based Melrose Industries Plc for 430p, causing GKN (under its new CEO Anne Stevens) to announce its rejection of Melrose’s offer as inadequate, the launch of a two-year operational improvement plan and its intention to split the business. GKN shares now trade at 447p, up almost 50% from when Roepers promoted the idea publicly and from Atlantic’s purchase costs. GKN was Atlantic’s largest position in its Global Fund and its European hedge fund, resulting in a stellar beginning to 2018 for those funds.

Japan’s NGK Spark Plug [5334:JP] is another quality automotive supplier enjoying leading global market shares in its key served end-markets, where share price potential may be under-appreciated due to it having two divisions with very different profiles. The spark plugs business is a predictable cash cow as 75% of spark plugs are replacement. One billion autos globally all need spark plugs, and the threat from electric vehicles is de minimis over the next decade. It is NGK’s sensors division, measuring engine and exhaust emissions, that is the real growth story – partly due to VW’s ‘dieselgate’ scandal. Atlantic thinks that NGK’s valuation of six times EBITDA and 10x P/E is too low, and the dividend yield of 2.5% is high by Japanese standards, providing downside



Pictured Kenichiro Yamada,
Director of Asian Research

support. “We expect NGK will be able to earn its current market capitalisation of USD 5 billion several times over the next 15 years,” says Roepers.

Away from autos, Atlantic has identified a telecoms-related infrastructure play as growth area with some interesting names with low valuations. CommScope [COMM:US] is geared to the explosion in high speed mobile data traffic, which is expected to multiply nine-fold out to 2022, to keep pace with wireless, smart phones, cars, rail networks, sports stadiums, and other end uses. CommScope builds the infrastructure, including equipment for FIRSTNET, a dedicated communication network for first responders, and the 5G networks being rolled out over the coming years. Yet CommScope trades at a forward P/E ratio of 12-13x and EV to EBITDA of just 8x. Atlantic expects the firm’s free cash flow will be used for deleveraging, share buybacks and acquisitions.

Outlook

Roepers thinks that “synchronised global economic and corporate earnings growth, low interest rates and the pro-business tax reform in the US, place equities on a solid footing overall.” Within that context however, he appraises markets to be close to

an inflexion point that will see value outperforming growth and thinks that February 2016 may have already marked the start of the rotation to value. “Dollar strength and the lower oil price extended the growth cycle, but now that those two macro factors have reversed, we see good conditions for value stocks. For instance, the world’s largest glass bottle maker, Owens-Illinois, which remains one of our top investments, has doubled since early 2016, yet remains highly compelling trading at a P/E of 8x on estimated 2018 EPS. Our US Cambrian Fund is up 54% since then, but we believe that this is just the start of a five to ten value cycle.” Roepers views growth investing as being closely linked to momentum as well as passive and index investing. He reckons that many investors following these approaches will become net sellers when the VIX spikes and when markets stagnate or correct. Roepers has watched the pendulum swing between growth and value in several multi-year cycles over his career, and he remains highly confident that Atlantic’s focused and disciplined value investment approach will continue to achieve superior investment returns over time and that another strong relative performance period may be right ahead amid his rotation to value thesis. **THFJ**

Atlantic’s Good Times, Bad Times 1988-2018

Atlantic has stayed true to its liquid style of value investing through multiple booms, bubbles, busts, major recessions, bear markets, cycles when growth or value investing were in vogue and a roller coaster ride for the firm’s own level of assets. The real genesis of Atlantic back in 1988 was Roepers’ value mentality, and dislike for illiquidity and for paying large control premiums during his corporate development days. To start Atlantic, Roepers secured backing from the CEO of Thyssen-Bornemisza, Dutch bank ABN Amro and Carlo de Benedetti who was dubbed “Europe’s Carl Icahn” and was then running Europe’s second largest PC firm, Olivetti. The late 1980s and early 1990s proved to be a baptism of fire, as the quadruple whammy of the Milken junk bond collapse, the Savings and Loans crisis, the early 1990s US recession and Iraq war, hammered many value stocks and drove investors into “expensive defensives”. Roepers resolved to repurpose the firm and in 1993 started a hedge fund strategy that could short stocks, alongside the revamped long only fund.

The next challenge was to come in the late 1990s, though it sowed the seeds for Atlantic’s most spectacular chapter of outperformance. The TMT bubble of the late 1990s saw the top technology stocks (captured by the NASDAQ 100) surge 85% in 1998, causing the Nasdaq to advance 39%, while the unweighted S&P barely was up 10% that year, partly because ‘old economy’ stocks were being sold down. The bifurcation intensified in 1999 as fears over Y2K lured more investors into technology stocks. (Roepers sees some parallels between internet mania then and social media now). The bubble climaxed in early 2000, when Atlantic’s strategy was down 15% in the first two months of the year while the Nasdaq had gained another 15%, but by the end of 2000, Atlantic was up 52% and the Nasdaq was down 39%. This set Atlantic onto a huge growth trajectory with solid up years in 2001 and 2002 while markets were down substantially, winning a large mandate from the Soros Quantum fund. The surge of inflows and performance also afforded the opportunity to demonstrate discipline with respect to capacity. Atlantic hard closed in 2003 in order to maintain its level of concentration, adhere to its mid-cap investment universe and liquidity criteria. In 2004, Atlantic launched its first international funds, focusing on Europe and Japan, expanding its team substantially including hiring Gevert and Yamada. Assets peaked at USD 5 billion, with around USD 2 billion in the US, USD 2 billion in Europe and USD 1 billion in Japan. “We were hard closed for five years and we would do it again if need be,” says Roepers.

Then, 2008 allowed Atlantic to prove its commitment to liquidity to its investors. So indiscriminate was the 2008 sell-off that there was virtually nowhere to hide for a long-biased investor. Investors needed liquidity – and they got it. “We had no locks or gates as we always have reasonable liquidity in all our portfolios and as we defer to our clients to make their asset allocation decisions,” explains Roepers (today, larger investors who feel comfortable with a two-year lock-up can obtain discounted fees). Though Atlantic recovered its 2008 drawdown by early 2011, a new challenge was that market leadership had reverted to growth and large cap stocks. Combined with the 2008 drawdown this made it harder to grow assets, which currently are around USD 1.3 billion. Having maintained its team and infrastructure for well over ten years, the firm currently has plenty of capacity, with all funds having been open since 2008, and is reaching out to a wider investor base with the launch of several new Luxembourg UCITS-type investment vehicles.