KICKING THE TIRES

How SilverCross stays close to the companies it owns

By David Simons

In our third SilverBullet issue, we focus on the extensive travel our investment team undertakes to meet management of the companies in the portfolio. Travel is an essential part of the investment process, as we sometimes jokingly compare Amsterdam to Omaha – both are far removed from the pinnacle of the global financial industry. Most management teams of listed companies engage in investor roadshows and choose cities where the opportunity exists to schedule a full day of meetings with large (potential) shareholders. Amsterdam is not one of those cities.

How does this impact our ability to do research on small companies listed around the world? Not much if, and only if, a significant travel budget is available to meet the management of the companies wherever they are located.

Several companies that SilverCross owns spend very little time on investor roadshows, nor do they present at investor conferences. We don't think that's necessarily a bad thing; We like it when our management teams focus on what they do best, which is spend their time on growing the business, in which they often have a large stake themselves.

In the first quarter of 2015, we have spent about 33% of our time on the road, visiting our investments in Germany, Switzerland, USA and Japan. Altogether, we met the management of 15 of our 26 investments, and over 50 US, 20 Japanese and 15 European companies altogether. We like to share some of our findings from these trips.

Conviction

As SilverCross only invests in about 25-35 companies, it is imperative we know these companies intimately. Desk research can offer detailed insight where disclosure is sufficient. Even as regulation has forced more transparency, some companies feel this should not equate to opening their books to the eyes of competitors. As a result, investor press releases may contain little more than bare facts.

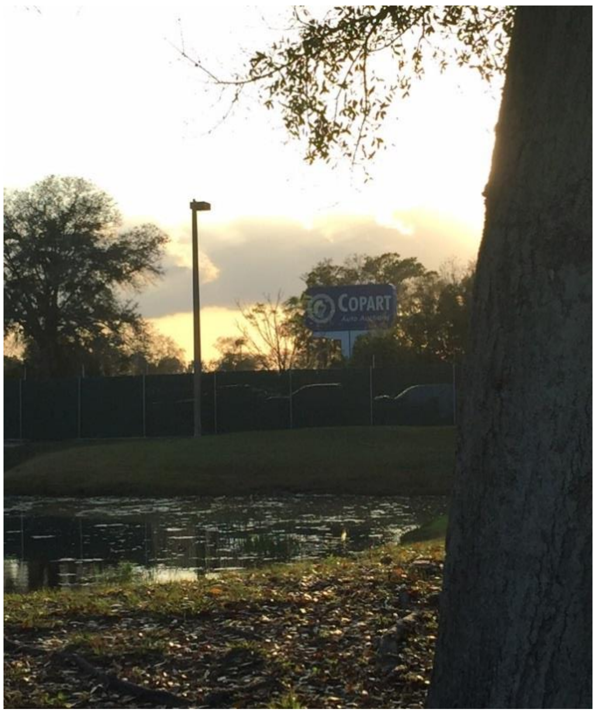
We read annual reports, investor presentations, news releases, industry reports and more to get insight into companies. What is difficult to read in these documents however, is a company's culture. A visit to a company's office can tell a lot in that respect. A culture of thrift or extravagance, a culture where employees are prized or seen as 'a pair of hands' – elements that are all taken into account when we make investment decisions. It helps us get the conviction required to make significant capital allocations and keep our investments for years.

Kicking the Tires

We have travelled to the United States of America twice this quarter. We saw companies in New York, Orlando, the Atlanta region, in and around Dallas, and San Marcos, TX. As an example of the work we do, we highlight Copart. This Dallas, TX based company is, together with KAR, dominant in salvage car auctions. The founder Willis Johnson started the company with the purchase of a single junk yard, and subsequently grew and bought other junk yards to become a market player with about 40% US market share. It makes money from auctioning off the salvage cars that insurers obtain after a car is deemed a total-loss. Both the buyer and the seller pay Copart for its auctioning and adjacent services. The company throws off tremendous amounts of free cash flow that it invests either in international acquisitions or share buy backs. The fact that the owner still holds 10% of the equity ensures disciplined capital allocation. At the same time, Copart doesn't need the stock market to raise new capital, leading to a diminished effort towards investor relations. So they haven't been presenting at any investor conferences organised by brokers. The company is followed by a number of regional and just one bulge-bracket investment bank. Some sell-side analysts have given up coverage as they found the company's communication too infrequent to serve as 'catalysts' for actionable broker research.

We invested in Copart after following the company's progress for several years. In our upcoming quarterly report we will discuss the investment case.

Recently, we undertook to make an unannounced visit to a large junk yard in Orlando, FL, where we had an opportunity to talk to the yard manager and literally 'kick the tires'.



Spending an hour with Copart's employees helped us to get a better understanding of the day-to-day operations of a junk yard, its types of clients, how it aligns its operations with the interests of its clients, how litigation sometimes causes an inability to auction off certain cars, RVs, motors, trailers, etc.

Subsequent to our junk yard visit, we travelled to Dallas, TX, where Copart is headquartered. They moved from California last year as it consolidated its overhead to a lower cost and fiscally more attractive location.

We met the relatively recently appointed Senior VP Finance and anticipated to be CFO. His background is with American Airlines and Yum! Brands (known for its Kentucky Fried Chicken chain) where he served in various finance and investor relations positions. We discussed their international expansion strategy, drivers for growth, the emergence of self-driving cars and the impact that may have on accident rates, as well as the potential uses of its excess cash on the balance sheet.

Our conviction in the quality of the business and our investment case was reinforced. The company benefits from secular growth drivers thanks to a growing car park in the USA and the average age of cars is increasing. A higher technology component in cars leads to higher repair costs, causing cars to be more easily declared a total-loss. Margins, temporarily depressed by a confluence of one-offs, are expected to return back to its historic highs. A likely repeat of a large share buyback will help to drive the share price higher over time.

Our research trips have led us to add a number of companies on to our watch list. We also increased the size of some of our existing investments, as it became apparent we have been too conservative in some cases.

As a general remark, we discussed with all our investments the impact of the US Dollar appreciation versus the Euro. The conclusion is that in most cases the impact is marginal, as operations outside the USA are limited. We will report in more detail about this in our quarterly report.

The Japan Factor

Investing in Japan is a different ballgame compared to Europe or America. Disclosure is less, while language and a more polite, closed culture are communication barriers. This has made us focus even more stringently on companies with leadership positions in defensible niches that benefit from secular growth drivers, serving as continuous tail wind. Our desk research led us to invest in Nabtesco, Eagle Industry and Miraca. In our quarterly investor letter over 4Q 2014, we highlighted the investment case for Nabtesco (see a copy at the back of this letter). We have talked to the management twice over the phone before we met them in Tokyo, partly with the help of translators. We discussed in more detail its ability to sustain its market leading position in precision reduction gears, the opportunity that 'robotisation' of the economy is bringing, its level and growth of recurring business streams, its Chinese ambitions that seem to be out of reach as long as that market remains economically challenged and its cash return policy. This last point is a new phenomenon in Japan. Companies are more open towards returning excess cash, which has helped drive stock prices higher.

We had the honour to attend a conference where Prime Minister Shinzo Abe highlighted his plans for kick starting the Japanese economy. Abe is pushing hard to make Japanese companies spend their excess cash on (international) acquisitions and capital investments, "*we want to change the mind set of business managers*", so that the inward looking mentality is changed – "*Japan's companies must switch from defence to offence*." Incentives are lower corporate tax rates, deregulation of agricultural sector and the electricity sector, and a big push to increase inbound tourism, underpinned by the Summer Olympics set to be held in Tokyo in 2020.

We are positive about the reforms being implemented in Japan. Japanese equities have been left for dead for more than 2 decades, although in the last 2 years they have come back to life. Still, the benchmark trades 55% below its all-time high achieved in 1990.

Overall, we continue to believe each of our investments in Japan meets our criteria. Strong stock price increases since our initial purchases have made valuations less attractive. We are encouraged by the initiatives the government is taking to move Japan's economy forward by becoming business friendly. We are currently working on a few new investment opportunities in Japan, which may or may not enter the portfolio, depending on our research conclusions.

Want to know more about our investment process?

Visit www.silvercross-im.com

About the author: David Simons is managing director and portfolio manager of SilverCross Investment Management. SilverCross is an Amsterdam, The Netherlands based asset manager, focused on managing high-conviction global small-cap equity portfolios.

About SilverBullet Insights: With this newsletter we aim to offer a mix of thought-provoking research and small-cap insight. A silver bullet refers to a straightforward solution perceived to have high effectiveness. This is what we aim for in our newsletter.

Investment case

Nabtesco

"Think Global, Act Local"

By: Chris Andrews
Director

Excerpt from the Quarterly Letter to Investors

Date: 6 January 2015

History

Nabtesco was founded in 2003 through an alliance of Teijin Seiki and NABCO and listed on the Tokyo stock exchange in 2004. They manufacture motion control technology based products to move and stop objects in a precise manner. Products include precision reduction gears for industrial robots (shown in Figure 3); door operating units and brake systems for railroad vehicles; flight control actuation systems for aircrafts and traveling motors for construction machines.

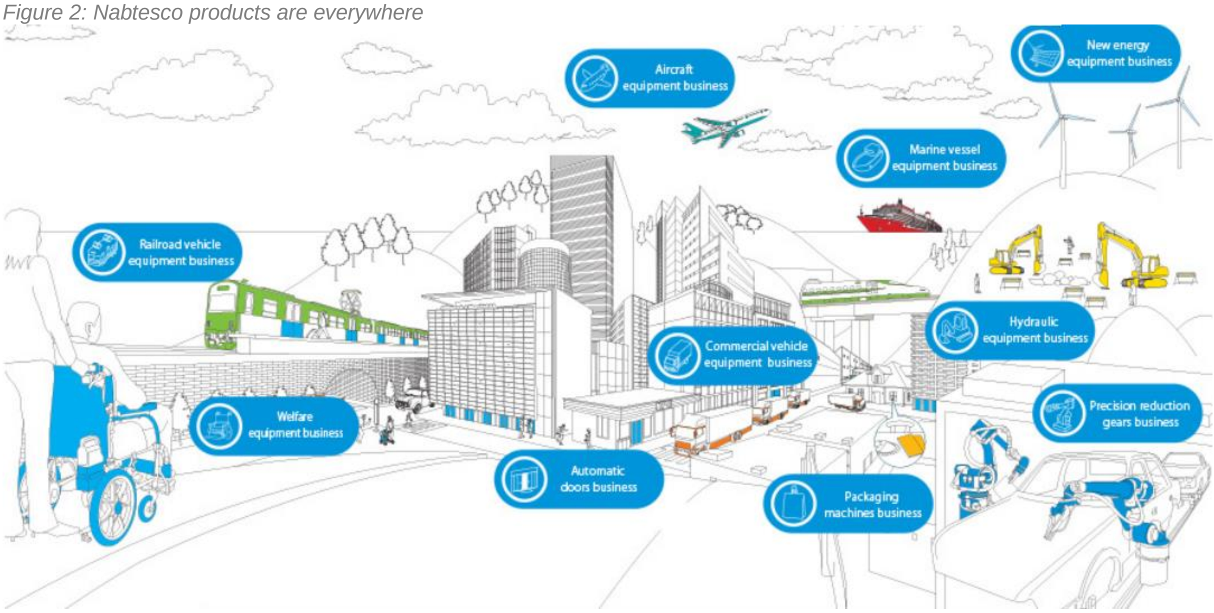
Nabtesco's motion control technologies feature in a huge range of applications as demonstrated in Figure 2. Their products focus on safety, comfort, security and social infrastructure. They target niche applications in which they can dominate the market and have proven successful as they have market shares of between 40-85% depending on the business.

Price is not the key determinant for its customers in choosing whose product to use. This allows Nabtesco to defend and grow their 'moat', as Warren Buffett likes to say, generating high return on invested capital and strong cash flows as a result.

Clients and Geographic Presence

Nabtesco boasts an A-rated client list such as Boeing and the Japanese & Chinese railway and subway operators. They also supply world leaders in robotics such as Fanuc, ABB and Kuka. Nabtesco is well regarded by its clients and received a 2013 Boeing Supplier of the Year Award. Currently 53% of revenues are generated in Japan, 17% in Europe, 16% in China, 8% in North America and 6% in other Asian countries.

Figure 2: Nabtesco products are everywhere



High Barriers to Entry

Barriers to entry are very high, as Nabtesco works closely with clients from an early development stage. Their products must work with extreme precision. Clients need a very reliable partner, because product failure is not an option, as it could cause trains to crash, airplanes to fall out of the sky, or plants to shut down. This implies a high barrier to switching supplier.

Sustainability

At SilverCross we aim to invest in companies that provide solutions to challenges caused by a growing global population and that act responsibly to help reduce potential risk of reputational damage. Nabtesco is a fine example of such a company. Its products help to prevent global warming through the development of motion control technology that is world leading in terms of energy efficiency. Enforcement of emission standards across a variety of sectors often drives demand for Nabtesco's products so their focus on sustainability has long term benefits for both society and Nabtesco's business. They have been placed in the top 10% of Japanese companies in both 2012 and 2013 for the disclosure of their anti-climate change strategies and greenhouse gas emissions. In April 2014 they signed the United Nations Global Compact which demonstrates their commitment to manage risks and opportunities from an environmental, social and governance perspective.

Growth Opportunity

There are a variety of growth drivers for Nabtesco's revenues. Rising labour costs, increasing demand for automation and an increased focus on energy efficiency will inevitably increase demand for their products particularly in emerging markets. A key driver for Nabtesco's long term revenue growth will be the precision equipment division which will benefit from growth in the robotics market. Robot adoption remains very low in emerging markets and is below 200 per 10,000 employees versus 1500 in Japan. Robot adoption in the developed world grew at a compound annual growth rate of 15% in the 1980's and this level of growth can now be expected for emerging markets going forward. There are two further key drivers for revenue growth at Nabtesco. Firstly a pick-up in the US construction market will help drive demand for Nabtesco's highly efficient and durable traveling motor, the main product sold in the Hydraulic Equipment business. Secondly expansion of the Chinese subway will increase demand for their safety technologies for rail transportation including space saving brake units and door operating systems. Nabtesco's door operating systems are already used on various bullet train carriages across Japan.

Nabtesco targets revenue growth of almost 40% between 2013 and 2017 and 100% between 2013 and 2020. Japan represented over 50% of group revenues in 2013 but growth is forecast to be muted in this region and expected to represent only 30% by 2020. Revenues in Asia & Emerging countries, on the other hand, are forecast to grow to ¥160bn from ¥41bn in 2013 and Europe & America to ¥120bn from ¥46bn.

Valuation

The stock has performed well and is up 23% from the initial point of purchase. Our estimate of fair value implies a further 30% upside even though our estimates are below management forecasts. We look forward to meeting management on our planned trip to Japan in February.

Figure 3: Typical Robot in which Nabtesco precision reduction gears are installed. These gears help provide movement in 60% of all industrial robots

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