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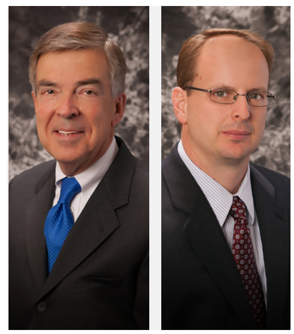
Value Investor INSIGHT

The Leading Authority on Value Investing

Thinking Small

When he started Fenimore Asset Management in 1974, Thomas Putnam focused on overlooked small companies he thought were mispriced. Success and expanding assets under management naturally pushed the market cap of his holdings up, but he saw an opportunity to fully recapture that early focus in 2008, starting a private small-cap partnership which prospered and begat the FAM Small Cap mutual fund in early 2012. That fund has continued to excel, earning since then a net annualized 13.9%, vs. 12.6% for the Russell 2000.

Concentrating their bets, Putnam and co-PM Andrew Boord see upside today in such areas as fast food, business-process outsourcing and insurance. See page 2



FAM Small Cap Fund
Tom Putnam, Andrew Boord

Fair Trade

After 10 years working in New York, much of that at First Eagle Investment Management, Jiro Yasu returned home to Tokyo in 2005 to take over his family's brokerage business. Pivoting from that long-held plan, however, he decided the family should sell the brokerage and that he would instead start a value-investing firm, co-founding VARECS Partners in 2006.

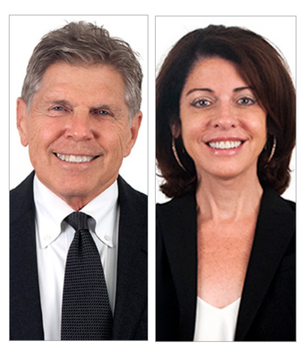
Targeting small companies with good or improving capital-allocation skills, VARECS' VPL-I Trust since Yasu became its sole portfolio manager at year-end 2009 has earned a net annualized 14.0%, vs. 9.6% for the TOPIX index. He's finding opportunity today in such areas as medical devices, medical software and real estate. See page 8

Jiro Yasu
VARECS Partners

Final Frontier

From his first China trip for Batterymarch Financial in the mid-1980s, Lawrence Speidell had a front-row seat as "native capitalists" in emerging markets helped create opportunity for adventurous investors. When looking to start his own firm in 2006 he cast an even wider geographic net, toward pre-emerging "frontier" markets: "I expected to see the same process occur again," he says.

While frontier markets haven't yet boomed, Speidell's Frontier Market Select Fund has earned a net annualized 9.0%, vs. 0.3% for the Russell Frontier Markets (ex-Gulf Cooperation Council) Index. Among hidden gems he sees today: a Jordanian tobacco producer, a Kenyan investment holding company and a Bangladeshi bank. See page 14



Frontier Market AM
Larry Speidell, Andrea Clark

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Other companies in this issue:

Investor Insight: Fenimore

Thomas Putnam, Andrew Boord and Kevin Gioia of Fenimore Asset Management describe why they prefer the familiar to the new, what out-of-favor sector has become of particular interest, the first thing they do when a position goes sharply against them, and why they see unrecognized value in Sonic Corp., ExlService Holdings and Hallmark Financial.

Your small-cap strategy mirrors your approach overall, which we'd put at the "quality-business" end of the value-investing spectrum. Do you make any adjustments when targeting smaller companies?

Thomas Putnam: We look at any business through four primary filters. Is it understandable, with sustainable competitive advantages and a favorable long-term outlook? Is it financially durable, with strong free cash flow generation, high returns and low leverage? Does management have a proven history of high ethical standards, honesty, astute capital allocation and creating shareholder value? And finally, can we buy at a significant discount to a reasonable estimate of intrinsic value?

The strategy and process are the same, but the smaller the company the better chance it's overlooked and we can understand and analyze the business in a way that can give us an edge. It's not unusual for us to visit a place like DeRidder, Louisiana and the management of a company like Amerisafe [AMSF], which provides workers' compensation insurance, tells us a live analyst had never shown up at the headquarters. We think that gives us the opportunity to get to know management and the company much better than we could otherwise. That's true with a lot of the companies we own.

Andrew Boord: We like to say most of our holdings are either under a rock or under a cloud. If you turn over more rocks than everyone else you can find some pretty interesting small- and micro-cap companies.

Under a cloud is interesting too. There are 2,000 small caps in the U.S. and we probably ignore 1,800 of them because they're not high enough quality. Often we've followed a company for years and years and then finally something goes wrong. Industries have down cycles. Companies miss a beat with a product. A new strategy makes things worse before they get better. These types of things don't make something a bad business, just a real business. If the criteria Tom mentioned are met, we're getting excited when something goes wrong.

How about an example or two of the type of company that attracts your interest?

AB: I've followed Choice Hotels [CHH] for about 15 years and as a company it has everything we're looking for. It has excellent brands, even if maybe they don't target the typical investment-manager demographic. It's a franchise model that produces tremendous cash flow and requires almost no reinvestment. Every year the number of rooms in the system grows, and the revenue per available room tends to at least increase with inflation over time. Royalty rates can be stepped up as old deals expire.

ON GOING THE EXTRA MILE:

It's not unusual for us to visit a company and they tell us a live analyst has never shown up at the headquarters.

And management actually gets capital allocation, which is rare. If your goal in life is to grow intrinsic value per share, shrinking your share count can be an excellent way to do so if you buy right. While increasing buybacks when the stock is cheap and cutting back or not buying when it's dear, Choice over time has taken shares outstanding from 120 million 20 years ago to around 56 million today.

In the swoon at the beginning of last year the stock fell sharply because the market was assuming a weakened economic environment would mean bad news for hotels. While Choice's results are moderately cyclical, it's a very profitable business that generates considerable free cash flow even in tougher environments. The market in this case gave us an opportunity we were more than happy to take advantage of. [*Note*: As low as $42 in January of last year, Choice shares recently closed at $62.70.]

Also early last year we established a position in Lindsay Corp. [LNN], the #2 maker of agricultural irrigation equipment in the world. It ticked all of our boxes: a history of technological advances to keep ahead of the competition, a growing global manufacturing and distribution footprint, high profitability, strong free-cash generation even during down cycles, proven, experienced management and little debt. Cycles tend to be longer here and many investors were tired of waiting for better days, but with corn prices depressed we were able to buy Lindsay shares at only 10x peak earnings from the previous cycle.

I wasn't at Fenimore then, but I bought Lindsay for the first time in 1998 in an almost identical scenario, which ended up working out very well. We're rather Pavlovian when it comes to certain situations we've seen before.

Some small-cap value managers say they're finding bargains scarce today, at least in the U.S. How would you assess the opportunity set?

AB: We're habitual complainers, so for a long time – outside of February 2016 – we've talked about how hard it is to find anything to do. That said, we own 27 stocks, so we really only need to find a few names a year. Since the election we're finally beginning to see some industries split off and go their own way, which is keeping us busy.

For example?

AB: We've invested in fast-food companies for a long time, and in the past year or so the whole industry has struggled. Whenever that's happening there are always theories as to why, but the primary one seems to be food-price deflation at grocery stores. That's widened the differential between what it costs to eat at home and what it costs to eat out, which seems to be pulling just enough demand out of the fast-food business to hinder performance and push down share prices. We don't know when this ends, but we consider it just part of the cycle and are pretty confident it will end. In cases like this, something like Sonic Corp. [SONC], whose headquarters we first visited in 2002 and which is a cash-flow machine run by smart capital allocators, can become very interesting.

Kevin Gioia: We are also not averse to investing in turnarounds and there are usually a number of those to look at despite the overall level of the market. One holding today that I'd put in that category would be AngioDynamics [ANGO], a company not far from us located in Latham, New York, just north of Albany. It's a medical-device company primarily focused on vascular-access products, but was mismanaged for a number of years as management tried to grow the business through acquisitions that didn't necessary fit or produce the growth expected.

New management was brought in led by a CEO, James Clemmer, who had a successful run in charge of the medical-supply division of Covidien, where he was successful in distinguishing between businesses that deserved fresh capital and those that didn't. He has outlined a strategy for AngioDynamics that rationalizes the product portfolio, harvesting some for cash and investing in others where the company has demonstrable strength and can generate the highest returns. It's not a turnaround in the sense that the balance sheet needs repair or there are accounting problems to resolve, but it's a good business generating cash that is working on becoming a great business.

How would describe your general approach to valuation?

AB: We come at valuation from two general directions. We will do discounted cash flow models, and while we know they're wrong and we don't feel overly addicted to them, they give us some comfort about what direction is north so we find them helpful. We're also big fans of trying to establish what cash buyers have paid for similar businesses in open-market transactions and the levels at which comparable public peers trade.

ON REDEPLOYING CAPITAL:

It's easy to get excited about something new, but you're often better off looking first to what you already own.

We believe that most of the value creation doesn't come from buying $1 for 50 cents, but from that $1 becoming $2 in five years, $4 in 10 years and $8 in 15 years if you get it right. We're willing to pay a modest discount on a great business and let the business generate much of the returns. Deep value investors might see that as heresy, but we're quality-biased and want to compound capital in a name as long as possible. We like to believe we can earn at least 10-12% annualized on each holding over a number of years.

TP: One thing I'd add is that it's easy to get excited about something new, but in my experience you're better off looking first at what you already own for putting additional capital to work. We run a concentrated portfolio for a small-cap fund, and a key way we manage risk is through the economic ability of the firms we own and know well to weather cycles and take advantage of long-term prospects. You just don't know as much about the new idea. I say all the time that if we're going to invest in a new name, make sure it's going to make the train faster, not just longer.

How do you respond when a position is going against you – say like transportation-services provider Echo Global Logistics [ECHO] recently?

AB: The first thing we do is to take the plane, train or car and go see them. We need to determine whether this maybe isn't the business we thought it was or if whatever is happening is just one of those things that sometimes happens to good businesses. That's not to say it's always obvious or we figure it out quickly, but it's helpful that we've already gotten to know the management team and can better understand what they're saying and how they're responding.

With Echo, 80% of the business is transportation brokerage, some of which is fairly stable and recurring, but some of which is done on the spot market, which can be highly volatile with respect to both volume and pricing. As a result, while the company has done a great job of growing the intrinsic value of the business, the results are uneven and investors in the stock tend to go from ecstatic to depressed every few months. As long as we believe the business over time can continue to increase its cash flow and then allocate it well – which we do with Echo – we'll trim when things are going great and add when they're not, which has been the recent case.

Describe in more detail your investment case for Sonic.

AB: We love the business model. Nearly 95% of the company's stores are franchised, which results in significant operating leverage and high free-cash-flow generation because so little capital needs to be reinvested in the business. Another unique attribute is Sonic's tremendous beverage franchise, including shakes and other high-margin frozen drinks that customers treat almost like an extra meal.

After six consecutive years of growth, same-store sales have declined in the last three quarters. It's important that this doesn't appear to be an issue specific to Sonic, as overall industry demand has softened over the past year. We've spoken with the management teams at other firms like Jack in the Box [JACK] and Bojangles' [BOJA] and have read conference-call transcripts for nearly every competitor, and they've all made similar statements about demand and the impact of food-price deflation making eating at home more economical. The fast-food industry has responded by discounting, causing market-share shifts – roughly one-third of fast-food customers simply chase the best deals – and lower margins. As I alluded to earlier, this type of industry dynamic has occurred in the past and has proven to create investing opportunity.

Sonic didn't fare particularly well in the Great Recession. Is the balance sheet at all a concern today?

AB: In a case of very poor timing, the company in 2007 funded a large share repurchase with debt, so it entered the recession with a fairly weak balance sheet. We waited years for the company to de-lever sufficiently before seriously considering it again as an investment. We're comfortable that management has learned from that experience and we believe we're much better protected if the cycle turns sharply negative.

Sonic shares, recently near $27, are off 22% over the past year. What upside do you see from here?

AB: There have been several fairly recent transactions in the 16-18x EV/EBITDA range, including buyouts of Panera Bread, Popeyes Louisiana Kitchen and Krispy Kreme. We'd like to be proven wrong, but we consider those valuations too high for Sonic. It currently trades at 10x forward EBITDA, but I'm comfortable assuming 13x as a private-market valuation, which implies a $32 share price.

Earnings growth should provide upside on top of that. Management believes they can grow earnings at a 14-20% annual rate over the next few years, through 2-3% unit store growth, 3-5% same-store sales growth, 2-3% royalty-rate increases as older franchisee deals are renewed, 3-4% from operating leverage and leveraging best practices and 4-5% from share repurchases. While we don't dismiss that as impossible, our top-line assumptions are more conservative and we're modeling earnings growth in the low double digits. If we're right on that and there's then an opportunity for multiple expansion as well, the shares today will end up looking very attractive.

What's creating the opportunity you see in ExlService Holdings [EXLS]?

AB: This is a business-process outsourcing company with strong franchises in end markets such as insurance, healthcare, transportation and utilities. Say an insurance company has 50 back-office employees in the basement on-boarding new annuity customers. ExlService will come in, use its expertise to automate and streamline the process while getting the actual work done in India, and provide the service for far less than the customer was originally paying.

Because the company typically takes over an entire process, customer relationships tend to be long-term and sticky. Once one process is successfully implemented it often leads to additional business with a customer, providing a natural

INVESTMENT SNAPSHOT

Sonic Corp.
(Nasdaq: SONC)

Business: Largest chain of drive-in quick-service restaurants in the United States with 3,500 locations, 90% of which are owned and operated by local franchisees.

Share Information (@4/28/17):

Price	**26.88**
52-Week Range	21.12 – 35.39
Dividend Yield	2.3%
Market Cap	$1.14 billion

Financials (TTM):

Revenue	$557.1 million
Operating Profit Margin	21.8%
Net Profit Margin	11.6%

Valuation Metrics
(@4/28/17):

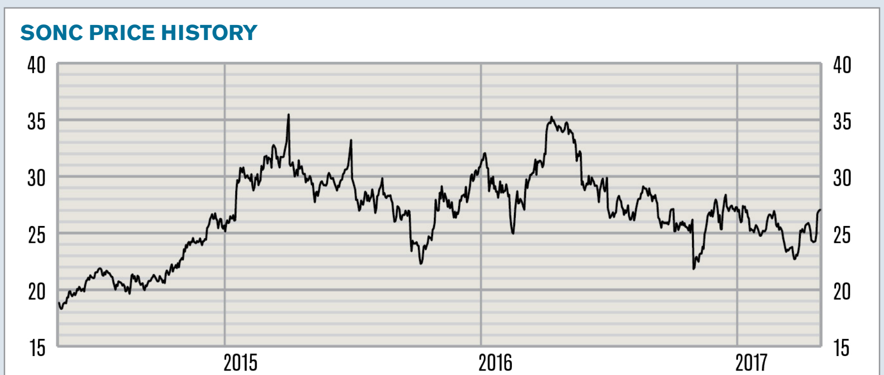
	SONC	S&P 500
P/E (TTM)	19.5	24.2
Forward P/E (Est.)	19.2	18.4

Largest Institutional Owners
(@12/31/16):

Company	% Owned
BlackRock	10.8%
Southeastern Asset Mgmt	10.6%
T. Rowe Price	9.8%
Vanguard Group	8.0%
Dimensional Fund Adv	4.2%

Short Interest (as of 4/13/17):

Shares Short/Float	18.3%



THE BOTTOM LINE

Fast-food-industry woes caused by grocery-store price deflation should not be permanent, says Andrew Boord, who sees the resulting weakness in the company's shares as an opportunity. He pegs the stock's fair value at $32, with upside beyond from low-double-digit annual earnings growth he thinks the company can deliver in the next few years.

Sources: Company reports, other publicly available information

growth pipeline at little or no acquisition cost. In addition to outsourcing, which accounts for about 75% of total revenues, ExlService has also developed an analytics business that harvests massive amounts of customer data that it can upsell to clients as well.

The company stumbled in the third quarter of 2016 when two of its units – consulting and property survey – ran into some performance issues. In each case we're confident the problems can and will be addressed. The property-survey business, for example, which provides data to insurers on higher-end residential real estate properties for underwriting purposes, historically has some earnings variability as underwriters due to their own loss experiences become at the margin more or less apt to buy Exl's survey data. That's a cyclical phenomenon that we don't expect to be a long-term problem. Anyway, these two businesses under stress account for maybe 10-12% of total revenues, so their impact ultimately shouldn't be that important.

Is the new administration's rhetoric around outsourcing and immigration a potential problem?

AB: This is also likely weighing on the stock. About 80% of ExlService's revenues are from U.S.-based companies, so it could certainly be impacted if the Trump administration makes it more difficult for companies to offshore services. But so far the administration's focus appears more on manufacturing, and the company says its customers haven't indicated at all that they're planning to pull things back in house. On the immigration side, the risk from possible H1-B visa reductions is modest because the company's use of that program is limited.

I'd mention that one offset on the regulatory front would be if it became easier for U.S. companies to repatriate cash. Companies like ExlService have considerable cash piled up in India.

How cheap do you consider the shares at a recent $47.70?

AB: Adjusting for $4.50 per share of net cash on the balance sheet and about $1 per share for an outstanding options liability, the stock currently trades at only 15x cash earnings. We think earnings can grow at least at a 10% annual rate, driven primarily by a continuing shift toward business-process outsourcing and increased demand to harness "Big Data" for goals like improving customer service and predicting customer behaviors. If earnings grow as we expect, we'll likely get some multiple expansion as well. It's not unreasonable that we could see the shares compound at close to a mid-teens annual rate.

Hallmark Financial Services [HALL] certainly qualifies as under the radar. Describe the upside you see in it.

AB: Fenimore has owned Markel and White Mountains, so we believe we understand specialty insurance. We like that specialty niches are less competitive and offer the opportunity to build strong franchises that generate float. The bell rang for us with Hallmark because it is an off-the-radar company targeting these types of specialty-insurance nooks and crannies. It has franchises insuring odd-lot truck fleets,

INVESTMENT SNAPSHOT

ExlService Holdings
(Nasdaq: EXLS)

Business: Global provider of outsourced business-process and analytics services meant to help customers in a wide range of industry sectors streamline their operations.

Share Information (@4/28/17):

Price	**47.71**
52-Week Range	42.00 – 54.78
Dividend Yield	0.0%
Market Cap	$1.61 billion

Financials (TTM):

Revenue	$686.0 million
Operating Profit Margin	9.4%
Net Profit Margin	9.0%

Valuation Metrics
(@4/28/17):

	EXLS	S&P 500
P/E (TTM)	26.6	24.2
Forward P/E (Est.)	16.8	18.4

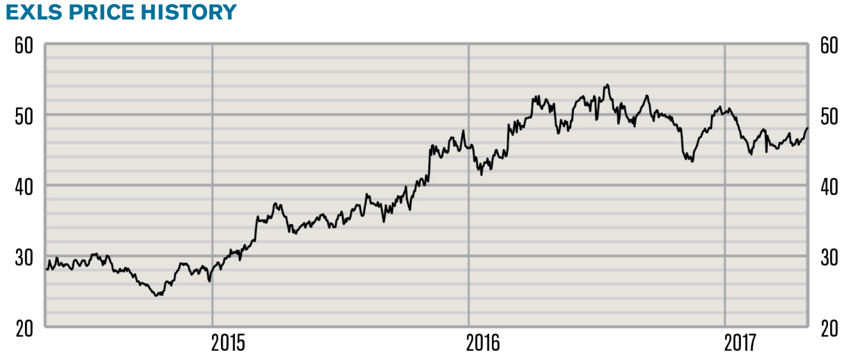
Largest Institutional Owners
(@12/31/16):

Company	% Owned
Fidelity Mgmt & Research	10.6%
BlackRock	10.1%
Vanguard Group	8.2%
Wellington Mgmt	6.1%
Invesco	4.0%

Short Interest (as of 4/13/17):

Shares Short/Float	2.5%

EXLS PRICE HISTORY



THE BOTTOM LINE

Despite non-core-unit stumbles and negative political rhetoric, the company remains well positioned to benefit from positive secular trends in business-process outsourcing and data analytics, says Andrew Boord. If earnings grow at the 10% rate he expects, with multiple expansion, he believes the share price could grow at a mid-teens annual rate.

Sources: Company reports, other publicly available information

INVESTMENT SNAPSHOT

Hallmark Financial Services
(Nasdaq: HALL)

Business: Diversified provider of property/casualty insurance products to businesses and individuals, primarily focused on insuring low-severity and short-tailed risks.

Share Information (@4/28/17):

Price	**10.51**
52-Week Range	9.50 – 12.09
Dividend Yield	0.0%
Market Cap	$195.7 million

Financials (TTM):

Revenue	$375.9 million
Operating Profit Margin	3.5%
Net Profit Margin	1.7%

Valuation Metrics
(@4/28/17):

	HALL	S&P 500
P/E (TTM)	30.9	24.2
Forward P/E (Est.)	9.1	18.4

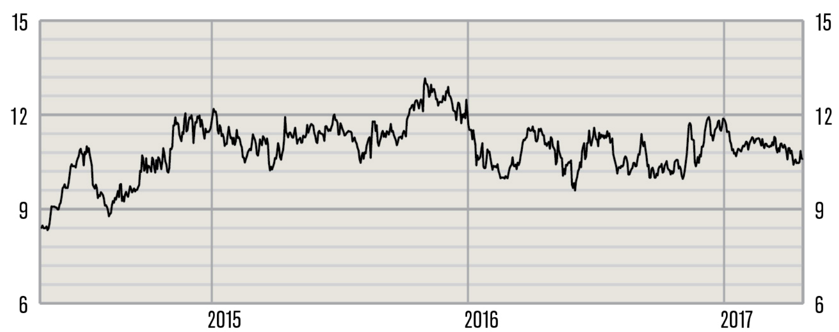
Largest Institutional Owners
(@12/31/16):

Company	% Owned
Cove Street Capital	11.2%
Dimensional Fund Adv	8.3%
Staley Capital	4.8%
BlackRock	4.2%
Bank of Montreal	3.8%

Short Interest (as of 4/13/17):

Shares Short/Float	0.3%

HALL PRICE HISTORY



THE BOTTOM LINE

By targeting insurance "nooks and crannies" that can be less competitive, Andrew Boord believes the company through portfolio gains and underwriting profits can increase its book value at around 11% annually. If it also earns what he considers a private-market 1.3x to 1.5x book-value multiple, the shares can compound at a mid-teens annualized rate.

Sources: Company reports, other publicly available information

doctors with blemished records, small airports, and older general-aviation aircraft. These are not business lines where Hallmark faces heavy competition.

After years of successfully executing its strategy, the company got somewhat derailed in recent years by flubs in its non-standard auto-insurance business, including its expansion into Florida, where fraud rates proved to be high and costly. The board responded by bringing in a new CEO, Naveen Anand, who has reined in the non-standard-auto line and has generally heightened the focus on underwriting quality across the company.

Often the best time to invest in insurers is right after they've had underwriting issues – if they're responding in the right way. Every time we see Anand we push on the issue of underwriting risk and he responds by stressing the importance of prudence when it comes to premium growth. We like that they seem to be erring on the side of caution.

Is the company's bond-heavy investment portfolio at risk from rising interest rates?

AB: Higher interest rates would certainly hinder near-term book-value growth, but the duration of the overall portfolio is just three years so the bonds will cycle through to higher rates relatively quickly, ultimately benefitting earnings.

Mark Schwarz has been Executive Chairman of Hallmark since 2000 and through an investment vehicle owns just over 25% of the company. He manages the float and has been more pessimistic than most about interest rates, holding 12% of the portfolio in cash, which has been a drag on earnings. We think he behaves as a prudent value investor and believe that having someone with real capital at risk in his position provides an added layer of protection.

How attractively are the shares priced at today's $10.50?

AB: Assuming after-tax rates of appreciation for stocks and bonds of 6% and 1.5%, respectively, combined with a modest 2% underwriting profit margin, Hallmark's book value could grow 11% annually. In addition, the current tangible-book-value multiple of just under 1x is well below our private-market estimate of 1.3x to 1.5x. Again, combining the earnings growth and some multiple expansion could translate into a mid-teens annualized return in the shares.

In your Q4 2016 letter, you described selling your stake in specialty-materials maker Ferro Corp. [FOE] because the company "just was not up to our standards." What did you mean?

AB: It's a pretty exclusive club when your portfolio only has 27 stocks, and the longer we owned Ferro, while we concluded it is a fine company run by decent people that will likely do well over time, we also thought the business was cyclical enough and the debt level high enough that if we woke up in a recession, this is a stock that would more than likely be down a lot. And if that happened it wouldn't be the same obvious and exciting opportunity we'd likely think a Choice Hotels or a Sonic or a Penske Automotive [PAG] would be. Given that, when Ferro's shares moved up after the election we took advantage and sold.

Describe a recent mistake.

AB: Several things went wrong at once last year in First NBC Bank [FNBC]. A large loan to an offshore oil producer went bad when a key pipeline broke. There was a large factored receivable from an ethanol plant whose parent company in Spain went bankrupt. The accounting on loans to tax-credit businesses in New Orleans was questioned by auditors. There's some bad luck there, but our mistake was in not recognizing fully the extent of the exposure to these risks. Better to have lots of modest-sized credits than a smaller number of big ones. You can imagine our checklist for bank investing has been updated.

How quick were you to get out?

AB: We sold half of our shares in August and the rest in November when it appeared that regulators were going to make it particularly hard for the bank to rebuild capital. The investment was clearly unsuccessful, but it could have been worse. [*Note*: At $37 at the beginning of 2016, FNBC shares ended 2016 at around $7. They recently traded at $2.65.]

ON CHANGE:

The speed at which one can access information hasn't improved our ability to really think the way we should.

Tom, you've been at this a long time. What do you consider the biggest changes in the business since you started out?

TP: The process and strategy we follow today are very similar to what I was doing originally. But when I started out in 1974 there were maybe 200 mutual funds. The competitive environment has changed a great deal and it is now quite a bit harder than it was in the past to find things that are still under a rock.

I taught computer science for a while prior to starting Fenimore. We worked with punchcards and with computers that were the size of a large room but had less computing power than my iPhone. So the quantity of information and the speed at which one can access it have also dramatically increased. While that's helped in some ways, it hasn't improved our ability to really think the way we should. All the noise only adds to the confusion and complexity of investing, which has probably been harmful to a lot of people who don't take full advantage of the powerful compound effects of a long-term strategy. There's still an advantage to thinking about businesses rationally and trying to cut out the noise. That's what we try to do every day. VII

Investor Insight: Jiro Yasu

Jiro Yasu of Tokyo-based VARECS Partners describes why capital allocation at Japanese companies is often abysmal, the extent to which that's changing, key lessons learned from First Eagle Investment's Jean-Marie Eveillard, why he has the perfect name for a value investor, and what he thinks the market is missing in Medikit, EM Systems and CRE Inc.

Value investors in Japan are a fairly rare breed. How did you find it or it find you?

Jiro Yasu: Stock investing has always been around me. My family ran a brokerage business originally founded by my great-grandfather, and in high school my father told me I would be his successor and asked me to study economics and get some relevant experience outside of our company to prepare for when he was ready for me to take over. After graduating from college in 1996 I moved to New York and worked for two years at Daiwa Securities before getting a job at Arnhold and S. Bleichroeder, which during my time there became First Eagle Investment Management. I worked first in marketing and then on selecting managers for a multi-manager portfolio at the firm, but over time I got to know both Jean-Marie Eveillard and Charles de Vaulx, who recommended things for me to read about value investing and who from time to time would let me help out when they were looking at Japanese companies.

After my father asked me to move back to Japan in 2005, fairly soon I concluded that we should sell the brokerage business and that I was more interested in starting my own firm to pursue value investing, which as you say, is not that typical in Japan. We did get out of the brokerage business and I and two partners started VARECS Partners in 2006 with money from my family, from the Arnhold family of First Eagle, and from one institutional investor.

The Chinese character for my last name has the joint meaning of cheapness and safety – perfect for value investing.

Describe your original strategy and how it has, or hasn't, evolved.

JY: What we look for hasn't changed. We try to find small, overlooked companies – usually less than $500 million in market cap – earning 10%-plus operating margins through strong market positions in businesses that are relatively stable and that have some industry tailwinds. We're not expecting super-fast growth, but we want there to be a high probability that the business will expand over the next five years and that through operating leverage profits will grow even faster.

ON KARMA:

The Chinese character for my name has the joint meaning of cheapness and safety – perfect for value investing.

We want some kind of downside protection in the form of tangible assets like cash or valuable real estate – something to protect us if we're wrong about the value of the operating business. Finally, we are very price sensitive. Some value investors will say today that anything less than 10x earnings before interest and taxes on an enterprise-value basis is cheap. For us cheap means 2-3x EV/EBIT – maybe 6x for the very best businesses.

What we try to avoid also hasn't changed: businesses with low barriers to entry, frequent technology disruptions, short product cycles, little pricing power and long payback periods. High leverage is a red flag – good businesses should have strong balance sheets – as is aggressive behavior related to accounting, deal making or balance-sheet growth.

Initially we may have put more emphasis on being hands-on with the management of companies we own. We very often have opinions on the best ways to realize shareholder value and we are not at all shy about communicating them, but we're also more than happy to generate returns by doing nothing on that front. Now any activist-type suggestions we make tend to be just an added bonus rather than central to our thesis.

Please give an example or two of the type of business you favor.

JY: One of our largest holdings is a company called EM Systems [4820:JP], which sells software used by pharmacies in Japan to manage their businesses. It's the #1 player, with about 30% of the market. It has shifted more to a subscription model, with highly recurring revenues. Customer switching costs are high, and incremental growth is driven by an aging population and the potential to buy smaller competitors as the industry consolidates. This type of business profile is attractive to us.

Another example would be Asante Inc. [6073:JP], which offers termite-control services. This isn't exactly a sexy business, but the climate in Japan is conducive to these types of bugs and you have to treat your house on a recurring basis to keep them away. The company also has potential tailwinds from higher market-penetration rates, expansion in western Japan from its traditional base in the east, and from government regulations to make houses usable for a longer period of time. As it continues to grow, that should reinforce its market leadership.

How do you surface ideas?

JY: We don't do much screening. I take some of that from Jean-Marie and Charles at First Eagle, who thought that valuation screening based on published numbers – which they were always skeptical of and looking to adjust – wasn't that helpful.

One thing we do is monitor carefully M&A transactions done around the world and then try to see if there's something related in Japan that is worth a look. As Disney was buying up Marvel and Pixar and Lucasfilm, we started looking at Japanese animation companies. When Berkshire Hathaway bought Iscar, we starting learning about the cutting-tools business.

More recently we've read a lot about how the music business after years of decline is finally turning around as paid services like Spotify and Apple Music gain traction. Connecting some dots, we earlier this year invested in Amuse [4301:JP], a talent-management company for Japanese artists, musicians and actors that also organizes large-scale live entertainment events. After less-than-positive earnings news, the shares had fallen 30% over the previous year and when we bought in the enterprise value after taking out cash was around $100 million. In a good year the company can make $40-50 million, so on that basis we thought it was very cheap.

One other thing I'd mention about our process is that we're known as a firm that will take almost any Investor Relations meeting we're offered. For some companies that are too small or too boring, brokers sometimes have a hard time lining up institutional investors to meet with management. We'll take the meeting. There's always something to learn and maybe we'll get an investment out of it.

You wrote a paper not long ago in which you discussed some root causes of the often-abysmal capital-allocation practices at Japanese companies. Can you share the CliffNotes version here?

JY: The most common reason for the undervaluation of Japanese companies is poor capital allocation. What I wrote about was the concept of longevity and how it is generally revered in Japan. The current Japanese emperor is the 125th, representing a continuing succession for over 2,700 years. Ise Jingu, the most important Shinto shrine in Japan, has been rebuilding its facilities every 20 years for over 1,300 years. I found a statistic that there were 5,586 companies in the world that have over 200 years of operating history, and 56% of them were in Japan.

When we talk with CEOs of cash-rich Japanese companies and ask them why they hold so much cash, the reason is almost always to make sure their company survives no matter what might happen in the world. We looked at one mail-order company in Kobe, Felissimo [3396:JP], that had a market capitalization of about $90 million and net cash of $130 million. It was ironic that even though the enterprise value was negative, the EV/EBIT multiple was positive because the company regularly lost money. Management argued that keeping all the cash was essential to the company's future, but it was obvious to us that it was just a crutch that allowed them to postpone needed cost-cutting.

Another interesting example is Japan Digital Laboratory, which we looked at before it was acquired late last year. It had a tax-accounting software business that earned over 25% operating margins, but the return on equity for the entire company was maybe 5%. That's because it held over $500 million in net cash and for some reason operated a commercial airline with low-single-digit operating margins.

These may be extreme examples, but we see similar problems with many Japanese companies: too much cash, large cross shareholdings and poorly performing non-core businesses, all of which dampen returns on equity and stock valuations. As much as you want to believe that poor capital allocation can't go on forever, you can't succeed in investing in Japan without partnering with management teams that understand the difference between prudent management of capital and destroying value.

What to you constitutes a bargain?

JY: I am of the Jean-Marie Eveillard school, focused on EV-to-EBIT. One of my early partners was a buyout guy who tended to focus more on EV-to-EBITDA, and while I originally didn't think there would be a big difference, we found out in 2008 that the stocks that looked cheap on EV-to-EBITDA went down a lot, while those that were cheap on EV-to-EBIT held up much better.

I try to estimate the normalized annual EBIT level a company can sustain and then apply to that the multiple a rational buyer would pay for the whole company. For the target multiple we look at similar businesses overseas as well as prices paid in past deals, but we don't just blindly apply multiples from elsewhere to Japanese small caps. Termite-control companies like Asante are highly valued in the U.S., for example, at 16-18x EBIT. But for our fair values we generally assume 6x, up to maybe 10x for the very best businesses.

From there, we keep it very simple. If we believe EBIT will normalize at $100 million and the multiple should be 8x, we think the business is worth $800 million. If the company has $200 million in net cash, we arrive at an intrinsic value for the company of $1 billion. We then want to be able to buy the stock at least at a 30% discount from that intrinsic value.

How concentrated is your portfolio?

JY: We typically have 20 to 30 holdings. If we have very high conviction, we will have positions that are as much as 10% of the portfolio, which is roughly the case today with EM Systems, Medikit [7749:JP], CRE Inc. [3458:JP] and Agro-Kanesho [4955:JP]. Part of our conviction in companies like this is that we have good relationships with the management teams and believe their interests are completely aligned with ours. Beyond the biggest positions, we have a number of positions of around 2% of the portfolio. These could be core positions one day or were core positions before, or for some other reason we are just more comfortable holding a smaller position.

Let's talk in more detail about some of your large positions. What do you like about medical-device maker Medikit?

JY: The company has over 50% market share in Japan for two core products: catheters for kidney-dialysis treatment and intravenous catheters with a special valve that prevents the reverse flow of blood upon insertion. Currently 90% of revenue comes from Japan, with one-third of that from dialysis catheters. That's a great recurring business, as there are 300,000 kidney-disease patients in Japan who need on average four dialysis treatments a week, for which they use two catheters each time. The number of such patients should continue to increase as the population ages and changes in diet have increased the incidence of diabetes in Japan.

We first invested in the company in 2008 when despite it having 20% operating margins and a strong dialysis franchise, its stock traded at a negative enterprise value – net cash exceeded the market cap. It was then just launching its new IV catheter, which we considered a real innovation, and it steadily took market share to now be the dominant product on the market, generating roughly one-third of total company revenue.

Is there anything new on the horizon, product-wise?

JY: Medikit last year outbid several other Japanese healthcare companies to sign an exclusive distribution agreement with an American company, Cardio Vascular Systems [CSII], to sell a product called Diamondback 360 in Japan. It's used in a pre-treatment procedure on severely calcified arteries to increase the effectiveness of stent or balloon catheters. Based on estimates of the number of patients in Japan suffering from calcified coronary and peripheral arteries, we think this product could ultimately generate several billion

INVESTMENT SNAPSHOT

Medikit
(Tokyo: 7749:JP)

Business: Japan-based manufacturer of disposable medical devices primarily used for vascular access, including hemodialysis, intravenous and guiding catheters.

Share Information
(@4/28/17, Exchange Rate: $1 = ¥111.495):

Price	**¥4,640**
52-Week Range	¥3,500 - ¥4,720
Dividend Yield	1.5%
Market Cap	¥43.80 billion

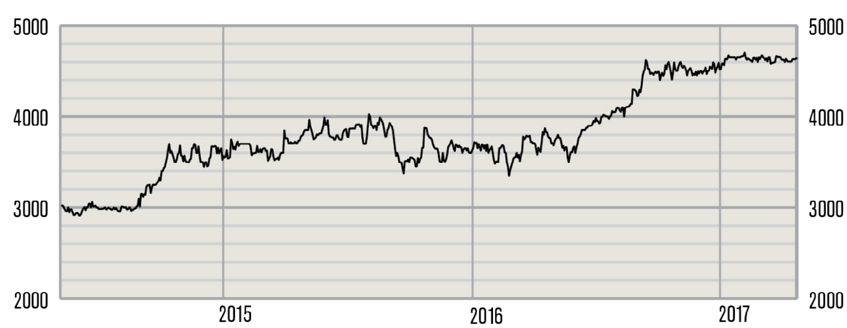
Financials (TTM):

Revenue	¥16.58 billion
Operating Profit Margin	21.7%
Net Profit Margin	13.3%

Valuation Metrics
(@4/28/17):

	7749:JP	S&P 500
P/E (TTM)	17.8	24.2
Forward P/E (Est.)	n/a	18.4

MEDIKIT PRICE HISTORY



THE BOTTOM LINE

Jiro Yasu doesn't believe the market adequately recognizes the strength and stability of the company's core businesses, the prospects of a new one, and the value-creating potential in its large cash hoard. Applying a 10x EV/EBIT multiple to his 2018 estimates, plus net cash and investments, he arrives at a fair value for the stock of around ¥6,500.

Sources: Company reports, other publicly available information

yen in revenue for Medikit, not insignificant for a company with current annual revenue of ¥16.6 billion. Commercialization of the product is scheduled to start next year.

Are you satisfied with the capital allocation here?

JY: We were happy to see the reinvestment in the business with the CSII deal, and the company over the past two years has been increasing dividends and has bought back 10% of the shares outstanding at only 2x EBIT. But cash on the balance sheet still represents roughly half of the current market cap and we think there's plenty of room for more capital return. The company celebrates its 45th anniversary next year, so we've suggested they take the opportunity then to announce a long-term business plan that includes a clearer strategy on the use of cash.

How are you valuing the shares at today's price of around ¥4,650?

JY: Acquisition multiples in medical devices tend to be fairly high, even in Japan, with acquirers typically paying 15-20x EV/EBIT. To be conservative, we apply a 10x multiple to our roughly ¥4 billion 2018 EBIT estimate and add ¥22 billion in net cash and investments to arrive at a fair-value estimate of ¥6,500 per share. Given the cash level and the stability and profitability of the business, we think we're also very well protected on the downside.

Describe the potential you still see in EM Systems.

JY: We first invested in EM Systems eight years ago after the company changed its business model from selling its software for a large upfront payment to a more attractive one with lower upfront fees but also monthly maintenance fees and a fee per processed prescription. It's an excellent recurring business – there are 700 million prescriptions processed in Japan every year, about six per person, and this number is increasing as the population ages.

The main competitors, Panasonic Healthcare and a small division of Mitsubishi, have 10-20% of the market and both appear more focused on other areas than the dispensing pharmacies in which EM is so strong. The remaining competitors are much smaller and struggle to keep up with rising regulatory costs. That allowed EM to buy three smaller and barely profitable competitors in the past few years for cheap prices. We expect it to continue growing its market share for the foreseeable future.

The company also has a number of promising growth initiatives underway. It recently began selling software systems for small medical clinics and for nursing care. It's in a partnership with Medipal [7459:JP], one of the largest drug distributors in Japan, which has integrated EM's software into a new service called PRESUS (for Pharmacy Real-time Support System), which helps client pharmacies streamline their order, inventory and delivery functions. We also think the company has the potential to better monetize all the pharmacy prescription data it collects, which could be very valuable both to drug companies and healthcare regulators.

Your take on management?

JY: Kozo Kunimitsu, now the Chairman, founded the company and was CEO when it changed the business model to more recurring revenues. This initially caused a large decline in reported sales and led to three years of losses before things started

INVESTMENT SNAPSHOT

EM Systems
(Tokyo: 4820:JP)

Business: Develops, sells, supplies and maintains medical-prescription filing and administrative computer systems used by dispensing pharmacies in Japan.

Share Information
(@4/28/17, Exchange Rate: $1 = ¥111.495):

Price	**¥1,822**
52-Week Range	¥1,130 - ¥1,893
Dividend Yield	1.7%
Market Cap	¥32.90 billion

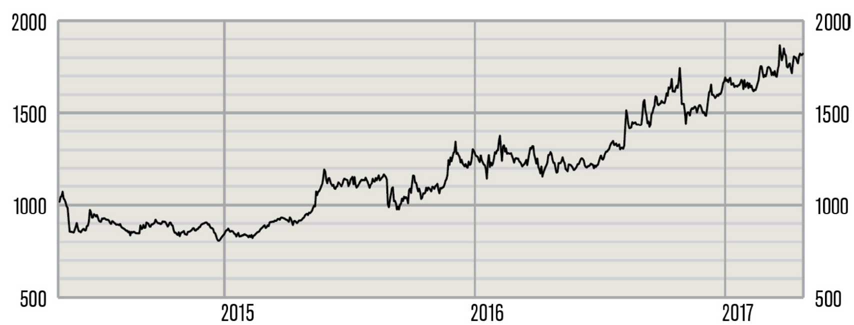
Financials (TTM):

Revenue	¥13.54 billion
Operating Profit Margin	12.1%
Net Profit Margin	13.7%

Valuation Metrics
(@4/28/17):

	4820:JP	S&P 500
P/E (TTM)	17.2	24.2
Forward P/E (Est.)	15.6	18.4

EM SYSTEMS PRICE HISTORY



THE BOTTOM LINE

The company is leveraging its strong position in software systems for Japanese pharmacies to pursue growth initiatives that Jiro Yasu believes have significant and unrecognized potential. At 10x his 2018 EBIT estimate on an enterprise-value basis, plus net cash and the value of a large owned office building, he pegs intrinsic share value at nearly ¥2,500.

Sources: Company reports, other publicly available information

to improve. We like management that can take short-term pain for long-term gain. We have a good relationship with company leadership and they will often call us when they want investors' input.

The stock is up 50% in the past year. What upside do you still see from today's ¥1,820 price?

JY: Based on prices at which relevant deals have been done and the fact that this is a high-quality operating business with good growth prospects and margins, we think it should be valued at 10x our 2018 EBIT estimate of ¥2.5 billion. On top of that the company has roughly ¥4 billion in net cash and also owns a large office building in front of Shin-Osaka station, which at a 5.5% cap rate we value at around ¥14 billion, after the potential tax burden. Altogether, our intrinsic-value estimate for the shares is close to ¥2,500.

It really doesn't make sense for a software company to own such a large building – they occupy two of the floors and lease out the other 13 – which accounts for 75% of the company's fixed assets. We have suggested they consider either selling the building outright or putting some debt on it, using the proceeds to buy back shares at less than intrinsic value. We'll see what happens.

From software to real-estate development, what attracted you to CRE Inc.?

JY: We invested in CRE in 2015 when its stock declined after its initial public offering and we are now the third-largest shareholder. The company primarily develops and manages distribution warehouses located around metropolitan Tokyo. It usually develops three to four warehouses per year and sells them off to REIT's or other investors while maintaining the contract to manage them.

They are true experts in this area of the market, which we consider quite attractive. Many existing warehouses around Tokyo are old and small and there's great need for more cutting-edge, large warehouses that can save customers money and better handle ever increasing volumes driven by the growth in e-commerce.

Revenues for the development business can be lumpy depending on the number of warehouses developed and sold each year, so we don't ascribe a high valuation multiple to it. On the other hand, we like the property-management side of the business because it is based on long-term contracts and is quite stable.

Describe your relationship with CRE's management.

JY: We know the controlling family well and in August of last year signed an agreement with them to assist in creating a long-term business vision for the company and a new capital-allocation plan. Our main input has been to focus on expanding recurring revenue streams from master leasing, property management and REIT management. We also suggested the company implement a capital-allocation policy that calls for at least 50% of the cash flows generated by recurring-revenue business lines be paid out as dividends, and for cash flows from the development business to be used opportunistically for buybacks, dividends, M&A and new developments. They have adopted most of our recommendations.

As an example of developing new recurring-revenue streams, the controlling family launched a REIT, with assets of about $400 million, which buys warehouses developed by CRE. The company manages this REIT so it earns management fees for

INVESTMENT SNAPSHOT

CRE Inc.
(Tokyo: 3458:JP)

Business: Development, management, leasing and brokerage of commercial real estate, with a primary focus on logistics/distribution facilities located in metropolitan Tokyo.

Share Information
(@4/28/17, Exchange Rate: $1 = ¥111.495):

Price	**¥1,558**
52-Week Range	¥1,103 - ¥1,850
Dividend Yield	1.3%
Market Cap	¥19.61 billion

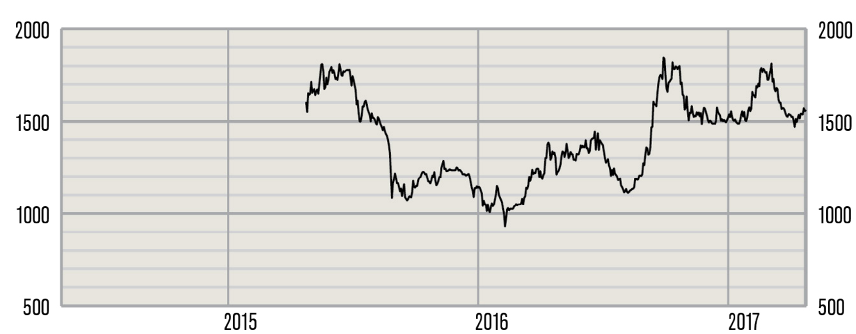
Financials (TTM):

Revenue	¥34.12 billion
Operating Profit Margin	12.1%
Net Profit Margin	7.1%

Valuation Metrics
(@4/28/17):

	3458:JP	S&P 500
P/E (TTM)	7.5	24.2
Forward P/E (Est.)	6.7	18.4

CRE PRICE HISTORY



THE BOTTOM LINE

The company is a "true expert" in an area of commercial real estate – distribution warehouses – in which Jiro Yasu sees considerable upside in metropolitan Tokyo. He expects shareholders to benefit as it capitalizes on that expertise by offering new, related products and services that generate added recurring revenue. His share price target: ¥2,600.

Sources: Company reports, other publicly available information

that as well as fees for leasing and managing the warehouses. CRE has also developed a master-lease business in which it earns fees for acting as an intermediary between owners of warehouses and the occupants.

How cheap do you consider CRE's stock at today's ¥1,560 per share?

JY: At the current share price the market cap is over ¥19 billion and the enterprise value is over ¥24 billion. On our 2018 estimates, we value the development business at 5x EBIT and the recurring-revenue businesses at 8x EBIT. Add to that net cash on the balance sheet and we arrive at a price target of around ¥2,600 per share, almost 70% above today's price.

Turning to Japan as a whole, there's much debate about the financial reforms pursued by Prime Minister Abe since he came into power at the end of 2012. Are you a fan, a critic, or both?

JY: With respect to corporate governance, I do think there has been a significant improvement in the last three or four years in Japan. The government is mired in debt, so the administration set its sights on trying to get some of the $2 trillion of cash sitting on Japanese corporate balance sheets moving around the economy to foster growth. If more cash was returned to shareholders, ROEs would improve, equity multiples would expand, and that would have a further positive wealth effect on the economy.

ON ABENOMICS:

I assume life is tough and will remain tough, and just look for companies that can still make good money.

To put pressure on companies to do something with their cash stockpiles, the government has implemented a series of policies such as new corporate-governance codes that push for more outside directors, Government Pension Investment Fund reforms, and the launch of the JPX-Nikkei 400 index, which consists of 400 large-cap companies that are selected primarily based on having high returns on equity. The government pension fund now uses that index as a benchmark and it has become sort of a new elite club which Japanese companies – which often play follow the leader – want to join.

Five years ago when we'd talk with CEOs about return on equity or buybacks or capital allocation, many didn't try to understand. Today at least they understand these are important issues. You see more companies announcing they will return more than 100% of annual cash flow to investors, and share buybacks overall have significantly increased. It's all coming off a low base, but we believe the trend is positive and will continue to improve.

All that said, in picking stocks I try not to have a very strong opinion on the macroeconomy. I'm not counting on strong improvement in the general economy or in how stocks are valued. I assume life is tough and will remain tough. In that environment I'm looking for companies that can still make good money. VII

Investor Insight: Lawrence Speidell

Frontier Market Asset Management's Larry Speidell and Andrea Clark describe why their target markets are a "paradise" for stock pickers, why their research priorities may differ from other investors, some unusual site visits they've made, and why they see opportunity in companies such as Jordan's Al-Eqbal, Bangladesh's BRAC Bank and Kenya's Centum.

You've built a successful business investing where many fear to tread. Describe your going-in rationale.

Lawrence Speidell: Opportunities for investors generally occur when there is an arbitrage opportunity between perception and reality. If you consider the conventional wisdom about frontier markets, it's generally that they are dreary and uninteresting. But if you go to these countries you find wonderful people, dynamic economies and exciting companies with good management. These markets are a relative paradise for stock pickers because there aren't financial analysts everywhere. You can actually practice active management and expect to earn rewards for doing so.

Start off by defining your opportunity set.

LS: Over the past 10 to 15 years a number of indexes have been created for frontier markets, initially by the World Bank's International Finance Corporation and then by Standard & Poor's, MSCI and Russell. They basically include most of the countries that have stock markets that aren't otherwise in either developed-market or emerging-market indexes. Of those we'll invest in around 30 different markets.

We focus primarily on businesses offering quality products and services that benefit from rising consumer incomes. Globalization really took off with the fall of the Iron Curtain and the Bamboo Curtain and people – 1.2 billion of them in frontier markets – are increasingly aware of what we in the U.S. and elsewhere take for granted, and they want it. We've seen companies in emerging markets flourish in catering to those consumer demands, and we're looking for businesses that can do the same in frontier markets.

What sectors provide the most fertile ground for ideas?

LS: Our primary focus is on consumer staples, consumer durables and financial services. Providing a representative example of each, we own a glass-container company in Nigeria called Beta Glass, an assembler and distributor of cars in Pakistan, Pak Suzuki, and a retail bank in Georgia, TBC Bank.

Our interest in consumer staples and durables is directly tied to rising incomes and standards of living. With respect to banks, most frontier markets have been systematically underbanked. In these countries banks historically just took deposits, paid nothing for them, and offered practically no services to consumers. Driven in large part by smartphone technology, the situation is changing rapidly as more services are now accessible to more people. That's creating a dynamism that we think makes the banking sector – which makes up about 40% of the universe of stocks traded in the frontier – an extremely attractive area for selective analysis and investment.

ON THE OPPORTUNITY:

We focus primarily on businesses offering products and services that benefit from rising consumer incomes.

Why did something like TBC Bank meet your standards?

Andrea Clark: We visited Georgia in mid-2014 soon after TBC had gone public and we wanted to meet with management. The bank has a strong presence in retail and small-business banking, areas we find especially interesting. The stock is listed in London, so it's fairly liquid, and we found the financial reporting to a high standard. At the country level, we saw the underbanking Larry talked about on the consumer side, and a relatively stable political environment. Finally, the stock traded at an attractive valuation – we first bought in at around 7x earnings. As we've gotten to know the company, we appreciate how well it has navigated a difficult economic environment, including a currency devaluation, without a material increase in nonperforming loans. They also have made a couple of well-timed acquisitions that look to have been integrated quite well.

LS: In all of our work, the non-financial data are equally or more important than the financial data. If we don't believe the business and management are of sufficient quality, we're not going to invest no matter how cheap the stock. That's why we think there's no substitute for direct contact with management, field research and hands-on confirmation of the key elements of our thesis. There's really no standard form of analysis in these markets.

We see a selection of locally traded subsidiaries of global multinationals – like Pak Suzuki or British American Tobacco Bangladesh – in your portfolio. Does that tend to help on the qualitative assessment?

LS: Governance is one of the prime areas we must gain comfort with, and while there's no guarantee, we can generally presume good oversight when the parent is a global multinational.

AC: There's also a level of business expertise and brand and marketing support in these companies that can be very beneficial. I had dinner not long ago in Nigeria with a senior manufacturing executive for Unilever who had been brought in to improve the manufacturing efficiency of the company's local subsidiary. That's not to say there aren't extremely well-run businesses to invest in that don't have big parent companies, but the ability to tap global expertise can be a valuable resource.

How do you source ideas?

LS: Today there are more brokers and analysts following stocks in frontier markets than when we started. While that's somewhat helpful in sourcing ideas, our inclination is more toward smaller companies that have little or no analyst coverage and that aren't being touted by brokers who often tend to sing the same song.

One of the best resources for us is simply to prepare with a few keystrokes on Bloomberg what we call comp sheets on individual markets, basically listing companies by market cap, profitability and P/E ratio. When we're on the ground in the country we'll start asking questions about the stocks with the attractive relative valuations and potential for profit expansion. If we're asking enough good questions of the right people, we'll generally be able to surface ideas worth looking into further.

Is financial information readily available?

LS: I think people misunderstand the contrast between frontier markets and the rest of the world on this front. When we started out it was indeed hard at times to even get annual reports – companies often didn't think prospective investors deserved them. We'd have to enlist local brokers to drum up hard copies and scan them into PDFs for us. But that's completely changed, as data is far more robust and available across the frontier world. Approximately 90% of the firms we research are audited by Big 4 accounting firms.

The real challenge isn't finding decent financial data – it's putting it in the right context and understanding what's behind it. That's why being on the ground and visiting companies is really indispensable.

Picking out one colorful holding, how did crocodile-farmer Padenga Holdings get on your radar screen?

LS: We had invested in Zimbabwe in the period after the dollarization of its economy, expecting that to lead to a revival of economic activity in the country. During that time we got to know Innscor Group, a holding company that had acquired Padenga during the hyperinflation in Zimbabwe. It was particularly valuable because it was a hard-currency earner, selling crocodile meat in a variety of international markets and, more importantly, selling crocodile skins to big clients like Hermes, which sells crocodile bags for as much as $20,000 each. When Innscor spun off Padenga in 2010 it wasn't a popular item to many Innscor shareholders, so we ended up buying on the spinoff and ultimately added to our position to make it a significant holding.

ON RESEARCH:

The challenge is putting financial data in the right context – being on the ground is really indispensable.

Any good site-visit stories to share here?

LS: We've met with top management in Harare and we consider them the equal of the best managers of the best companies from around the world. We also last year visited one of the crocodile farms in the bush and were particularly struck by the commitment of the staff there to the animals, which can mature at 15 feet long and weighing 1,000 pounds. The crocodiles are coddled like you wouldn't believe and eat only the best food designed scientifically to produce the highest-quality skins and meat. As was the case here, these types of visits can add considerably to our knowledge and conviction on a company.

How about another research tale or two from what are certainly more exotic locales than what most value investors typically encounter?

LS: One that stands out for me was my first meeting with the chief executive of Al-Eqbal [Jordan: EICO], which is based in Jordan and is a leading global supplier of flavored shisha tobacco, which is very popular in the Middle East and becoming more so elsewhere as hookah bars and other similar venues proliferate around the world.

The meeting felt right out of *The Arabian Nights*, with the CEO seated at an elevated desk, chain smoking long thin cigarettes and engulfed in a circle of smoke. I was sitting in front of him on a low hassock and there was a large, muscular gentlemen standing to his left who gave the impression that if I asked the wrong question I might never have left the room. It certainly stirred the imagination.

AC: One visit that made a real impression on me was a meeting I had with the largest, self-contained vintner in Montenegro, which is a beautiful place by the way. The company was partly state-owned, which is usually a red flag, and I had been warned that it maybe wasn't so focused on profits, let alone shareholders. I'm speaking with a top manager and asked her about why profit margins are so low and she says through a translator something to the effect that they didn't really pay attention to or care about margins, adding, "We're state-owned and have to employ a lot of people, most of whom are lazy." I had to applaud how upfront she was, but let's just say that's not the type of response we're looking for. While we thought there was a lot of low-hanging fruit, so to speak, we didn't think it was going to get picked anytime soon.

How do you think about valuation?

AC: We're primarily focused on P/Es, particularly in combination with earnings growth rates. We don't have strict rules because markets and companies are so unique, but something like Padenga trading at a forward P/E multiple of maybe 9x, with a prospective earnings growth rate of 15-20%, is a combination we would consider quite attractive.

We don't think the relative valuation levels in frontier markets are widely known. On trailing earnings, the P/E for the MSCI Frontier Markets Index is around 13.5x, while for the comparable emerging-markets index the P/E is around 15x and in the U.S. it's 22-24x. The weighted-average P/E on our portfolio is generally lower than the FM index.

We don't know when or the full extent to which the valuation gap narrows, but we very much believe such a wide discrepancy isn't warranted. If growth in these markets comes through, we have to believe that will ultimately be recognized in at least somewhat higher valuation levels.

You mentioned investing across 30 or so countries. How many positions do you typically hold at a time?

LS: While we pride ourselves on our company-specific research, we need to be sufficiently humble about the depth of our knowledge on each company we own. That's especially true when there are also so many externalities involved in frontier markets. Even if we have the specifics of a company addressed thoroughly, we're still exposed to a number of risks at the country level such as those around politics and regulation. As a result, we diversify the portfolio across 70 or so stocks, limit individual-country exposure to 15% and usually consider positions above 4% as a source of funds.

How do you handle currency risks?

AC: We don't hedge, which is often prohibitively expensive in many of the countries in which we invest. We do, however, on a company-by-company basis assess exposure to currency risks or opportunities and that gets built into our assessment of individual stocks.

LS: Over time, currency has been a drag of 2-3% per year on the portfolio. It's been a period, of course, in which the U.S. dollar has been generally strong. There's no guarantee the future will look exactly like the past.

Describe your investment case for Kenya's Centum Investment [Nairobi: ICDC].

LS: This started out as a partly government owned development entity that is now a prototypical holding company that acquires and develops businesses that it believes have excellent long-term potential and holds them in a diversified portfolio. You could consider it kind of the Berkshire Hathaway of Kenya, with a very smart entrepreneur, Chris Kirubi, controlling about 25% of the company.

Centum has a number of areas of emphasis, but the business mix is fairly broad. It's developing an upscale shopping mall in Nairobi and a large residential, commercial and marina property in Uganda. (As an aside, the Nairobi mall will include a water park that will have dolphins, a first for Kenya.) It distributes Carlsberg beer in Kenya and runs the largest Coca-Cola bottler. It owns asset-management firms, banks and microfinance companies and also wants to become East Africa's leading independent power producer. The management team is very smart, has a great eye for value and knows how to do deals. They are a favored partner and always have an attractive pipeline of future projects in the works.

Are you bullish on Kenya in general?

LS: Kenya is very appealing to us, with a strong entrepreneurial culture and more economic diversity than many countries in West Africa, or example, that rely heav-

INVESTMENT SNAPSHOT

Centum Investment
(Kenya: ICDC)

Business: Kenya-based holding company with investments across a variety of sectors, including real estate, power production, asset management and beverage distribution.

Share Information
(@4/27/17, Exchange Rate: $1 = KSH 102.95):

Price	**KSH 35.75**
52-Week Range	KSH 30.50 - KSH 51.00
Dividend Yield	2.8%
Market Cap	KSH 23.79 billion

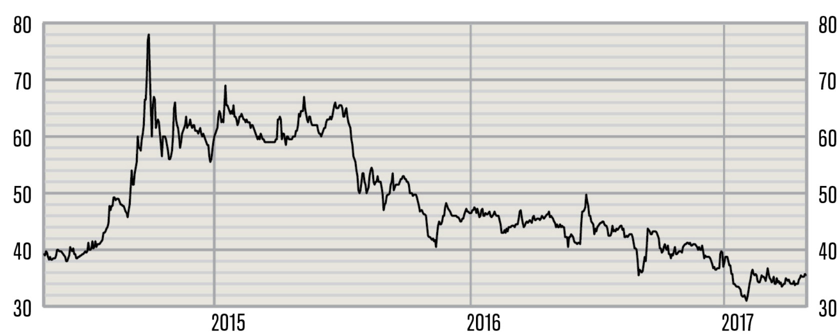
Financials (TTM):

Revenue	KSH 24.16 billion
EBIT Margin	n/a
Net Profit Margin	44.7%

Valuation Metrics
(@4/27/17):

	ICDC	S&P 500
P/E (TTM)	3.0	24.2
Forward P/E (Est.)	n/a	18.4

ICDC PRICE HISTORY



THE BOTTOM LINE

With exceedingly capable management and a positive macroeconomic backdrop, Larry Speidell expects the diversified investment holding company to compound shareholder value for years to come. But its shares today trade for only 70% of a reported book value that he believes significantly understates the current value of the company's assets.

Sources: FactSet, company reports, other publicly available information ily on oil. By and large, the political situation in the country has been improving and we're hoping the upcoming election – which will likely keep the ruling party in power – is as uneventful as we expect.

At a recent 35.75 Kenyan shillings, how inexpensive do you consider the shares?

AC: The stock currently trades at only 70% of book value. When we value the assets on a sum-of-the-parts basis, we arrive at a net asset value that is well in excess of even the current stated book value. So we believe we're buying assets at a significant discount to what we think they're currently worth, and we think that asset value through smart stewardship can compound at a very healthy rate well into the future. We expect this to be something we can own for a long time.

Getting past your *Arabian Nights* meeting with Al-Eqbal, why are you bullish on its prospects?

AC: The company is the second-largest global supplier of shisha, which is a syrupy tobacco mix containing molasses and other flavoring and is typically smoked in a hookah. The product is very popular throughout the Middle East and in many parts of Africa, but the company is also penetrating new markets, especially those with large Arab populations. They've even started selling into the West Coast of the United States.

LS: This is a case where we were looking at comp sheets for the market in Jordan and we see this stock trading at an attractive P/E with what seemed to be appealing financial characteristics. We then went through a local broker to set up that first meeting I told you about. Despite all the atmosphere at the meeting, it was clear early on that management had a clear vision for the company and that its shisha held a dominant position at the premier end of the market. Since then we've only gotten more comfortable that this company can provide us with a compounding long-term return.

INVESTMENT SNAPSHOT

Al-Eqbal
(Jordan: EICO)

Business: Production, sale and distribution of flavored shisha tobacco, primarily in Middle Eastern markets but expanding as well in Europe, Asia and the United States.

Share Information
(@4/27/17, Exchange Rate: $1 = JD 0.709):

Price	**JD 23.20**
52-Week Range	JD 20.00 - JD 26.25
Dividend Yield	5.7%
Market Cap	JD 696.0 million

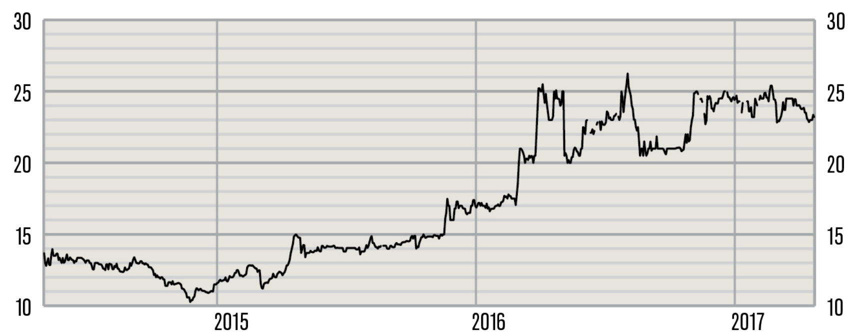
Financials (TTM):

Revenue	JD 142.7 million
EBIT Margin	28.8%
Net Profit Margin	26.2%

Valuation Metrics
(@4/27/17):

	EICO	S&P 500
P/E (TTM)	18.6	24.2
Forward P/E (Est.)	n/a	18.4

EICO PRICE HISTORY



THE BOTTOM LINE

Fueled by positive demographic trends, efficient manufacturing and well-developed distribution, Andrea Clark believes the company can generate annual earnings growth for some time of 15-20%. Adding in a healthy dividend yield, she says, "even if the multiple stays where it is, we'd be happy with keeping the earnings growth and the dividend."

Sources: FactSet, company reports, other publicly available information

AC: This is also a case where on-the-ground research was critical. We were already positive on the long-term opportunity in shisha, driven by good demographic trends in the Middle East. We saw how profitable the company was – its ROE is typically in the 40% range – and liked that it paid 90% of net income in dividends. But then we spent a day at the company's new factory in the Emirates tax-free zone and were extremely impressed by the state-of-the-art equipment, the efficiency of the operation and the quality of the people in charge. Seeing all that clearly gave us a higher comfort level that the business really was on as solid a footing as we thought.

What upside do you see from today's 23.20 Jordanian dinar share price?

AC: This is one where we find the P/E multiple relative to growth potential very attractive. Last year sales increased 16% and earnings increased 20%, but the stock currently trades at around 18x trailing-twelve-month earnings. We think annual earnings growth of 15-20% is a reasonable expectation and the dividend yield today is about 6%. Even if the multiple stays where it is, we'd be happy with keeping the earnings growth and the dividend.

Explain your thesis for Bangladeshi bank BRAC Bank [BRAC:BD].

AC: The bank is 47% owned by BRAC, which is based in Bangladesh and is one of the largest non-governmental development organizations in the world. BRAC

Bank's traditional focus has been on financing small and medium-sized businesses in Bangladesh, but it has also developed the biggest retail-banking network in the country and has had a huge success in launching bKash, a mobile-payment platform that is bringing banking services to a large segment of the population – up to 70% of the total – that has never used banks before. When we spoke earlier about banks that are well positioned to grow as their countries develop and their services reach more people, this is a perfect example.

The company's financial metrics are very good. It has the best asset quality among competing banks. In 2016 total assets grew 17%, net earnings grew 74% and the return on equity was just over 19%. I mentioned the bKash division – it's operating earnings grew 63% and now account for just under 10% of the total. We think that's just getting started as the services offered through the platform expand. This year, for example, they're launching a new micro-loan program, offering $150 loans, say, with 18% annual interest rates.

How attractive do you consider Bangladesh as a market?

AC: It is one of the fastest-growing economies in our universe, with a large population (165 million), low labor costs and some political stability, finally, over the past two years. That stability has a clear positive effect on the economy, which we believe can generate fairly steady 6.5% to 7% GDP growth.

How are you valuing the shares, recently trading at 73.20 Bangladeshi taka?

AC: Bangladesh isn't a country like Nigeria, where you find banks trading at 4x earnings. But it also doesn't present the challenges you see in Nigeria, and in fact the country's economic prospects are quite bright.

BRAC Bank stock currently trades at 2.7x year-end 2016 book value and at a P/E of about 15x. Not putting too fine a point on it, we basically think that's a very reasonable valuation for a Bangladeshi company with the potential for strong earnings growth well into the future. Net profit from 2012 to 2016 grew at an annualized rate of 55%. Even if that moderates substantially, we believe there's plenty of upside in the stock.

As a frontier-markets pioneer, what would you say has surprised you the most about investing where you do?

LS: I would say broadly that we've been overoptimistic over the past 10 years, about how quickly good government would span the world, how quickly frontier equity markets would develop, and how quickly investors would embrace the opportunity available. I think we were ten years too early and I hope we're not 100 years too early. I honestly don't believe that's the case, and I believe now is the perfect time to be looking at these markets.

AC: You're looking at countries that for the most part will benefit from small incremental change. When I was in Nigeria it felt like the lights went out at least hourly. Think about that and the impact on productivity and income levels if basic services, infrastructure and educational levels continue to improve at even modest rates. Unlike in more-developed markets, small incremental changes can have big impacts. That may be lost on many investors in today's world, but we hope and believe that will not always be the case. VII

INVESTMENT SNAPSHOT

BRAC Bank
(Bangladesh: BRAC)

Business: Leading commercial bank in Bangladesh focused on small and medium-sized companies; also owns and operates fast-growing bKash retail mobile-payments system.

Share Information
(@4/27/17, Exchange Rate: $1 = BDT 82.09):

Price	BDT 73.20
52-Week Range	BDT 41.10 - BDT 97.50
Dividend Yield	1.1%
Market Cap	BDT 62.15 billion

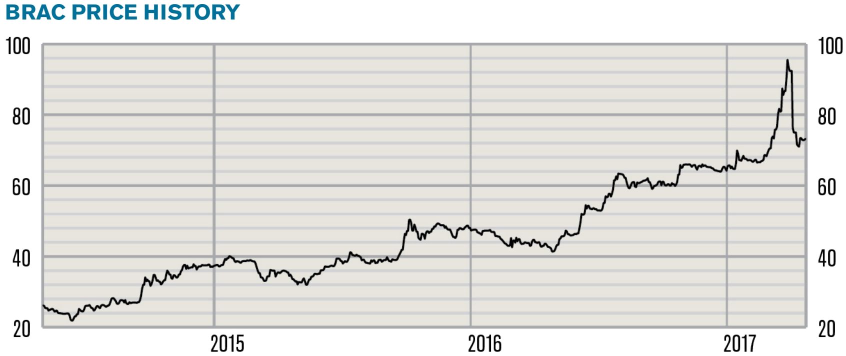
Financials (2016):

Total Assets	BDT 268.32 billion
Return on Assets	1.6%
Total Capital/Assets	12.1%

Valuation Metrics
(@4/27/17):

	BRAC	S&P 500
P/E (TTM)	16.1	24.2
Forward P/E (Est.)	16.0	18.4

BRAC PRICE HISTORY



THE BOTTOM LINE

Already strong in serving small and medium-sized businesses in Bangladesh, the company is also significantly expanding its retail products and services through its bKash mobile-payments platform, says Andrea Clark. She believes the 16x P/E at which the shares currently trade is "very reasonable" given the company's earnings-growth potential.

Sources: FactSet, company reports, other publicly available information

Built to Last

Taro Pharmaceutical has not been immune to increased generic-drug price competition. Despite Wall Street's indifference, however, it may be one of the best-positioned competitors to ride out the storm. By Ted Crawford

If Saber Capital's John Huber were to guess which player in the beaten-down generic-drug industry would trade at far below the valuation level of peers, one of his last choices would be Israel-based Taro Pharmaceutical. Founded in 1950, the company manufactures some 200 generic drugs for niche markets, specializing in dermatological products and other treatments for chronic but non-life-threatening conditions. While current industry-wide pricing pressures hurt – Taro's revenues fell 15% in its most recent quarter on stable volume – he considers the company uniquely prepared to prosper over time due to a deserved reputation for cost control. "This is a market where the low-cost producer wins," he says.

Rising generic-drug prices in recent years invited plenty of new competition, but Huber believes falling prices will have the opposite effect as many new entrants – including larger pharmaceutical companies with cost structures built around selling proprietary drugs – retreat to their traditional markets. Even if that takes some time, he says, Taro's 60%-plus operating margins and $1.4 billion in net cash on the balance sheet provide it with plenty of cushion to absorb even the most-aggressive shots on price. As competitors weed themselves out, pricing pressures should at least then somewhat abate.

One complicating factor around Taro is its relationship with controlling shareholder Sun Pharmaceutical, founded in India with $200 by Dilip Shanghvi in 1981 and now the country's largest drug company. Sun – itself known for its owner-driven culture with no tolerance for waste – began accumulating shares of Taro in 2007, and in 2012 made a bid to acquire the entire company that was rejected as inadequate by minority shareholders. While Sun has been quiet on the takeover front for some time, it has effectively increased its ownership stake in Taro as Taro implemented two stock-buyback programs last year in which Sun didn't participate. As a result, Shanghvi's company now controls 82% of Taro's outstanding shares and Huber believes it's only a matter of time before it bids for the remaining shares, having shrunk the "stub" piece for which it may have to pay a premium price.

By Huber's reckoning, even if Taro's annual operating income fell from the current $600 million to $500 million and it earned the 14.5x EV/EBIT multiple Fresenius has agreed to pay for peer Akorn Inc., its stock would trade above $200.

Is there risk that the value-conscious Shanghvi will try to take the company out at far below what Huber pegs as fair value? Yes, he says, but Israeli law mandates that any deal would need to be approved by a majority of minority shareholders. Given what he believes the shares are worth, he wouldn't expect any deal to be approved for less than 40% more than today's market price. In light of the company's long-term prospects, he says, "There's just no reason for minority shareholders to accept an inadequate price." VII

INVESTMENT SNAPSHOT

Taro Pharmaceutical
(NYSE: TARO)

Business: Manufacturer of generic pharmaceutical products sold in the U.S., Canada and Israel mostly for dermatologic, anti-fungal, allergy and cardiovascular conditions.

Share Information (@4/28/17):

Price	**116.85**
52-Week Range	92.28 - 150.75
Dividend Yield	0.0%
Market Cap	$4.79 billion

Financials (TTM):

Revenue	$948.0 billion
Operating Profit Margin	62.8%
Net Profit Margin	51.5%

Valuation Metrics
(@4/28/17):

	TARO	S&P 500
P/E (TTM)	10.0	24.2
Forward P/E (Est.)	n/a	18.4

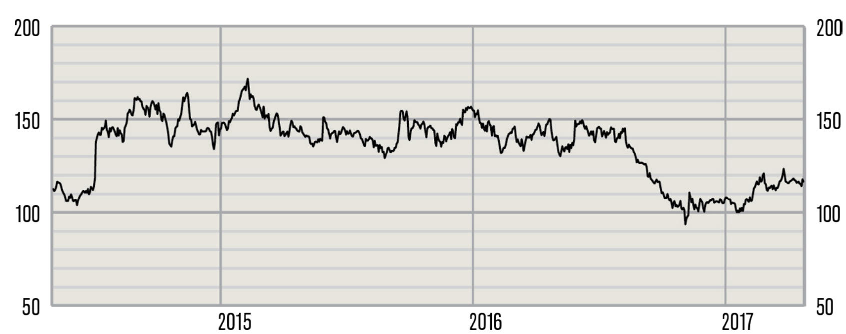
Largest Institutional Owners
(@12/31/16):

Company	% Owned
Matthews Intl	2.0%
Schroder Inv Mgmt	1.7%
Renaissance Tech	1.3%

Short Interest (as of 4/13/17):

Shares Short/Float	21.6%

TARO PRICE HISTORY



THE BOTTOM LINE

Given its cost discipline and rock-solid finances, John Huber would expect the company's shares to trade at a premium to peers rather than the current discount. At the EV/EBIT multiple recently paid for a competitor, he says, the share price could exceed $200.

Sources: Company reports, other publicly available information

Hard Lessons

Having built an excellent track record mostly by investing in quirky, overlooked micro-cap companies, Roumell Asset Management's Jim Roumell [*VII*, April 30, 2009] was riding high as an investor at the end of 2013. Net annualized returns of 10.2% since he launched his main Opportunistic Value strategy in 1999 were more than 700 basis points per year above the S&P 500, despite averaging a 24% cash balance over the period. Rolling three-year returns, calculated on a quarterly basis since inception, beat the index nearly 80% of the time. "We were feeling quite smart, confident and in every way on top of the world," he writes in his latest investment letter.

As value investors, reading that lead-in likely prompts an immediate, natural response: "Uh-oh." And it is warranted here. As he goes on to recount in his refreshingly candid and thoughtful letter, Roumell made a number of key decisions that, in retrospect, he would love to have back. He decided to "go big" and shoot for more than tripling his asset base to $1 billion. He brought in an experienced value manager as a partner to try to help complement and broaden the firm's skills. Finding it difficult to find securities in his traditional sweet spot, he increasingly ventured outside his "zone of competence" to find value. The ramifications proved swift and painful as dismal 2014 and 2015 performance prompted investor defections. Rather than growing, assets under management fell by more than two-thirds, to under $100 million.

To repair the damage, Roumell did an about face on most of his failed initiatives and committed to returning to the strategy and process with which he had been successful. While he calls it very much a work in process, the early results are promising. Since the beginning of 2016 through the first quarter of 2017, his Opportunistic Value mutual fund is up 27%, vs. 18% for the S&P 500. That's while holding roughly 40% in cash.

The key lessons learned? In his words from his letter:

- We have no business trying to manage $1 billion and our hunger to "go big" led us astray. Our value lies in micro-cap investing – typically $100 to $500 million market-cap companies – and that market segment, absent a broad bear market, does not lend itself to managing much more than $300 to $400 million, in my opinion.

- Our country's culture is obsessed with growth, often at the expense of value. RAM reflexively pursued growth because of the mistaken belief that it's the path that all businesses should pursue. In fact, some businesses, like ours, deliver diminishing value if they grow too large.

- We have restructured the relationship with our outside marketing firm with the intent to limit marketing trips to only a handful per year. We are fortunate to have partnered with a terrific third-party marketing firm that deeply understands our investment process. The capital it brings to us is of the highest quality – sophisticated investors willing to make at least a three- to five-year commitment. Properly aligned capital is important and is the only type of capital we want to manage.

- Temperament is a leading indicator of investment performance because "smarts" are commoditized in an industry that attracts highly-educated and intelligent individuals. We believe that investing is ultimately one's character in motion, expressed over time. It is imperative that investors manage their emotions as public-security prices often fluctuate dramatically during a given holding period.

- We want to enjoy our daily work lives.The right culture – how it feels to enter the office each day – is essential to maximizing investment performance. It is not just important, it's everything for us.

- When the topic of cycles is discussed in our industry, it typically refers to business, investment, interest-rate and commodity cycles. However, there is also a "hubris cycle," or the waxing and waning of overconfidence, which can lead to periods of poor decision making that typically follow on the heels of a few good decisions. Our character will surely be tested going forward as we exit this recent experience and we'll have to remain vigilant about absorbing what we know about our true investment selves and honoring that knowledge, while keeping a watchful eye on our own hubris cycle.

For any investor who has hit a rough patch – in other words, any investor – words to the wise. VII

John Heins

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