KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 44

Third Quarter 2016 Review of the Small Cap Quality Value Portfolio

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Hello, this is Julie Kutasov, Portfolio Manager at Kayne Anderson Rudnick. Today, I'm here to provide a third quarter 2016 review along with some highlights of our Small Cap Quality Value Portfolio.

Equities produced outstanding returns during the third quarter, with reduced investor anxiety over Brexit, better economic data, improved stability in the oil markets, and accommodative monetary policy worldwide, helping propel markets to all-time highs. The S&P 500 Index advanced almost 4 percent, bringing the year-to-date return up to nearly 8 percent. Small cap names were particularly strong. The Russell 2000 Value Index, this strategy's benchmark, increased 8.9 percent during the quarter, bringing the year-to-date return to 15.5 percent. The third quarter's Russell 2000 Value benchmark's performance was primarily driven by technology, health-care (with biotech names posting an impressive 25 percent plus return), and materials sectors while utilities, consumer staples, and consumer-discretionary sectors lagged.

Risk appetite continued to accelerate as investors priced in a rising interest rate environment, driving up valuations of lower-quality, higher-beta, pro-cyclical segments while higher quality as well as interest rate-sensitive segments (such as utilities and real estate) lagged. To give you some color, the benchmark's high quality names, those rated as "B plus" and above by S&P Quality Rankings, were up 5 percent during the third quarter while lower quality names (rated "B" and below) were up nearly 11 percent. Companies with a below investment-grade credit rating (these represent over 60 percent of the benchmark) were up over 9 percent, while those names with beta over 2 returned over 19 percent.

Clearly, this is an unfavorable environment for us as high-quality investors, and our Small Cap Quality Value Portfolio lagged the Russell 2000 Value Index during the quarter. The over 700 basis points underperformance was driven primarily by negative stock selection in the more capital intensive producer-durables and financial-services sectors where our portfolio holdings are particularly different from those of the benchmark. We did benefit quite nicely, however, from our underweight exposure to the underperforming utilities sector. Recall that, for us, this underweight exposure to utilities is structural in nature due to the segment's inherent capital intensity, lower competitive differentiation, and highly regulated (capped) returns profile.

The two positions that contributed most positively to performance during the quarter were Thor Industries (ticker THO) and G&K Services (ticker GK).

We discussed our purchase of Thor Industries with you last quarter. At that time Thor was the second largest manufacturer of recreational vehicles (RVs) in the U.S. This scale is vital, as it allows the company to enjoy significant purchasing power with its suppliers, which translates into meaningful advantages in cost of materials over smaller competition. Shares performed strongly during the quarter driven by investor enthusiasm over the company's early July acquisition of a rival RV manufacturer, Jayco. Usually, we are not too fond of acquisitions, but we welcome this deal. Reasonably priced, the acquisition provides Thor with additional scale. Thor is now the largest RV manufacturer in the U.S., while expanding its fast-growing (and in large part due to a growing interest from younger millennial buyers) towable-trailer platform. Importantly, overall RV industry volumes continue to post consistent growth, with 2016 volumes expected to pass the prior peak setback in 2006, driving the company's solid top-line growth and profitability expansion.

G&K Services is a uniform rental company. G&K shares rose sharply in mid-August following an announcement of the company's acquisition by a larger competitor, Cintas Corporation, for $2 billion in cash, representing a nearly 20 percent premium to the previous-day closing price. With shares trading at an insignificant discount to the acquisition price, we exited our position in the company during the quarter.

The stock that detracted the most from the quarter's performance was National Beverage (ticker FIZZ) that we discussed with you as our top performer last quarter. The company was also our number one contributor last year. It also remains the top contributor for the trailing twelve months period, and one of the top contributors for the trailing five-year period. As you may recall, National Beverage manufactures and markets flavored beverages including soft drinks, juices, teas, and sparkling waters. It is that latter category with the company's sparkling-water brand, LaCroix, that has been driving the company's robust growth recently, in the environment where consumers have been increasingly shifting away from carbonated soft drinks to healthier unsweetened beverages.

With the shares' price up meaningfully over the past year, driven primarily by continued market share gains of LaCroix, some selling pressure was evident in the latter part of the quarter. In addition, two days prior to the quarter-end, a short-seller released a report questioning the integrity of the company's management, adding further downward pressure on the shares. We held a detailed discussion with the company's management team on the issues raised by the report and do not agree with key allegations presented by the short-seller. More importantly, independent third-party sales tracking data is readily available in this industry. This data provides us with confidence in the fast-growing consumer demand for the La Croix brand. In fact, the success of the brand is observable with "a naked eye" so to speak. Those of you shopping at Whole Foods Market or any major supermarkets these days have probably seen it firsthand. Some of you may also recall an article about the company published in the April 7th issue of the Wall Street Journal with a photo of a "wall" of La Croix cases at a Brooklyn Whole Foods store. As noted in the article, U.S. sparkling-water consumption grew a robust 26 percent last year, with LaCroix being the fastest growing unsweetened brand, now second to only Nestle's U.S. Perrier brand in the category. We are happy to say that we reduced our position in the stock meaningfully when it was trading at a highly attractive valuation level earlier in the quarter, and remain confident in holding our remaining position.

We made two new purchases during this quarter: Sally Beauty Holdings (ticker SBH) and Scotts Miracle-Gro Company (ticker SMG). And as I mentioned earlier, we sold our position in G&K after the announced acquisition by Cintas. Let me provide some color on the purchases.

Sally Beauty Holdings is a distributor and retailer of beauty supplies with nearly 4,800 stores worldwide. The company has two segments: Sally Beauty Supply (roughly 60 percent of revenues) and Beauty Systems Group or BSG (representing the remaining 40 percent). The Sally Beauty Supply segment targets the retail customer, offering attractively priced salon-quality beauty products. For example, where many salon-quality shampoos retail for 20 dollars or more, Sally Beauty shampoos usually sell for under 10. BSG, on the hand, caters exclusively to licensed salon professionals. Sally's vast distribution scale allows the company to have both a strong private label, and third-party products offering including BSG's ability to secure exclusive contracts with leading brands internationally. Importantly, Sally's business model is characterized by low capital intensity which results in solid free-cash-flow generation, with the company consistently returning excess capital to shareholders in the form of opportunistic share repurchases.

Scotts Miracle-Gro (the company's name is probably well familiar to those garden enthusiasts among you) manufactures and sells lawn and garden products. Scotts has established four very solid brands in the lawn and garden industry: Scotts (lawn care), Miracle-Gro (soil and plant food), Ortho (insect and weed killer), and Roundup (weed and crab-grass killer). Brand is important as most of us only make one soil or weed killer purchase a year. At a relatively low price point of below 20 dollars, we are usually willing to pay a little more for a product that we know will work for us the first time. All of the four brands possess strong brand awareness and market share, and this strength translates directly into pricing power. Being the largest lawn and garden product manufacturer also results in multiple scale advantages. One key benefit is the size of the company's advertising budget that smaller competitors are simply unable to match. Also, Scott's three largest customers are Home Depot, Lowe's, and Wal-Mart. To effectively supply these giant national retailers, Scott's has transformed the company's operations to integrate supply chains, electronic systems, and infrastructure. Smaller competitors just don't have the scale and capabilities to do so. Importantly, Scott's business model is also characterized by low capital intensity, with capital expenditures averaging just 2 percent of sales over the past 10 years. Consistent operating cash flow combined with limited CapEx resulted in steady free-cash-flow generation, with the company returning excess capital to shareholders in the form of cash dividends and opportunistic share repurchases.

While we are certainly disappointed with the underperformance of our portfolio in the quarter, we are not letting short-term events or near-term volatility drive our decision-making, and remain fully committed to our high-quality discipline and focused on the long-term outlook for our companies and our portfolio.

We are also very satisfied with the Portfolio's positioning both in absolute terms and versus the benchmark on all of the quality, growth, and value metrics that we monitor and manage to. Five-year average return on equity for our companies stands at a solid 21.4 percent, versus just 7.9 percent for the Index. Importantly, it is derived from solid underleveraged balance sheets, with Debt-to-EBITDA ratio for our companies of 1.5 times versus 7.3 times for the Index. Diluted earnings per share compounded annual growth rate for the past 10 years (which includes the great Recession) for us stands at a solid 8.3 percent versus 4.8 percent for the Index, and our companies have grown quarterly cash dividends per share at an impressive compounded annual growth rate of 9.5 percent over the past 10 years versus just 1.4 percent for the benchmark. Importantly, the Portfolio's valuation at the end of the quarter stood at a meaningful six multiple discount to the Index on a trailing twelve months price-to-earnings ratio basis.

We understand that the investment philosophy of owning high-quality businesses may face headwinds during certain periods of time. When investment-grade rated companies see lower returns than below investment-grade rated companies, when higher-beta companies outperform lower-beta companies, we know that this is not a favorable environment for us. Nonetheless, this will not alter our belief that investing in high-quality businesses will yield superior risk-adjusted returns over the longer term. In fact, our discipline of being a high-quality investor has been proven through our long-term alpha generation.

Running a focused portfolio of roughly 30 names allows us to stay close to our companies and make investment decisions based on fundamentals of the underlying businesses rather than short-term issues or fears. That is why we focus on longer term performance and encourage our clients to do so also. In fact, we like to think of ourselves as investors in businesses more so than investors in stocks.

Thank you again for taking time to listen to this recording today, and as always, if there are any questions or comments, please do not hesitate to reach out to us.