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ValueInvestor INSIGHT

The Leading Authority on Value Investing

# Affordable Quality

It sounds almost old-fashioned in today's day and age, but François Rochon's investing strategy since founding Montreal-based Giverny Capital hasn't wavered: "We're looking for 20 to 25 companies we can own for the long run that we believe can increase their intrinsic values by about twice the rate of the S&P 500," he says, "and we want to be prudent about what we pay for them."

Now managing $1.6 billion, he's executed on that deceptively simple premise quite well. His Global portfolio, typically 85% invested in the U.S., has earned a net annualized 14.2% since 1993, vs. 10.2% for the S&P 500. Today he's finding what he considers affordable quality in such areas as Internet services, insurance and used cars. See page 2

**François Rochon**
Giverny Capital

# All In

Adam Wyden's investing style is not, using a baseball analogy, focused on hitting a steady stream of singles and doubles. He owns only a handful of stocks at a time. He seeks out opportunities where big company changes in strategy, execution or capital allocation are underway. "We'd rather hold cash than something that isn't a fantastic opportunity," he says. "That to us is how we'll generate a return independent of the market over time."

So far, so good. Wyden's ADW Capital since inception in 2011 has earned a net annualized 24.6%, vs. 11.2% for the Russell 2000 index. His concentrated bets today include those in waste disposal, commercial services, point-of-sale systems and hospitality. See page 7

**Adam Wyden**
ADW Capital

# Ahead of the Curve

Despite South Korea's admirable economic growth and the continued success of its largest companies, the country's equity market has been stagnant for years. You wouldn't know that by Albert Yong and Chan Lee's success since they founded Petra Capital Management in 2009 to root out mispriced value among neglected small and mid-sized Korean companies. The firm's Value Equity Strategy since launch in 2009 has earned a net annualized 13.7%, vs. 5.4% for the MSCI Korea Small Cap Index.

As the market shows signs of waking from its slumber, Yong and Lee still see opportunity in classic Korean value plays like holding companies as well as in new-economy areas like renewable energy and semiconductors. See page 13

**Petra Capital**
Chan Lee (*l*), Albert Yong (*r*)

## Inside this Issue

**FEATURES**



**INVESTMENT HIGHLIGHTS**



**Other companies in this issue:**
Bank of America, Berkshire Hathaway, CarMax, Carvana, Com2uS, CS Wind, Five Below, Floor & Decor, Grenke, JPMorgan, Kiwoom Securities

# Investor Insight: Petra Capital

Petra Capital Management's Chan Lee and Albert Yong describe why now is a particularly interesting time to be investing in South Korea, why they consider flexibility one of their most important traits as investors, where they're spending the most time today looking for new ideas, and what they think the market is missing in Daou Technology and Soulbrain.

**You've done very well over a long period in which the Korean market has gone mostly sideways. To what primarily do you attribute that?**

**Chan Lee:** This may be less true today than it once was, but to a certain extent we've benefitted from a level of competition when it comes to value hunting that is much lower in Korea than in other advanced equity markets like the U.S. There just aren't as many truly long-term investors who are sophisticated and experienced enough to correctly assess intrinsic values of Korean companies. Our ability to do that in an ever-changing economic environment and in difficult-to-analyze sectors or industries has so far proven to be somewhat of an edge.

We also think that we have an edge investing in small and mid-cap stocks that are not covered by many sell-side and buy-side analysts and that don't attract much interest from foreign institutional investors. Roughly 30% of the total equity market in Korea is held by foreign institutions, but many will not look at companies below a certain size, say around $2 billion in market cap. That all makes it more likely for us to find mispricings in smaller-cap companies.

**Albert Yong:** Another reason we've had some success is that we have an open mindset when it comes to opportunities. We haven't deviated from our core principle of buying stocks trading at significant discounts from their true values, but we're flexible about the type of company or situation in which that can be the case. Maybe it's more of a Ben Graham-type cigar butt. Maybe there's a significant holding-company discount compared to the sum-of-the-parts value. Maybe there is a growth opportunity that the market just isn't recognizing. Maybe there's a rising champion from Korea that most investors have not yet heard of. In a dynamic economy like Korea's, we think it's important to not be overly rigid about where we look for value.

**After a long slumber, the Korean market came back very strongly in 2020 to be one of the better performing markets in the world. Is there a chance you'll have the wind at your back in the domestic market for a change?**

**CL:** Part of that was that the pandemic relative to most countries has had a relatively minor economic impact. But the market was also very cheap prior to the pandemic, unlike the U.S., so there also might have been some pent-up demand when the economy turned out to be not as impacted as feared. We're also seeing the same kind of increase in retail investor activity as in other countries that seems to be driving a lot of the move up.

From a valuation perspective, Korea is still one of the cheapest equity markets in the world despite the rally from its March lows. Using Bloomberg data, as of the end of 2020 the market index was trading at a Price/Book ratio of 1.1x and a P/E of 14x. In Japan those numbers were 2.1x and 22x. In the U.S. the price to book was over 4x and the P/E on forward earnings nearly 23x. We're still dumbfounded by the fact that MSCI classifies Korea as an emerging market – along with places like Argentina, Turkey, Russia, Nigeria and Pakistan – but the case can be made that the country is the safest place to invest among emerging markets and that combining that with the current valuation levels could result in the market doing very well as the world fully recovers from the Covid-19 crisis. As we've already discussed, we don't count on things like that, but we do think it's a real possibility.

**ON FLEXIBILITY:**

**In a dynamic economy like Korea's, it's important not to be overly rigid about where we look for value.**

**Did you actively reconfigure your portfolio much during the market's free fall early last year?**

**CL:** We have a variety of different kinds of ideas in the portfolio, but I would say that even before the pandemic we had been shifting more emphasis to what might be considered "new age" companies. Korea is known for its heavy manufacturing and industrial base, but we started to increasingly find growing companies in areas like Internet services, e-commerce, renewable energy and digital media that below a certain market cap size were still trading at surprisingly cheap prices.

Given that we'd already positioned ourselves in more of these new-economy stocks, we didn't trade much at all as everything came down during the March crash. We felt the companies we owned for the most part were in the right areas and that, if anything, they could benefit from an acceleration of pre-existing economic trends that were already working in their favor. As it turns out we were right to not change our portfolio much because these types of companies ended up recovering faster and further.

**AY:** I can't say it's the best value at the moment, but CS Wind [Seoul: 112610] would be a good example of the dynamic Chan just described. The company manufactures the towers that support the turbines made by companies like Siemens, Vestas and GE to produce energy from wind. It has an excellent reputation for quality, a global production footprint, and is one of a very small number of providers of towers to best-in-class partners building onshore and offshore projects.

You wouldn't think such a company in a hot global sector would be ignored in the Korean market, but we thought that was exactly the case prior to the pandemic. Part of that may have been because we don't have much of a wind-power market in Korea, but whatever the reasons, the shares had been going nowhere and we were able to buy them at close to 10x earnings. When the pandemic first came the stock got hit even a bit harder as oil prices fell so sharply and people thought that might have an incrementally negative impact on demand for wind power. That all changed relatively quickly and investors finally discovered CS Wind and started to recognize its long-term potential. [Note: That's putting it mildly – trading at around ₩35,000 at the beginning of 2020, CS Wind's shares fell as low as ₩15,000 in March. The stock currently trades at ₩160,000.]

**When we last spoke [VII, September 30, 2018] you described mobile-gaming company Com2uS [Seoul: 078348] as an example of an idea with strong growth prospects that the market seemed to be ignoring. The stock is up modestly since – are you still interested?**

**AY:** Yes we are. Our thesis for the company was that its flagship game, which is called Summoners War, would have a much longer lifespan than people seemed to expect and that the cash it generated could be put to good use by reinvesting in new mobile games both developed in-house and acquired from others. Even with significant investment spending on growth, there was enough cash on the balance sheet that some of it could also be returned to shareholders.

While Summoners War has continued to do well, there hasn't been much tangible progress on the capital-allocation front. The company started paying a small dividend. They've announced launch dates this year for two new games based on Summoners War intellectual property. They say they're looking to use cash for accretive acquisitions, but just haven't found the right fit yet.

We remain optimistic and think management will eventually prove to be good stewards of shareholder capital and build the company's value over time. And the stock still trades at less than 10x earnings if you exclude the cash. The pace at which things change can be frustrating at times for investors, but we need regularly to be patient and we've learned that patience is often rewarded.

**Why do you believe IT-services holding company Daou Technology [Seoul: 023590] is mispriced?**

**CL:** This is a classic example of a holding company whose market value is too far below the sum of its component parts. It's not so common in the U.S. for a public parent company to also have publicly traded subsidiaries, but it happens often in Korea. In Daou's case the company was founded in 1986 as an information-technology services provider and over the years has created a number of somewhat IT related businesses that have been suc-

## INVESTMENT SNAPSHOT

### Daou Technology
(Seoul: 023590)

**Business**: Holding company whose traditional business is in IT services, but that also owns public stakes in Internet-focused brokerage, job listings and certification subsidiaries.

**Share Information**
(@1/29/21, Exchange Rate: $1 = ₩1,118):

| | |
|---|---|
| **Price** | **₩26,600** |
| 52-Week Range | ₩11,550 – ₩28,950 |
| Dividend Yield | 1.5% |
| Market Cap | ₩1.15 trillion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | ₩5.01 trillion |
| Operating Profit Margin | 16.7% |
| Net Profit Margin | 5.6% |

**Valuation Metrics**
(@1/29/21):

| | 023590 | S&P 500 |
|---|---|---|
| P/E (TTM) | 4.3 | 40.9 |
| Forward P/E (Est.) | 4.0 | 22.1 |

**Largest Institutional Owners**
(@9/30/20 or latest filing):

| Company | % Owned |
|---|---|
| Daou Data | 46.7% |
| Orbis Investment | 9.4% |
| National Pension Service of Korea | 7.1% |
| GMO | 5.3% |
| International Value Adv | 5.0% |

**Short Interest** (as of 1/15/21):

| | |
|---|---|
| Shares Short/Float | n/a |

**DAOU PRICE HISTORY**


**THE BOTTOM LINE**

Chan Lee considers this a classic example of a Korean holding company whose market value is too far below the sum of its component parts. Summing his estimated values for its operating business and its publicly traded and private subsidiaries, he values the company (in U.S. dollars) at $2.6 billion, vs. its current market cap of just over $1 billion.

Sources: Company reports, other publicly available information cessful in their own right. Kiwoom Securities [Seoul: 039490] is by far the largest, having become the leading online brokerage in the country, patterned after Charles Schwab or E*Trade in the U.S. Saramin HR is one of Korea's leading online job-listings companies. Korea Information Certificate Authority is the leader in providing certification and authentication services that facilitate online communications and transactions, not dissimilar to Verisign in the U.S. There are other still-private subsidiaries as well, but these three companies are all publicly traded and Daou retains a controlling equity share.

The valuation math here is relatively straightforward. Daou Technology's market cap in U.S. dollars is around $1 billion. Against that you have the company's 42% stake in Kiwoom Securities, which is worth nearly $2 billion based on its current public valuation. The equity stakes in Saramin HR and Korea Information Certificate Authority are collectively worth around $250 million or so, and we value the other privately held companies at about $50 million. Then there's the traditional IT business at the parent company level, which makes $25 million a year and at a 12x multiple would be worth another $300 million. Add those up and we arrive at $2.6 billion in value for Daou, which is more than 2.5x the current market cap.

**How does something like this happen?**

**CL:** Holding company discounts of 20-25% are not unusual, but it happens sometimes in smaller companies that the market is very slow to recognize changes in the sum-of-the-parts value. Because so much of its value comes from its Kiwoom Securities stake you would think the two stocks would move more in concert, but that is not always the case. Last year, for example, Kiwoom's stock went up almost 60%, while Daou's was up only 15%.

For non-Korean or less-sophisticated investors, Korean-style holding companies can be a bit difficult to analyze at a first pass. Under the IFRS accounting standards, for subsidiaries in which the parent company owns more than a 50% stake or exercises de facto management control, the entire financial activity of the subsidiary companies is reported in the parent's numbers. Although you can get all the component detail as well, the consolidated numbers can provide a somewhat distorted picture.

**ON HOLDING COMPANIES:**

**Sometimes in smaller companies the market is very slow to recognize changes in the sum-of-the-parts value.**

**Are there any catalysts to narrow the discount here?**

**CL:** We have on several occasions tried to be our own catalyst in working with companies to help bring out unrealized value. Here it's relatively difficult. The Founder/CEO owns more than 40% of the company through a family-controlled entity and is a real entrepreneur who is focused on investing and growing the business. So there's maybe not much an activist can or should do right now.

In our experience, sooner or later the market should recognize the value it's missing and that eventually will be reflected in the parent firm's stock price. As Albert said earlier, we need to be patient, and we expect that patience to be rewarded.

**From a parent holding company to an operating-subsidiary spinoff, describe why you're high on the prospects for Soulbrain Co. [Seoul: 357780].**

**AY:** The company was originally established in 1986 as a producer of specialty chemicals and materials used in the semiconductor manufacturing process. As you mentioned, the operating company was spun off as a subsidiary in August of last year and the original entity became a holding company. We believe Soulbrain Co. is significantly undervalued given its growth potential and profitability.

The business today is focused primarily on etchants and other materials that are used in the semiconductor deposition process and also in the manufacture of LCD and OLED displays. In its niche markets it has very strong market shares in Korea – as high as an 85% share in semiconductor etchants and roughly 40% in display etchants.

Traditionally, big Korean semiconductor manufacturers like Samsung Electronics and SK Hynix have bought more of their input materials from outside Korea, especially Japan. In 2018, Korea had a small trade war with Japan and the Japanese government blocked for a time the export of a number of materials used to make semiconductors. This provided an opportunity for domestic materials companies, including Soulbrain, to step in and take market share. We think this trend will continue, resulting in increasing revenues and profits for the company. Its return on equity is nearly 40% and its return on invested capital is over 30%. This is not a stock that should trade at 12x earnings.

We are also bullish in general on the semiconductor industry. Samsung is Soulbrain's largest customer and its memory chips are vital in many areas of the new economy, including cloud computing, driverless cars and artificial intelligence. At the same time, the supply side of the business has become more concentrated as the capital costs to compete grow ever higher, scale is more important, and the complexity of the manufacturing process increases. We think that sets up for a very positive outlook for the big manufacturers that Soulbrain can supply. While its focus is now in Korea, we think it will have the opportunity to supply large manufacturers in Taiwan and elsewhere as well.

**Trading today at around ₩269,000, what upside do you see in shares from here?**

**AY:** As the company continues to improve its market share in a nicely growing market, we believe earnings can increase 15-20% annually over the next several years. Even if the valuation multiple stayed the same – 12x estimated 2021 earnings of around $170 million [₩188 billion] – we think the shares should provide an attractive return. But on top of that there is also significant potential for P/E expansion. The company's market cap is in the range of $2 billion, which means it's likely to start to get noticed by more institutional investors from outside Korea.

**Where are you spending your time looking for new ideas today?**

**CL:** One theme we've been exploring is Korean consumer-brand companies expanding more aggressively outside the domestic market. Korean pop culture – including K-pop music, movies and TV dramas – is becoming increasingly popular in Asia and even in the U.S. If you hear Netflix describe its rapid growth in Asia, one key factor it cites is its emphasis on acquiring much more Korean content that has helped drive subscriptions.

We have always tried to find high-quality companies that start out domestically and have a strong growth runway ahead through expanding regionally and then even globally. As Korean pop culture finds a broader audience, we think it's possible that a number of innovative branded food, beverage, fashion and lifestyle companies can take advantage of that and build their businesses overseas. We still need to do more research to separate the fads from the real opportunities, but as a value investor you want to get there before other investors figure it out. This is one big reason why we think it's actually an exciting time to be investing in Korea. VII

## INVESTMENT SNAPSHOT

**Soulbrain Co.**
(Seoul: 357780)

**Business**: South Korea-based producer of specialty chemicals and materials that are used primarily in the manufacture of semiconductors and of LCD and OLED displays.

**Share Information**
(@1/29/21, Exchange Rate: $1 = ₩1,118):

| | |
|---|---|
| **Price** | **₩268,700** |
| 52-Week Range | ₩201,100 – ₩328,000 |
| Dividend Yield | 0.0% |
| Market Cap | ₩2.09 trillion |

**Financials** (TTM):

| | |
|---|---|
| Revenue | ₩992.00 billion |
| Operating Profit Margin | 23.5% |
| Net Profit Margin | 16.0% |

**Valuation Metrics**
(@1/29/21):

| | 357780 | S&P 500 |
|---|---|---|
| P/E (TTM) | 15.0 | 40.9 |
| Forward P/E (Est.) | 12.3 | 22.1 |

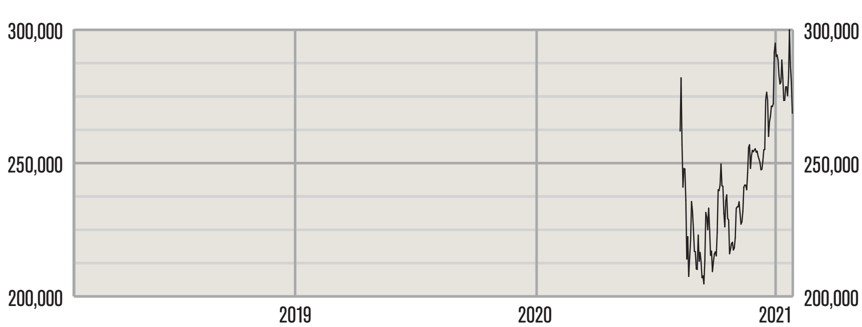
**Largest Institutional Owners**
(@9/30/20 or latest filing):

| Company | % Owned |
|---|---|
| Soulbrain Holdings | 46.5% |
| Mirae Asset Global Inv | 1.7% |
| Vanguard Group | 1.4% |
| Victory Capital Mgmt | 1.2% |
| RAM Lux Systematic Funds | 1.2% |

**Short Interest** (as of 1/15/21):

| | |
|---|---|
| Shares Short/Float | n/a |

**SOULBRAIN PRICE HISTORY**




**THE BOTTOM LINE**

The market in pricing the company's shares at 12x forward earnings is significantly undervaluing its potential growth in supplying a dynamic semiconductor-manufacturing market, says Albert Yong. From market-share gains in a high-growth market, he believes the company's earnings per share can increase at 15-20% annually for several years.

Sources: Company reports, other publicly available information