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ValueWalk

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To start off, can you tell us a bit about Phoenician Capital and the team working at the fund?

Phoenician Capital is a value oriented partnership that invests in small cap companies globally. I started Phoenician in 2007 after getting my MBA from Columbia Business School, incubated the Fund for two years, and opened to outside investors in 2009. Prior to Business School I had founded, operated for ten years and sold a successful business in the textile manufacturing space. By virtue of my past we think like owners, do our own research, use our own processes, and invest our own capital alongside our partners.

As the firm has grown, we have added to our management talent by hiring a COO with seventeen years of experience in hedge funds and have generally been strengthening our infrastructure. On the investment side, I work closely with our quantitative and qualitative analysts throughout the process, from idea generation to making a buy or sell decision. We are honored to have one of my mentors, Stephen Penman (George O. May Professor, Graduate School of Business, Columbia University) as Chairman of our Board of Advisors.

What makes Phoenician stand out from the rest of value funds out there?

Our partnership is quite unique and I can think of at least five structural advantages.

First, rather than value investors in the traditional sense, we are value buyers of growth companies. Traditional value investors generally look for companies with mature business models, trading at a discount to the overall market or sector in question. Our companies are typically growing, managed by CEO founders, and they possess a competitive advantage that manifests itself in a profitable business model and happy customers.

Our second edge consists of utilizing a private equity approach to the public markets. At the heart of our work lies a discipline focused on cash generation, unit economics, and long term value creation. We are passive investors but will take a hands-on approach when necessary. Being in the field is the best way to influence and improve the performance of a business.

Third, we are generalists. Many hedge funds have slotted themselves into sectors or industries and are so specialized that they sometimes cannot see the forest for the trees. We have created our firm with the freedom to figure out what to work on. Generating our own ideas each day and figuring out where to focus our time has led us to outperform over time.

Fourth, perceiving risk differently from other funds is another important way of creating value. We do not view short term fluctuations in price as risk but as volatility, and we view volatility as an opportunity. All investing involves some level of risk, yet intelligent risks can be taken if one's processes include strategies to mitigate it.

Finally, our interests are totally aligned with our investors since all employees are invested in the Fund and we must pass a 6% hurdle rate on top of a high water mark, before earning any incentive fees.

Among the many benefits that flow from our various competitive advantages are that our correlation to the markets is minimal, we do not use leverage to generate outperformance, and the great majority of our gains are long term and tax efficient for investors.

How do you go about looking for an investment (both long and short) at Phoenician; what's your investing process?

Our goal is to build a global portfolio of companies with managements who think and act like owners and understand value creation. The investment process starts with screening and we are particularly focused on screens that can help elucidate undervalued securities.

The screens arose out of a desire to design a pragmatic screening tool for evaluating equity securities with consideration given to the growth estimates of an enterprise. We have developed automated models that allow us to rapidly and effectively screen companies and calculate key metrics that would not otherwise be accessible without substantial effort. Our proprietary models reverse engineer a company's market price into a forecast of "implied expected return", and then calculate "intrinsic value" per share and a price/value ratio using a residual operating income model. The models are useful in determining whether there is directional evidence of a margin of safety within equity securities and they constitute a solid starting point for screening and evaluation, but they are not to be used as an end in itself.

Once a company has been selected on the basis of potential value, we read all of its publicly available documents (S-1, 10-k, 10-q, proxy statements) and over the course of weeks spent analyzing the different aspects of the business from afar – its products or services, the industry it sits in, its geography, competition, and prospects for growth – we go and see people; management, suppliers, customers, bankers and competitors.

How do you approach valuation?

Most investors would agree that the value of a business is the present value of its future cash flows. To value a business effectively, one needs to have a firm understanding of how a business operates, where it adds value, and how it returns value to investors. A valuation model conveys a false sense of precision since on the one hand it results in a precise mathematical value, but on the other hand it incorporates "suspect" components (long term growth and required return rates) which lead to that precise value.

DCF is the most popular valuation model, however for companies that are continuously investing in their operations to generate future growth, free cash flow (FCF) is not a good gauge of value: FCF is reduced by cash investments, but investments usually add value rather than reduce it. Firms that are growing and highly profitable often report negative cash flows as they are constantly reinvesting lucratively in their businesses. The DCF model fails to recognize this and instead treats such firms as though they are troubled.

Our valuation model is an accrual accounting valuation which anchors on book value and earnings. Investments are positioned on the balance sheet rather than subtracted from earnings and, income accrual flows are recognized in earnings. A firm only adds value if it earns a rate of return on book value greater than the required return. Growth is a key determinant of value but although growth can be accretive, it can also be dilutive. I have developed a process that uses estimates of the required return for operations to determine whether such growth is profitable for the enterprise and, by extension, for the owner of the stock.

Our valuation model is also an enterprise valuation, which means it takes into account the net values of debt, excess cash, and minority interests. Our investors can therefore rest assured that no stone has been left unturned in our valuation model. Opportunity lurks when there is directional evidence of a steep discount of price-to-value – our goal is to invest in companies at 25 to 50 cents on the dollar.

What are the qualities investors should be looking for when trying to identify the best companies?

The best companies are those that; take care of their customers' needs better than anyone else, have a large and unaddressed market, have managements that demonstrably think and act like owners, and produce significant returns on invested capital. Great businesses tend to surpass expectations over and over again, yet few investors ever hold them for the long term. Value investors sometimes do not understand the exceptional value of what they own and trade down for a lower quality business that looks cheaper. It is difficult to acquire the discipline of active patience.

How much concentration are you prepared to take in a portfolio, how would you weight your best idea?

Historically, our portfolio has consisted of approximately twenty-five companies. Our top five positions have averaged 8% each of the total portfolio, the next five have averaged 4% each and we've held approximately 15% in cash. We don't borrow and are fairly liquid – more than 75% of our portfolio could be liquidated within one week and 100% could be liquidated within four weeks.

After an idea has passed the initial screening and research phase, we run it through a proprietary process which we refer to internally as the "sixteen points". All ideas go through the same rigorous process and the one that ranks the highest makes it to the "best idea" stage. The concentration limit for our top position is 10% at cost and 15% at market.

Would you mind sharing some of your current holdings or perhaps your highest conviction idea?

We've recently added Trupanion to our portfolio. The company, based in Seattle, provides medical insurance plans for cats and dogs in the U.S. and Canada via a direct-to consumer monthly subscription service. Darryl Rollins, CEO and Founder, has built the business over the last fifteen years. Darryl and his team have achieved 25% growth per annum since launching in the U.S. in 2008, and took Trupanion public in 2014.

The pet insurance industry in the U.S. is still small with a penetration rate of 1% versus penetration rates in other developed countries which range from 5% to 40%. The U.K. for example, with 16 million pets, has a penetration rate of almost 25%. With 177 million pets in the U.S. and Canada, Trupanion is poised to dominate the market. They have recently been capturing 40% of all new pet enrollments in the U.S. which signifies a greater momentum shift in the growth of the U.S. pet insurance market. Every 1% increase in the penetration rate adds $1 Billion to the size of the addressable market.

Can you reveal one stock that's attracting your interest right now or maybe a stock that's on your watch list?

A company that we have owned in the past has recently come back on our radar. With the passing of time, it has gotten more valuable while its price has gotten cheaper which is a perfect combination. Radnet, the largest national owner and operator of outpatient diagnostic imaging centers, delivers high quality and cost effective imaging to consumers. Founded as a one center California operation in 1980, the company today has revenues of over $800 million from 310 locations across seven states.

Radnet is the largest consolidator in the highly fragmented imaging industry. Growth has been achieved through acquisitions (low multiples of EBITDA purchases) and demand is fueled by the culture of preventative medicine.

By leveraging economies of scale inaccessible to "mom-and-pop" imaging offices, Radnet offers long term stability to operators who want to join a larger and stronger infrastructure. The focus on scale has also paved the way for innovation. For example, Radnet is the only imaging center to provide exclusive managed care capitation arrangements with medical groups and insurance companies. What is interesting to us is that Radnet has achieved unparalleled scale in the imaging industry but the company's growth potential is still tremendous.

Do you invest outside the US? In which other markets around the world are you finding value?

Yes. We are currently invested in several European companies and we continually look for companies globally that fit our investment criteria.

And lastly, what advice would you give to value investors who are just starting out (or even experienced value investors) to help them navigate today's market?

Find your niche, find your own style, craft a robust investment process, and stick with it.

On a more personal level, I would add that to run a business that rewards not only the founder but also investors, the people who believed in what was being created, can be of enormous personal satisfaction.

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