Seeking Alpha

Long Ideas

SA Interview: Quantitative Value Investing With Jonathan Selsick

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Summary

- Jonathan Selsick is a Registered Investment Advisor who employs a long/short equity strategy focused on small/mid caps and a rules-based adaptive asset allocation strategy for retirement accounts.
- One of the first questions to ask when looking at a company, the value in certain mall REITS and how a stock can drop even if growth expectations are met are topics discussed.
- Jonathan Selsick shares a long thesis on Smart & Final Stores and Diebold Nixdorf.

Feature interview

Jonathan Selsick is a Registered Investment Advisor who employs a long/short equity strategy focused on small/mid caps and a rules-based adaptive asset allocation strategy for retirement accounts. We discussed with him the dangers in shorting a stock with a high short interest, how to identify turning points in the economy and why investors may want to stay away from PE-backed IPOs.

Seeking Alpha: Walk us through your investment decision making process. What area of the market do you focus on and what strategies do you employ? How do you find long and short ideas and what do you look for in them? Can you give an example?

Jonathan Selsick: The decision making process starts with having a big picture view on the market as a whole. This is essentially a rules based process using a quantitative framework I have modelled for understanding how the market behaves. Beyond that, I maintain a list of 50-60 stocks on my watch list, which I keep adding to, primarily long ideas of companies that I would like to own for the long term.

The sectors I focus on are mostly consumer, services, industrials, REITS, and some technology. I don’t really have any self-imposed constraints on industry type, but gravitate toward business models that are easier to understand.

I would consider myself a value investor. For long ideas, I try to determine the fair value and then decide on a price that would be a bargain, assuming no change in the fundamentals. Then, it's a process of waiting patiently for the bargain price to come around. The larger my watch list of candidates is, the higher the likelihood that something will be on sale. A lot of times I am researching a company that I know may be expensive at the moment, but is a company that I like and so will take the time to vet it properly and add it to the watch list, even though it may never get to a bargain price. It's not wasted time, because you generally always learn something by going through a company's 10K and investor presentations.

In terms of finding ideas, it's a combination of reading across a broad source of publications and using a stock screener. In addition to the usual financial news media, I enjoy keeping up with innovations in technology and business from sources like CB Insights, and some of the VC related websites. Finviz has a great free online screener which allows me to screen by company market cap and industry, as a starting point. If I am looking for long ideas, I look at stocks most down over the past year or quarter to see if there is anything in the bargain bin.

One of the first questions I ask myself when looking at a company is: do I think they will still be around in ten years' time, i.e. are the earnings and business model sustainable, and then also just think about the value of the assets (real assets, brand value, value to someone else). It's always a valuation thesis to start. An example of this is B&G Foods, Inc. (NYSE: BGS). In April of this year it was down 40% over six months and down 56% from its high two years prior. It's a solid consumer staples company, lots of well-known brands, a good operating model, the experience and resources to purchase smaller brands and scale them, and was selling at an 8% dividend yield which management assured was not at risk. Just a good value buy and something I could foresee owning for a long time. The stock added 40% over the next four months. It's down a bit again, but I still like it.

SA: What type of reader should follow your work? Who are some of your favorite Seeking Alpha authors and why?

JS: My focus is two-fold. I have done a lot of quantitative work and modeling on the overall market and asset allocation, because understanding the big picture is still the biggest driver of portfolio returns. I have published quite a few articles on Seeking Alpha regarding market timing and asset allocation and long term investing. With those models mostly on auto-pilot, my focus is on finding smaller to mid cap stocks, mostly long, but some short as well. I don't follow large cap names that are well followed because I don't believe I can find bargains there.

The Seeking Alpha authors I like to read are Ben Axler, at Spruce Point. He puts out very detailed research and analysis with some creative ways of investigating things. Victor Haghani of Elm Funds puts out a few short big picture articles with lots of wisdom from a guy who knows about risk and leverage from his days at LTCM. Michael Boyd is impressive because he seems to be able to distill the thesis in short order and puts out a lot of content so he must have a deep inventory of research. I find it very helpful when researching a company, to see what other authors on Seeking Alpha have to say about it, to see if there is something I am overlooking, or to determine if what I thought was an edge is already widely known.

SA: Mall REITS are a battleground industry with bulls saying they are undervalued and bears saying they are value traps – where do you land on this and why? Are there any REITs that stand out as under or overvalued?

JS: I think it's important to differentiate between mall REITS that focus on enclosed malls (e.g. Simon Property Group, Inc. (NYSE: SPG), GGP Inc. (NYSE: GGP)) and those that own open air big box centers (e.g. Kimco Realty Corporation (NYSE: KIM), DDR Corp., recently renamed SITE Centers Corp. (NYSE: SITC). The business model for the enclosed malls is more challenged, in my opinion. That model provided large department stores space at a low rent in exchange for being a traffic generator for their small shop space which they could charge a high premium for. With a lot of the fashion oriented department stores under pressure this has reduced foot traffic inside the malls and their ability to drive revenue to the small stores. In addition, the operating costs for malls are much higher than open air centers. I see continued challenges for enclosed malls to get people inside their malls; there are exceptions to this such as tourist and transit type locations, but in general I think enclosed mall REITS outside of prime locations have challenges ahead.

Open air centers still have their challenges too, but I think will hold up over time, particularly grocery, lifestyle, or mixed use centers. Clearly, a lot of big box retailers are being impacted by the shift to online shopping, ToysRUs being a recent example. But, on the other hand, companies like Office Depot, Inc. (NYSE:ODP) have mostly stopped closing stores, realizing that having a location close to customers can provide an advantage with an omni-channel offering, and there are a lot of other retailers that are adding locations in these types of centers (Lidl, Aldi, Ulta and many others). I saw an

Amazon Books store about to open in my area in an end cap location of an open air mall, which tells me that having a physical presence with a high visibility storefront still has value, even for the king of online retailing. Even with store closures, in many cases, landlords are able to use these to their advantage by subdividing vacant spaces into smaller higher rent spaces. Repurposing vacant spaces for other uses is also much easier for open air centers than enclosed malls. In general, I think open air mall REITs are a decent value proposition at the moment paying 7% dividend yields.

I purchased DDR in March of this year, because I thought it was too cheap trading at an 11% earnings yield. They had a plan in place to spin out a portfolio of centers, now Retail Value Inc. (NYSE:RVI), that no longer met the long-term vision of owning more grocery-type centers, in better locations. If I think about valuation relative to the market in general, and relative to replacement cost, I think they offer good value. I still own DDR and the spin-off RVI. DDR currently offers almost a 7% dividend yield, so I think it is a decent place to invest some money.

RVI is an interesting play. It is essentially a liquidating REIT originally comprised of 50 or so centers with the stated plan to sell them all over the next 2-3 years. Most of these are decent centers, but there is a large Puerto Rico component (twelve properties; two enclosed malls and ten open air big box malls) which was severely affected by the hurricane and Puerto Rico's economic woes. Currently trading at 50% of book value, I think investors will get a good return over the next 2-3 years; they have already sold eight centers (about 10% of the portfolio value) at basically book value, so if they achieved this pace for the balance of the centers, you should double your money. If they just sell the U.S. assets at book value, you end up getting the Puerto Rico assets for a very low price (about 30% of the space is leased to Walmart).

SA: Can you unpack the great point you made in your bearish thesis on Ulta Beauty (NASDAQ:ULTA), which dropped ~30% over the next seven months, re how a stock can drop even if growth expectations are met?

JS: The point I was making with ULTA was that investors were pricing in growth, i.e. a high P/E multiple, as though it could continue indefinitely without hitting a barrier, when management's own projections for their store roll out indicated that their store count would stabilize in 7 years when they had reached their store potential. It's a simple case of being easier to grow when you are relatively small, but the larger you get, the harder it becomes to maintain those growth percentages. The stock has recently recovered a lot of those losses, but we'll see what happens. I would not own the stock at these levels.

I observe the same phenomenon for the market as a whole; investors reliably price the cyclically-adjusted equity risk premium for the market based upon the last four years real GDP growth. In other words, as real GDP gets better, the equity risk premium declines, meaning higher P/E multiples. Investors price the market as though GDP growth can continue apace forever. However once the economy gets closer to capacity, and resource constraints start to appear, it becomes harder to maintain the growth. Investors either do not consider the growth rate that far out, or they think they will sell before everyone else realizes the same thing.

SA: All else being equal would you rather short a stock with a low or high short interest and why? Are well-known short ideas any less attractive because they are so well known?

JS: As a general rule, I think any idea, long or short, is less attractive, or at least less interesting to me, if the thesis is well known.

I think it is dangerous to short a stock with a high short interest, particularly if your short thesis is valuation based, as opposed to some type of accounting fraud. There is always a risk that some suitor sees value in a buyout, which can lead to a short squeeze, leaving you exposed to potentially large losses. An example that comes to mind is when Ant Financial, the Chinese company, tried to buy MoneyGram International, Inc. (NYSE:MGI) – I think that surprised a lot of investors because I don't think Ant Financial was on anyone's radar.

SA: What are some of your favorite or notable signs of a top or bottom in a stock, industry or market? Are there any you have acted on in the past and if so how did it play out?

JS: I think it is difficult or perhaps impossible to predict turning points with individual stocks. I have not had much success with this. I think the overall market is more predictable, if you are talking about a 3-6 month horizon and beyond. For longer term turning points, I would recommend looking at capacity utilization rates in the economy (unemployment and facilities utilization and the GDP output gap). Once you start bumping up against resource constraints, growth gets harder to achieve, and interest rates are generally rising. Once the market realizes that growth will slow, there is usually a reset in prices. We're getting close to that point in the cycle now.

SA: Are there any red flags investors should look out for when evaluating a company being brought public by a PE firm?

JS: PE firms are smart and know how to “prep” a firm for an IPO. Things like underinvesting and running an abnormally tight ship for a few years before IPO in order to boost the earnings. While you may be getting a fair price, I think it is unlikely you are getting a bargain, so I stay away from these offerings. That being said, I have been very wrong on Planet Fitness, Inc. (NYSE:PLNT), which I wrote about as a short idea when it was $23 and is now around $48. Even the PE firm didn’t see that double coming, since they also bailed out of their holdings in a series of transactions at around $20 - $25.

SA: What’s one of your highest conviction ideas right now?

JS: I’ll give you two ideas. The first is a grocery retailer, called Smart & Final Stores, Inc. (NYSE:SFS). They have 322 stores, mostly California and the business model appeals to both household and business customers. It’s a well-managed company, been around for over 100 years. 64 of their stores are a separate warehouse concept, Smart Foodservice, catering mostly to restaurants. I know the company well because I shopped there for 15 years when I was in the foodservice industry. Their market cap is $400 million and enterprise value is $1 billion. EV/EBITDA is about 6.5. They are disciplined with capital allocation and planned new store growth. Their new stores generate a cash-on-cash return of 20%-25% after three years. Their business customer base makes them more resilient to traditional grocery competition. Their top line revenue was negatively impacted over the past few years by price deflation in many staples, but inflation has picked up more recently and so we should start to see better comps on the top line going forward. In a low margin business like grocery, a 2% delta on the top line can make a big difference to earnings. New stores in 2018 will add about 3% count. The stock is close to its 3-year low having declined by two thirds over the past three years. In sum, a well-run consumer staple business that should see top line growth of 5% per year at a very reasonable valuation - a conservative value investment.

My second pick is at the other end of the risk spectrum, but I think could be a big winner. Diebold Nixdorf, Incorporated (NYSE:DBD) was on my watch list when it was at $12, with a note to buy if it gets below $8. Well it dropped below $8 after last quarter’s earnings report and is now down to $4. Earnings were not good and they also had a liquidity event related to having to buy outstanding shares in Nixdorf which were put to them. They resolved the liquidity issue with a new $650 million loan, albeit at a high interest rate – Libor +9.25%. The enterprise value is a little over $2 billion and the market cap is $300 million. Their top line revenue is not growing at the moment but is stable at $4.5 billion per year – so a decent size business. They purchased Wincor Nixdorf in 2016 and the integration needs some streamlining.

Adjusted EBITDA guidance for 2018 is $280-$320 million and the company has an operational plan in place, DN Now, to generate an incremental $200 million per year by the end of 2019. If they are successful in achieving the operational savings, the enterprise value should be perhaps $4 billion (8 times adjusted EBITDA). This would imply a value for the equity of approximately $2 billion or approximately $26 per share. CNBC reported on August 13, 2018 that they had hired Credit Suisse and Evercore to seek a potential sale so that could be interesting too.

There is a lot of embedded value here that would be very expensive and time consuming to replicate. This is a well established top 10 financial technology company (hardware and software) that has relationships with every major financial institution (ATM’s) and many of the largest retailers (point of sale solutions and connected commerce). They have 23,000 employees. Their enterprise value per employee is $87,000 which is one third that of competitor NCR, so quite a difference. The revenue is in place and fairly stable, and is well spread out in terms of number of customers. I see it as mostly an operational challenge at this stage (not a revenue challenge) which is what their DN Now plan is addressing. I like the risk-reward on this one.

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Thanks to Jonathan for the interview. If you'd like to check out or follow his work, you can find the profile here.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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Additional disclosure: Jonathan Selsick is long ODP, DDR, RVI, SFS, DBD.

Comments **(0)**