Interview With Centerstone Investors

ValueWalk

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First off, could you tell our readers a little about Centerstone and the fund's investment strategy?

Centerstone Investors was launched in 2016 and is a New York-based global value investment management firm registered with the US Securities and Exchange Commission. We are privately owned and pride ourselves on our 100% employee ownership culture.

We offer two risk managed, value-oriented Funds. The Centerstone Investors Fund (CENTX) is a global multi-asset strategy, focused on investing in both US domestic and foreign assets and seeks to generate equity-like returns with less risk than pure equity or index funds over a long-term investment horizon. The related strategy, the Centerstone International Fund (CINTX) seeks to generate long-term growth of capital by investing across international markets, including developed and emerging markets.

You have a relatively broad investment mandate when looking for investments. You can invest in almost any country around the world, as well as the high-yield space. What do you look for in a prospective investment, what makes you say, "yes we want that" or "no we don't"?

We look for businesses that have strong balance sheets, business model durability and management teams with a good track record of capital allocation. Highly leveraged businesses are more prone to experiencing an impairment in their intrinsic value during periods of distress and we have seen enough examples of this to avoid them. In addition to strong balance sheets, we seek to invest in businesses that have durable business models. These are businesses that have generated attractive returns and results over a long time period. The duration of these attractive results and returns is critical. Finally, we seek to invest in businesses that have management teams that have a history of allocating capital wisely. Capital allocation can have a significant impact on intrinsic value over time and we seek to avoid management teams that do share buybacks at inopportune times or make expensive acquisitions.

As global investors we have a large universe to look for prospective investments that meet our criteria. Although it should be noted that we typically have limited direct exposure to emerging markets as well-developed accounting standards and strong corporate governance are important to us and these can be lacking in some emerging markets. Many of the companies we have invested in may not be domiciled in emerging markets, but they may have a strong presence in these markets. As the world has become more global, it has become more important to look at where a business's sales and profits are generated and not just where it is domiciled.

Any case studies where it all went wrong that you could share?

In the late 1990s, as an analyst, I recommended the shares of footwear company Fila. Fila had been growing rapidly on the back of an endorsement deal with NBA star Grant Hill but then began to show some order weakness of its flagship shoe. The stock, which peaked near $80 declined to $40 when I recommended its purchase. The appeal was that they had been successful in the recent past, that the stock had declined by 50%, and that based on history, the stock appeared undervalued. There were three mistakes. First, I was reflexively contrarian, a trait of many value types. Over the years, I would learn that it's better to be skeptical, rather than cynical. Second, I relied on "reversion to the mean" in a famously fad-driven industry. In this case they compete against much larger companies with much deeper pockets for endorsement deals, which made it very hard to recreate what they had with the Grant hill shoe. Third, the cash flow statement should have led me to conclude that the business never generated any free cash flow to owners. The company eventually went bankrupt.

What kind of metrics do you use to try and establish if a particular investment is attractively priced? What sort of discount are you looking for?

We seek to invest in companies when their market price is below their intrinsic value. We assess a company's long-term earnings power when calculating intrinsic value. We make adjustments to operating profit for non-recurring expenses, non-economic expenses and also for where we are in an economic cycle. These adjustments aim to help us better assess the long-term earnings power of a company in a normal economic environment. Further, we look for businesses that have generated stable results and returns on invested capital throughout an economic cycle.

The discount to intrinsic value that we require varies. For high quality, long-duration businesses we are willing to pay a smaller discount to intrinsic value than we would for more cyclical businesses.

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

One holding that does a good job of reflecting our approach and what we look for in an investment is Emerson Electric (EMR). As of August 31, 2016, Emerson Electric was a 1.11% position in the Centerstone Investors Fund. Emerson was founded in 1890 and is a conglomerate in the truest sense of the word, with market leading franchises that span everything from air conditioning compressors to garbage disposal units to control valves for the oil & gas and nuclear power industries. Emerson's crown jewel is the Process Management segment, which accounts for a little less than half their profit and provides a broad range of automation solutions to customers across the oil & gas, power and chemical end markets. Here Emerson distinguishes itself from the competition by being one of only a handful of players globally with the product range and engineering know-how to integrate equipment as part of total solutions. By focusing on total solutions, the company has been able to add more value and earn higher margins than they would selling equipment on a standalone basis.

A very important dynamic in Process Management is that the solutions Emerson provides account for just a tiny fraction of the total project cost, but are often absolutely critical to the safety, reliability and efficiency of the customer's operations. A good example is the nuclear power plant industry, where the consequences of a failed control valve can be absolutely catastrophic, ranging from millions of dollars in damages to the loss of human life. Given what's at stake, any rational customer cares a lot more about getting a quality supplier than the small amount of money they could save by going with a supplier that's slightly cheaper. This in turn makes Emerson's strong brand reputation in the nuclear industry a huge competitive advantage, resulting in dominant market share. Emerson valves are installed in over 90% of the world's nuclear facilities and at premium pricing.

Aside from strong brands, a number of factors keep the Process Management business inherently well insulated from competition. For one thing, much of the equipment Emerson sells can last anywhere from 20 to 40 years, so competitors typically won't have an opportunity to come in until quite some time after the equipment has been installed. On top of that, the focus on offering total solutions means Emerson is likely to have a huge number of mission critical touch points at any given customer site. Switching out all that equipment for a competitor can be very tricky from an operational standpoint and there's a huge risk of unplanned downtime if something goes wrong. The more equipment you're trying to switch, the closer it gets to being the industrial version of an organ transplant and for that reason, most customers aren't eager to switch their automation supplier anytime soon.

Given the stakes if something goes wrong, it's also no surprise that service reliability is extremely important to the customer and a major factor in who they choose to buy equipment from. Emerson has a huge advantage in this regard as its massive global installed base – they've sold over $80 billion of equipment in just the past 10 years – gives them the scale to support a vast global service network, which in turn ensures the customer will be able to have their Emerson equipment serviced no matter where in the world the site is located. Having a well-developed service footprint not only helps you win the customer in the first place, it also makes it very hard for the customer to switch: sure, someone else may be able to sell you the equipment, but what happens when the equipment needs to be serviced and the new supplier doesn't have anywhere near the service coverage that Emerson does? In fact, a big part of Emerson's strategy is to co-locate their service facilities with major customer sites; that geographical proximity means it would be very hard for a competitor to provide service as effectively and cost-efficiently as Emerson can. Another benefit of having a strong aftermarket business – now more than 30% of consolidated revenue – is that the less discretionary nature of customer spending adds an element of resiliency to Emerson's results; after all, recession or no recession, it isn't really an option to stop having the equipment serviced.

Emerson also enjoys strong competitive advantages outside of Process Management, but the company's edge in these segments generally has less to do with switching costs and more to do with scale. For example, in markets like air conditioning compressors and garbage disposal units, Emerson is several times the size of their next closest competitor, which makes it virtually impossible for anyone else to serve the market as cheaply. In other areas, ever more stringent regulatory requirements and industry standards make it extremely difficult for new entrants to penetrate the market. This is especially true in the Climate Technologies segment, where increasingly stringent emissions and energy-efficiency standards have forced existing players to continuously improve their technology. This gives Emerson and the other existing players a very significant advantage versus a new entrant that hasn't spent the last few decades improving their technology and would effectively be starting from scratch.

Can you walk us through your investment thesis here?

Emerson's earnings have declined by approximately 25% over the past two years, with the company hit hard by a combination of factors, including a downturn in the oil & gas sector, lackluster fixed investment globally and a strong US Dollar. This has in turn caused a chain reaction for Emerson's stock price, with the shares now trading at around $52, down from a peak of approximately $70 at the end of 2013. However, we believe the sell-off has presented an excellent buying opportunity for those willing to hold Emerson with a long-term investment horizon. On the one hand we remain confident in Emerson's competitive position and that they have the balance sheet to endure a protracted down cycle, as net debt to EBITDA currently stands at a mere 0.6x. On top of that, we believe the slowdown in Emerson's end markets is temporary and that when these end markets recover, earnings may improve and the intrinsic value of Emerson's franchise will become much more readily apparent to the market.

We also believe that near-term headwinds are causing the market to overlook the transformation currently underway at Emerson, as the company sheds the commoditized network power, motors and drives businesses in order to focus on areas like Process Management where they have much more of a competitive edge. This re-positioning dramatically improves the margin and return profile of the business. The company estimates the 2015 pro-forma operating margin was 18% compared to the 15% that was reported and the pro-forma return on capital was 28% compared to the 18% that was reported. With the business now more uniformly high quality in our view, a potential premium multiple shouldn't be at all hard to justify. Thus, assuming only a modest recovery in the business lines that have significant oil & gas exposure we believe the shares are worth significantly more than where they are currently trading.

What's the timeline for the investment thesis to unfold?

We don't expect a recovery in Emerson's end markets to happen overnight and it may even take anywhere from three to five years. We are comfortable holding a cyclical business over that time period for several reasons. First, as we noted earlier, we're highly confident that we're buying into a business with an outstanding competitive position and a strong balance sheet. On top of that, we're buying into a company with an exceptional track record of increasing business value through the cycle, which they've done by consistently outgrowing their underlying markets from peak-to-peak and by steadily expanding their margins over the years. Indeed, even at their current depressed levels, Emerson's gross margins are over 500 basis points higher than they were 20 years ago. In other words, this is a business that has shown it can increase value even in a relatively weak end market environment. Lastly, there's a substantial "here and now" portion of our return as a result of management's decision to return virtually all free cash flow to shareholders in the form of dividends and buybacks, which corresponds to about a 6% yield on the current stock price.

What about in the high-yield space, are you finding opportunities here?

In the high yield space, our core principles of price-consciousness and downside protection still apply: we seek to buy bonds that are priced to deliver "equity-like" returns, but only if we're confident that those bonds will be money good under any reasonable operating scenario. However, given the recent rally in fixed income that's affected everything from high yield to Treasuries, it has been more difficult to find good ideas in the high yield space of late. As of August 31, 2016, the Centerstone Investors Fund had 6.56% invested in high yield.

Having said that, one high yield name we do like is PHI Inc., a US-based helicopter transport company where we're invested in the 5.25% coupon senior notes due March 2019. While offshore oil & gas is a major end market for PHI (as it is for most helicopter transport companies), the company also has significant exposure to less cyclical areas like emergency air medical transport. Even within offshore oil & gas, PHI's business is made more stable by the fact that they're typically serving producing wells rather than exploration sites. Aside from the relatively defensive end market positioning, another attribute we like about PHI is that the vast majority of the company's helicopter fleet is owned rather than leased, with a depreciated book value in excess of $800 million. As such, we feel we have a strong asset base backing our bonds and the cash flows should be less volatile than for helicopter companies stuck with long-term operating leases. We're also comfortable with our place in the capital structure as there are no material maturities ahead of the 2019 bonds and the company has a publicly traded equity market cap of close to $300 million. Right now our bonds are yielding around 7%, which we feel is an attractive rate of return for what is very likely to be a performing loan.

Does the fund tend to be highly concentrated or diversified?

We consider ourselves to be well diversified. When measuring diversification, it is important not to just look at the number of holdings in a portfolio. We are invested in companies that are in different industries and that have different geographic exposures. We don't have any outsized positions. Our goal is to generate attractive returns for our clients over a full market cycle with less risk relative to an equity benchmark/Fund. We believe that having a prudent level of diversification may help us to preserve our clients' capital during downturns and to potentially generate attractive returns over a full market cycle.

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?

While it can be more challenging to have a long-term time horizon during periods of a market cycle, we would suggest that investors remain focused on calculating intrinsic value and investing only when the market price is below intrinsic value. We believe that maintaining this discipline is the best strategy for potentially attaining positive real performance over a full market cycle. However, this process could lead value investors to make investments in out of favor industries or companies and value investors have to be comfortable being independent thinkers. In addition, value investors should be patient during periods in which other investment opportunities seem more exciting. Finally, maintaining your pricing discipline is critical in avoiding a permanent loss of capital. If you cannot identify attractive investment opportunities from a bottom-up approach, we believe it is prudent to hold a reserve in cash and high quality debt instruments until Mr. Market provides opportunities to deploy these reserves.

At Centerstone Investors we value flexibility. We suggest that value investors have a flexible mandate that enables them to invest in firms when their market price is below their intrinsic value. An investment policy that requires a portfolio to be fully invested at all times could expose investors to a greater risk of a permanent loss of capital in environments in which there is an insufficient margin of safety. It can be challenging to maintain a disciplined, long-term approach and we suggest that value investors establish a flexible investment policy that will make it easier to implement such an approach in all market environments.

Disclosures

Centerstone Disclosure

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The Centerstone Funds are new and have a limited history of operation. An investment in the Funds entails risk including possible loss of principal. There can be no assurance that the Funds will achieve their investment objective. In addition, the Adviser is newly formed and has not previously managed a mutual fund.

Domestic economic growth and market conditions, interest rate levels, and political events are among the factors affecting the securities markets in which the Funds invests. Value investing involves buying stocks that are out of favor and/or undervalued in comparison to their peers or their prospects for growth. There is a risk that issuers and counterparties will not make payments on securities and other investments held by the Funds, resulting in losses to the Funds.

Large-Cap Company Risk is the risk that established companies may be unable to respond quickly to new competitive challenges such as changes in consumer tastes or innovative smaller competitors. Investments in lesser-known, small and medium capitalization companies may be more vulnerable than larger, more established organizations.

In general, a rise in interest rates causes a decline in the value of fixed income securities owned by the Funds. The Funds may invest, directly or indirectly, in “junk bonds.” Such securities are speculative investments that carry greater risks than higher quality debt securities. In general, a rise in interest rates causes a decline in the value of fixed income securities owned by the Fund. The Fund may invest, directly or indirectly, in “junk bonds.” Such securities are speculative investments that carry greater risks than higher quality debt securities. Our value strategy may not meet its investment objective and you could lose money by investing in the Centerstone Funds.

Value investing involves the risk that such securities may not reach their expected market value, causing the Funds to underperform other equity funds that use different investing styles.

Investments in foreign securities could subject the Funds to greater risks including, currency fluctuation, economic conditions, and different governmental and accounting standards. Foreign common stocks and currency strategies will subject the Funds to currency trading risks that include market risk, credit risk and country risk. The Funds use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. There can be no assurance that the Funds hedging strategy will reduce risk or that hedging transactions will be either available or cost effective.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Centerstone Funds. This and other important information about the Funds are contained in the prospectus, which can be obtained by calling 1-877-314-9006. The prospectus should be read carefully before investing. The Centerstone Funds are distributed by Northern Lights Distributors, LLC, Member FINRA/SIPC.

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