IN175 Pzena INDepth

James Dunn: Hi, I'm James Dunn. Welcome to The Inside Network. Welcome to INDepth. I'm your host, Mishanda Here, and today I have Akil Submanan joining us from Pzena Investment Management. Welcome.

Akil Submanan: Thanks for having me.

Mishanda Here: China has been under the spotlight as of late. Where does Pzena see value in China?

Akil Submanan: Yeah, China has indeed been under the spotlight. What we've seen over the last four years is valuations have really come in, and that's been due to a whole host of factors. A lot of them are macro, a lot of them are political. That's interesting for us, but that's not enough. What we are looking for in China is a collection of businesses that have not just a macro or country-specific issue, but also an industry or company-specific issue, and that really allows us to pay a very, very low multiple of normalized earnings. Everything we do at Pzena is around normalized earnings, which is a 5-year-out midcycle earnings estimate. Over the last four years, we've gone from a position of underweight to overweight in China, primarily because we're finding good businesses that are trading at low multiples of normalized earnings. These are not just companies that are 100% inwardly focused in China. There are also global businesses, and we think that they represent a competitive value proposition globally. Haier comes to mind. That's a company that makes appliances—fridges, washing machines. They own the GE brand in North America, and they manufacture locally in North America. What we're finding in China is both inwardly and outwardly focused businesses trading at a very low multiple of normalized earnings, primarily because of the spotlight that you mentioned, concerns around the macro, concerns around the political.

Mishanda Here: Could you please tell us a little bit more about Pzena's investment philosophy and process?

Akil Submanan: Sure. Look, we are a value manager, and what that means is we want to buy a good business at a good price. We really want what everyone else wants: we want a good business, good returns, good management team, good capital allocation, but the last thing that really differentiates us is we want to pay a good price, which means we're cheap skates. We want to pay a low price for a business. We think in order to pay a good price for a good business, something has to have gone wrong. What we're hoping to do is find situations where whatever has gone wrong, whether it's an industry downturn or a company-specific issue, is temporary. What we want to do is think about what midcycle earnings look like and pay a low multiple of midcycle or normalized earnings. Everything we do at Pzena is around paying a low multiple of normalized earnings for a business. The way we do that is we believe we have a systematic, repeatable approach for screening the universe. So we rank every company in our universe from cheapest to most expensive. We have a screening tool that's an internal software that we've developed, and that screening tool allows us to focus on the cheapest 20% of the universe on our metric, priced at normalized earnings. So we're always looking in the cheapest

20% of the universe, and that's typically companies where something has gone wrong—it's either an industry downturn or a company-specific issue. We are harnessing the fundamental, bottom-up research that our analysts are capable of by looking into the businesses and saying, “Is this a good business? What are the returns like? What has gone wrong? Is it a temporary or permanent problem?” What we're really looking for is a company with a temporary problem that's a good business. As we think about 5-year-out normalized midcycle earnings, we want to pay a low multiple of that earnings for a business. Given the fact that we have a screening tool that's always pointing us toward the cheapest quintile and we have an analyst team that's researching those opportunities, we feel like over a long period of time, this is a systematic, repeatable process of screening our universe, identifying stocks via the screen, and then doing the fundamental, bottom-up stock selection to create a portfolio of approximately 50 to 60 securities.

Mishanda Here: Thank you. And what do you look for in value investing in Emerging Markets? Can you please provide an example of a company that you're currently invested in and what characteristics you're looking at?

Akil Submanan: Yeah. Look, as I mentioned, we want to find a good business that's trading at a good price. One example I can give you is a bank in Peru called Credicorp. It has generally been viewed as a blue-chip. It typically was in, you know, portfolios of core and growth managers because it's a good business. It has a very strong value proposition, a very good franchise, both in personal lending and microfinance. For a long portion of its life, it was trading at a good multiple. Then we had some political uncertainty in Peru. We had elections. We had talk about nationalization, and that caused the stock price to fall and the multiple to compress. What happened was this company fell into our cheapest quintile. So, which is to say, we look at the universe and we rank every company on normalized earnings, and this one fell into that cheapest 20% because of this political and macro uncertainty. At that point, we went into, you know, deep fundamental research mode. We analyzed the business. We sort of agreed that it was a good business with a good market position. It was taking share from local competitors. We understood what the risks were on the political and macro, and we tried to financialize what bad would look like. What would government interference look like? What would a credit cycle, which is to say, credit costs skyrocketing, look like? We felt comfortable that the company was capitalized and strong enough to weather a prolonged downturn, whether that's through interference or maybe a bad macro. After doing all of that, we decided to make the investment because we thought, at the end of the day, we're buying a good franchise that has a history of good returns at a very low multiple of normalized earnings. This is typical of the kind of company that we're looking for: good business that comes in at a good price because something has gone wrong, and ultimately we want to say, is it temporary or permanent? If permanent, we wouldn't want to make the investment, but if it's temporary and we can pay a low multiple of normalized earnings, that's really what we're looking to do.

Mishanda Here: Thank you. And Brazil's also another emerging country that has had its own raft of issues recently. Are there any opportunities that Pzena currently sees in that space?

Akil Submanan: Yeah, so we are actually overweight Brazil. We have a lot of very interesting opportunities, but one I can tell you about is a cosmetics company called Natura. This is a collection of brands, including The Body Shop and Aesop, which they've both sold at the moment. But when we looked at this business a year ago, it was about six times levered, so heavily indebted, and it had a bunch of operational issues. Then we woke up one day and found out that Natura had sold the Aesop business to L'Oréal for a very, very high multiple of EBITDA, and the balance sheet just went from net debt to net cash overnight. But the stock didn't move. I think this is sometimes you get this experience in EM, where fundamentals are improving but because the sentiment is so poor, you may not see a reaction. So for us, we were very excited by the opportunity to invest in a business where we knew there were some temporary problems and operational issues that the company had. We had stayed away because the balance sheet was quite levered, but after they sold this business at a high multiple and they delevered the balance sheet, we felt much more comfortable making an investment. And over the last 12 months, we can really see the operations and the fundamentals of the business improve, and we're excited to see the company starting to generate cash flow and return that to shareholders.

Mishanda Here: Lastly, what are the greatest learnings that Pzena has had in emerging markets through a value lens?

Akil Submanan: Yeah, so I think the greatest lesson is that we really believe value investing works in EM. A lot of people have this conception that EM is associated with growth, so you may tend towards growth investing, but what we find is what we do at Pzena, which is systematically screening the universe for companies that are undergoing pain and buying companies where that pain we believe is temporary, really works. I think the reason is because often people have behavioral biases towards moving away from uncertainty and judgment, and often in EM, this happens all the time. What we've learned is really anchoring to what midcycle 5-year-out earnings look like and wanting to pay a low multiple at that can really work in EM because our process lends itself to trafficking in the bottom 20% of the market where something has gone wrong. There is fear, there is uncertainty. That can be at the company level, that can be at the macro level, that can be at the political level. Our process of sticking our analyst team to really dig into these business-specific issues and finding good ideas that are trading at low multiples of normalized earnings really lends itself to EM because we're operating in an environment where often people aren't doing the fundamental, bottom-up research, and we get that behavioral advantage.

Mishanda Here: This has been INDepth, and I am Mishanda, your host. Thank you, Akil, portfolio manager from Pzena Investment Management, for joining us today.

Akil Submanan: Thanks for your time.