

Gaining Leverage

Investors often try to turn insight from one company or market into money-making opportunity elsewhere. Apis Capital appears to be particularly good at it.

INVESTOR INSIGHT



Apis Capital

Daniel Barker (l), and Eric Almeraz (r)

Investment Focus: Seek companies – generally those which are small and under-followed – for which a global perspective can provide a meaningful investment edge.

In founding Apis Capital in 2004, Daniel Barker and Eric Almeraz didn't want the typical constraints money managers face from things like market cap, geography or industry focus. "If we learn something in Germany that gives us an edge in Japan, great," says Barker. "We want to invest wherever we get the most leverage to our research."

That approach so far has worked splendidly. The long/short Apis Flagship Fund has since 2004 earned a net annualized 9.3%, vs. 6.4% for the MSCI All Country World Index. Their smaller-cap Deep Value Fund started in 2005 has delivered an annualized 13.0% net, vs. 6.0% for the same MSCI benchmark. Among areas in which Barker and Almeraz currently see opportunity: credit-card processing, semiconductors, online gambling, solar power and mail service.

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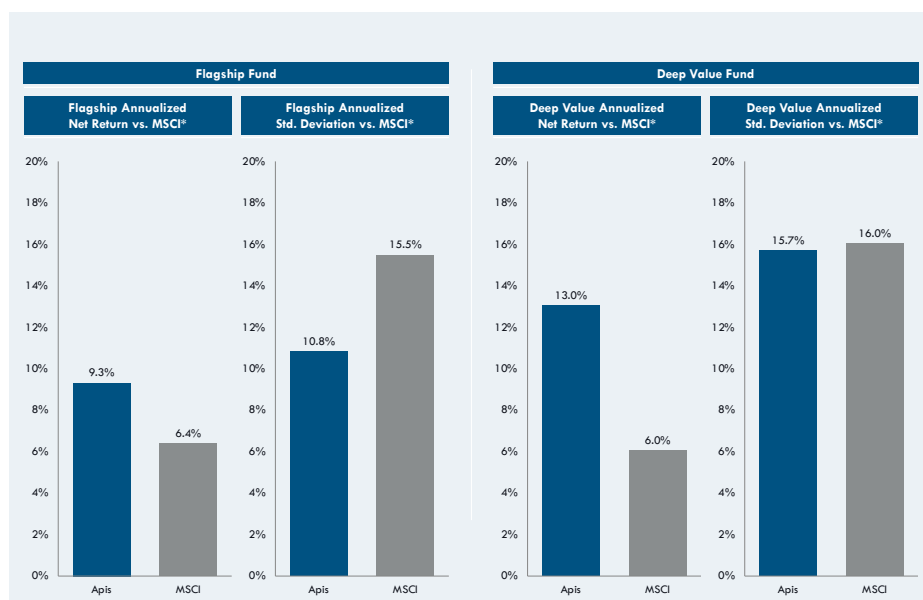
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Since inception, the Apis Funds have outperformed the MSCI All Country World Index (ACWI) with similar to lower volatility

Performance through May 2020



Note: Net returns generally assume a "1.5/20" fee structure and those for Day 1 investors. Investors entering the Deep Value Fund after June 1, 2007 are generally subject to a 2% management fee and thus would have lower returns. Please see disclaimer.

Investor Insight: Apis Capital

Daniel Barker and Eric Almeraz of Apis Capital explain how they think they can gain a competitive advantage, how they source ideas in a global 15,000-stock universe, how they try to avoid the value investor's curse of selling too soon, and what they think the market is missing in Intelligent Systems, Tokai Carbon Korea, Kambi Group and Royal Mail.

You describe your strategy as seeking investments “where we believe our research achieves the most leverage, inefficiencies are greatest, and analytical competition is weakest across countries, sectors, and market capitalizations.” Explain that in more detail.

Daniel Barker: Eric and I first started working together back in the early 2000s at J. & W. Seligman & Co., where I was managing funds focused on emerging markets and small and mid-size companies. We kept coming across situations where companies were competing on a global basis and a lot of times in doing research on one company it might shine a light on another company somewhere else.

One example I always use was our owning a generic pharmaceutical company in India called Ranbaxy Laboratories and seeing that it had filed a patent challenge to Pfizer's blockbuster cholesterol-lowering drug Lipitor. If that was successful – and as we did our research we came to believe it very well could be – that meant Lipitor's patent protection would end five years or so earlier than expected, and that every long-term Wall Street model for Pfizer was wildly overstating Lipitor's contribution, which accounted for as much as half of Pfizer's profits. But we were supposed to be looking only in emerging markets and only at smaller companies, so there was nothing we could do with that. In starting Apis, we didn't want to be restricted by an investment mandate from going wherever the research took us and investing, long or short, against that.

What that has meant in practice is that we focus on small-cap and mid-cap companies in Asia, Europe and North America that often compete in global industries, typically in the technology, healthcare, industrials and consumer-goods sectors. We're looking for situations where a global perspective can give us unique insight

and therefore an advantage over what, because our companies tend to be fairly small, is more retail-investor competition. We've typically made more of our money in Asia, particularly Taiwan, South Korea and Japan, which have liquid markets and active retail investor bases. We don't expect to have much of an edge in a gi-

ON STRATEGY:

We're looking for situations where a global perspective can give us unique insight and therefore an advantage.

ant company like Samsung Electronics, or in very localized businesses like Hong Kong real estate or German utilities, but in smaller companies where we might be able to connect the dots a bit better globally than our competition, we've been able to find opportunity.

To give one representative example, we were short a company in Belgium called Bekaert [Brussels: BEKB] that makes cables, tire cord and other similar products. One of its blockbuster products for a while was sawing wire, a very thin wire used to slice semiconductor wafers. When the growth in solar-related investments took off in China, demand for this sawing wire went through the roof and the company was earning supernormal profits for a while. It turned out to be somewhat of a bubble, and Bekaert came out with a profit warning tied to sawing-wire overcapacity and falling prices.

There is an analog company in Japan called Tokyo Rope [Tokyo: 5981], with a similar profile to Bekaert and that was showing the same explosion in profitability that had the stock hitting all-time highs. But when this obvious comparable in Bel-

gium started talking about how the game in China was over, nobody noticed with Tokyo Rope. We shorted it and it took four or five months to pay off when the stock finally collapsed after the company reported a significant profit shortfall. All our ideas aren't quite as straightforward as this, but it's a good illustration of what can happen.

To the extent that you can generalize, describe the profile of companies you look for on the long side.

DB: We're generally attracted to businesses that fall into the “compounder” bucket, which to us means they hold dominant competitive positions in markets that are healthy and growing. Very often they're run by owner/operators, and despite maybe being relatively small companies, they have world-class products and often an export orientation.

Eric Almeraz: A good example in the portfolio today would be Sinbon Electronics [Taipei: 3023]. It's a roughly \$1.2 billion market-cap company that is an important player in the business of electronic-component and cabling integration and assembly, serving a variety of end markets in industry, healthcare and green energy. It sounds kind of like a commodity business until you look at the financials, which show exceptional returns on capital and strong cash-flow generation. They provide quite complex solutions that have to perform at a high level with no mistakes, so customers aren't necessarily looking for the cheapest option.

Sinbon's earnings per share have been growing at about 15% annually for the past ten years. The shares today [at around NT\$149] have rebounded from their mid-March decline, but trade at only 15x forward earnings. We think that's quite attractive for a resilient company

that can continue to grow earnings at a double-digit rate.

Given the breadth of your opportunity set, describe how you source ideas.

DB: We do believe in the Peter Lynch approach, that whoever turns over the most rocks wins. You read everything and talk to everybody. We will always have to do our own work and reach our own conclusions, so to us there is no bad place to get an idea. It could be screening, talking to companies, talking to brokers, reading someone's research, following someone on Twitter, meeting someone at a "cocktail party." We actually love the chase, and even if 99% of the time it takes us nowhere, hopefully we learn something that helps us in some way.

In our world of stocks we have probably 15,000 potential names to look at, so a big benefit of experience is knowing how to filter out the less promising paths to go down and pick out the little morsels you want to follow that you think are more promising. Twenty or thirty years ago, getting at information was the tough part. Now the premium is on sifting through too much information to focus on what has the best chance of being actionable.

EA: We spoke about Sinbon Electronics, which actually came to us through a quantitative screen looking for high-quality financial metrics. The combination of it being a business that at first glance looked like a commodity one, but with financials that certainly weren't commodity-like, made it something we wanted to find out more about.

Often just going up and down the supply chain and across the competitive frame will surface ideas we otherwise wouldn't have looked at. To give a past example, in 2017 China started cracking down on environmental violations in the country. A number of industries were affected, but one that caught our eye was for processed magnesite, which is a type of rock that is crafted into bricks and used to line the interior of extremely high-temperature furnaces like those for making steel.

To make the bricks you have to heat the magnesite up, and the producers in China – which controlled 60-80% of the global supply – typically did so using coal, one of the worst environmental offenders. You could see that as the state started cracking down on environmental violations, prices for magnesite-based products skyrocketed. Our thought then was if you made this same product outside of China, where

ON IDEAS:

We will always do our own work and reach our own conclusions, so to us there is no bad place to get an idea.

you were already in compliance with your own country's regulations, there would probably be significant upside from this price increase. That led us to a company in Austria called RHI Magnesita [London: RHIM] which had significant earnings leverage to higher prices and a few other things going on that made it attractive. We likely never would have looked at it if we didn't follow where our research in China took us.

DB: To give another example of what attracts our attention, we recently came across in an independent publication a mention of a small company in Germany called Endor [Munich: E2N]. We've come over time to appreciate many of the business models around the world in recreational gaming, from videogame publishers, to distributors, to companies that make related hardware. So we were somewhat predisposed to be interested in Endor, which makes professional driving gear for iRacing, an online platform for car-racing simulations where you can compete with people from around the world. The company has exclusive licenses with firms like Porsche and BMW, and with racing governing bodies like Nascar and Formula One. This is high-end stuff, with equipment packages including things

like an authentic steering wheel, shifter and foot pedal going for \$1,500 or more, all sold online.

We just found this company in the past two months, but the business even prior to the pandemic had been growing at 50% per year. With the pandemic that growth should increase – they're having a difficult time keeping up with demand at the moment. Even with all that, while the stock has increased a lot, earnings have as well and the current share price [of around €143] is only 15x or so this year's estimated EPS. There's still a lot of discovery to be made on the company and stock. All the financials are in German. There's no Investor Relations department. There's no analyst coverage. This is a perfect kind of idea for us.

Are there very often thematic elements to your ideas?

EA: There can be. The solar space, for example, is an area where we've been active on both the short and long sides since our inception. It can be terribly cyclical up and down the supply chain – often driven by the current state of government subsidies – but the market overall has grown strongly and continues to do so.

One opportunity we see today on the long side is in the relatively new segment of the market consisting of solar-farm operators. These are companies that buy solar panels, install and connect them to the power grid, and then sell the power as independent producers. We've invested in four companies doing this in Europe and Asia – West Holdings [Tokyo: 1407], Encavis [Xetra: CAP], Solaria [Madrid: SLR] and 7C Solarparken [Xetra: HRPK] – which we expect generally to benefit from the same thematic dynamics. These include stable and high revenue visibility, low operating costs given that the primary fuel is sunshine, falling fixed costs as the prices of solar panels continue to decline, very low interest rates, stricter carbon-emissions regulations, and even increasing investor demand for shares that are deemed ESG-friendly. These are currently some of the larger positions in our funds.

We read that your process includes a monthly “rebuy the portfolio” meeting. Describe that.

DB: We have a weekly research meeting which is focused on going through the idea pipeline and talking about names, but we also wanted to build into our regular routine a monthly meeting where we really consider whether, if we were given a new pile of cash, the portfolio we have today is the one we’d put on. It’s also one of the few times we talk about the macro, going through a checklist of economic indicators Eric puts together and codes as green, yellow or red.

With the macro indicators there’s no formula for how we take them into consideration, but if warning signs are flashing, or receding, we want to think about that in the context of our gross and net exposures and make sure we’re comfortable with where we are.

We then go through the portfolio name by name, restate why we have the position and provide any updates. It’s really just about avoiding inertia. It’s quite easy for something to have worked and take up a bigger part of the portfolio as it has less and less upside to our price target. You could say we should be on top of this every day, but the reality is we’re not always thinking that way. It’s possible for us to find a 3-4% position that’s maybe 10% from its price target, while we’ve got a 1% position that has 50% upside. Maybe it makes sense from a risk-management standpoint to keep the higher-upside position smaller, but otherwise we should be selling the bigger one down to put capital to work in the other.

Can you give an example of an existing idea that required a full reassessment because of the pandemic, and describe what you concluded?

DB: Do & Co. [Vienna: DOC] is an Austrian firm that has been a quality compounder through providing high-end catering services to customers like British Airways first-class cabins or Formula 1 racing events. As much as we like the

company, it took a direct hit from the pandemic and we concluded that to continue to own it we needed to have a much better handle than we currently do on when the pandemic is over and when air travel is going to come back. We can be patient, but we just felt we had better places for our money where we can more successfully forecast the future.

ON FIGHTING INERTIA:

It's easy for something to have worked and take up a bigger part of the portfolio as it has less and less upside.

You also seem to take seriously trying to learn from mistakes. Tell us some of the key lessons you've taken to heart from that over time?

EA: An important element in learning from mistakes is to make sure you actually document your investment thesis from the beginning. We have small farm-team-type positions that we don’t do this for, but for every other idea that’s at least 1% of the portfolio, we have a one-page template that pretty fully articulates the thesis, the key financial metrics and our valuation work. That not only helps on the front end by allowing us to communicate clearly and quickly about ideas, but it also allows us 12 or 18 months in the future to better assess what we’ve gotten right or wrong on a specific idea.

There are a lot of ways to lose money, but there are a few categories I’d mention. One is making sure you get the competitive dynamic right. In particular, we’ve found for our companies that it’s easy to underestimate the impact a new competitor can have. That’s a red flag on the long side and maybe an opportunity on the short side.

Another I’d mention would be underestimating the risk around customer concentration. We’ve seen our share of names that have been impacted when a big cus-

tomers like Samsung leaves and the business has no chance to make that up any time soon. Regulatory issues, if they’re important to the business, are also something we’ve learned to be wary of. Handicapping what regulators are going to do and when is very difficult, so we try to mostly avoid relying on regulation to be a catalyst to the upside for a long or to the downside for a short.

DB: I’d highlight two more. One would be “cutting our flowers in the bloom,” which is not at all uncommon among value investors. We often put a lot of great work into a company, watch it execute very well in an attractive market, and then try to be disciplined when it hits our price target. Say we sell it at \$20 and then look at it five years later and it’s at \$60.

How do you address that?

DB: One thing we’ve put in place is that in addition to our traditional one-year price targets, we also calculate more blue-sky three- to five-year targets as well. These new targets assume that everything really goes right, management really executes, and the market turns out to be even better than we imagined. Doing that doesn’t mean we want to hold onto overvalued stocks, but the exercise is meant to counteract somewhat our tendency to put relatively pessimistic assumptions on everything so we can feel extra comfortable with our assessment of value. It doesn’t hurt to have a little dreamer in you as an investor.

EA: With our compounder ideas, we’ll also work up a reverse DCF to flesh out what kind of cash-flow growth is implied in the current stock price. We own shares today in a company in Europe that is richly valued, 40-plus times earnings, but it’s growing at better than 40% per year. It only really needs to grow 15% per year to justify the valuation. As long as we see that, we can accept owning something at what looks to be a high multiple. That’s been helpful in keeping us in ideas we might otherwise have sold.

DB: Coming back to one last lesson, we've learned not to fight management. There are activists who do a great job in identifying valuable assets that are just being mismanaged and then doing something about it, but that's not really our game. When we've tried to take management to task, it's usually been very frustrating and an enormous time suck. There are plenty of other things we can invest in, so we just move on.

Walk through your investment case for payments-processing company Intelligent Systems [INS].

DB: This is an idea we came across in the quarterly letter of an investor with a small fund who also had some previous work experience in the credit-card-processing business. The company has been around for a few decades and it historically has been kind of a public venture-capital investor, buying into businesses – often with some sort of financial-technology angle – helping to develop them and then selling them off. One of those companies, PaySys, was sold to First Data, where its technology is still the primary engine underlying one of the biggest credit-card processors in the world.

The story today is Intelligent System's CoreCard division, which has created what they call modern, customizable credit-card-processing technology that has been licensed to Apple and Goldman Sachs in their joint effort for the Apple Card credit card, one of the most successful card launches ever. It's a straight licensing deal, with Intelligent Systems getting something north of \$2 per new Apple Card sign-up and then 10-15% of that upfront amount as a maintenance fee as long as the card account is open.

We didn't find this until after the Apple/Goldman deal was signed, but we still don't believe the market is recognizing the potential upside from that deal for Intelligent Systems, let alone the opportunity it provides the company to challenge the current oligopoly in credit-card processing made up of giants like First Data, Global Payments and FIS.

Is it too early to worry about customer-concentration risk?

DB: More than half of the business today comes from Apple and Goldman, so that's obviously a risk, but those are pretty good partners to have in what is an early stage of those companies' stated global aspirations around credit cards and payment processing. (The licensing deal for the Apple Card is so far U.S. only.) The company has been focused on getting the Apple relationship right, but management claims they don't lack for interest from other large potential customers, including

what they say would be deals that are bigger than Apple/Goldman. We don't have to count on any of that to find the stock attractive, but the pipeline would seem to provide optionality on the upside.

How are you looking at that upside from today's \$33.20 share price?

DB: We model what we think we know. If we work our way down from the number of iPhones in the U.S., to the number of those that use ApplePay, to the number of those that will likely sign up for the Apple Card, we forecast that there will be nine

INVESTMENT SNAPSHOT

Intelligent Systems
(NYSE: INS)

Business: Provider of credit-related technology and processing services, including the payments engine used for Apple's credit card launched in partnership with Goldman Sachs.

Share Information (@6/29/20):

Price	33.22
52-Week Range	23.26 – 56.24
Dividend Yield	0.0%
Market Cap	\$296.1 million

Financials (TTM):

Revenue	\$35.2 million
Operating Profit Margin	37.3%
Net Profit Margin	28.2%

Valuation Metrics

(@6/29/20):

	INS	S&P 500
P/E (TTM)	32.5	27.1
Forward P/E (Est.)	n/a	25.0

Largest Institutional Owners

(@3/31/20 or latest filing):

Company	% Owned
Weitz Inv Mgmt	14.6%
BlackRock	4.5%
Janus Capital	4.1%
Investors Asset Mgmt of Georgia	3.0%
Vanguard Group	2.5%

Short Interest (as of 6/15/20):

Shares Short/Float	10.8%
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INS PRICE HISTORY



THE BOTTOM LINE

While being chosen to provide the payments-processing technology for the Apple Card credit card in the U.S. put the company on the map, Daniel Barker doesn't think its shares reflect full credit for that deal's potential, let alone of others to follow. At a forward 23-24x P/E, the stock on his 2022 estimates would trade a year from now in the mid-\$60s.

Sources: Company reports, other publicly available information

million Apple Card customers in the U.S. by the middle of next year. That might be impacted somewhat by the pandemic, but the numbers were running ahead of our expectations before that, so we don't expect the timing to be way off.

If we do the licensing-fee math on \$2 per card and 20 cents every year the card is held, with gross profits in the mid-60% range and operating profits in the high-30s, we think the company can earn \$1.40 or so per share this year, \$1.90 next year and \$2.80 by 2022. While comps on something growing like this could reasonably argue for a multiple of at least 30x forward earnings, even at 23-24x on our estimates, the shares a year out would be in the mid-\$60s. That's also in the range of the estimated value we get using discounted cash flows.

There's obviously uncertainty tied to the coronavirus, but as that works itself out we think the discovery potential here is high. When we first invested there were no Street analysts covering the stock, and now there are only two or three. If we're right about the potential here, it's hard to imagine this not getting noticed.

Is Tokai Carbon Korea [Seoul: 064760] the type of compounder business that attracts you?

DB: We've owned this for years and could certainly imagine owing it for several more. The company is a dominant global supplier of certain consumables used in semiconductor manufacturing, the biggest of which are silicon-carbide rings used to seal the chamber in which wafers are etched. They'll say they have 80% market share in these rings, but it's difficult to identify much substantive competition.

The financial metrics are excellent, with high returns on capital, annual top-line growth continuing above 10%, and operating margins around 35%. The company grew modestly even in 2008 and 2009, and over the past 20 years has compounded revenues at 15% per year and operating profits at 20%.

The semiconductor business is notoriously cyclical, but that's primarily due to

price. Underlying unit-volume growth – which is what a supplier of consumables like Tokai benefits from – has been consistently solid over time and that should continue. The company also benefits as chips and chip manufacturing become more sophisticated and require higher-performance consumables, like silicon-carbide rings rather than those just made out of silicon.

How high is the risk of new competition?

DB: A few things mitigate against that. The company legitimately claims to have

at least a three-year technology lead in a niche that isn't really big enough to attract much competitive attention. Its products are designed into customers' manufacturing processes over long periods, and those customers – the biggest of which are Lam Research and Applied Materials – are unlikely to take risks on a new supplier over the strong one they currently have just to save a bit of money on what is already a rounding error of the overall manufacturing cost.

How inexpensive do you consider the shares at today's price of around ₩86,000?

INVESTMENT SNAPSHOT

Tokai Carbon Korea
(Seoul: 064760)

Business: Supplier of components used in manufacturing semiconductors, prominent of which are silicon-carbide rings that help protect wafers during the etching process.

Share Information
(@6/29/20, Exchange Rate: \$1 = ₩1,200):

Price	₩86,000
52-Week Range	₩41,150 – ₩95,400
Dividend Yield	1.0%
Market Cap	₩1.03 trillion

Financials (TTM):

Revenue	₩176.44 billion
Operating Profit Margin	34.5%
Net Profit Margin	27.4%

Valuation Metrics

(@6/29/20):

	064760	S&P 500
P/E (TTM)	20.7	27.1
Forward P/E (Est.)	13.9	25.0

Largest Institutional Owners

(@3/31/20):

Company	% Owned
Tokai Carbon Co (Japan)	44.4%
KC Co	19.3%
National Pension Service	4.1%
Hanwha Asset Mgmt	3.9%
Meritz Inv	2.1%

Short Interest (as of 6/15/20):

Shares Short/Float n/a

064760 PRICE HISTORY



THE BOTTOM LINE

The company's dominant market share, enviable profitability and stellar track record in a secularly growing market don't appear adequately recognized in the 14x forward earnings multiple accorded its shares, says Daniel Barker. At what he would consider a more reasonable 20x his 2021 EPS estimate, the shares would trade at closer to ₩125,000.

Sources: Company reports, other publicly available information

DB: Growth was restrained somewhat last year as the company built a second plant to add necessary capacity, but with that on line we think earnings next year should be around ₩6,200 per share. So the stock currently trades at less than 14x forward earnings, which is solidly in the middle of its valuation range over time and less than its five-year average of 17x. It's traded as high as 25x.

Korean stocks can often trade at a discount to what they would elsewhere, and there's the added issue of not a lot of liquidity here given that the company is 44% owned by Tokai Carbon Co. of Japan. That said, we believe a company with this growth profile and profitability is worth at least 20x earnings. On our forward estimate that would put the shares at closer to ₩125,000. Even if it gets there, as long as we believe the company can increase earnings at the 15-20% annual rate we expect for the foreseeable future, we'd be unlikely to sell.

From silicon-carbide rings to online sports betting, describe your interest in Sweden's Kambi Group [Stockholm: KAMBI].

EA: Kambi provides the back-end support and processing for online sports-book gaming operators. It used to be a captive supplier to a gaming operator in Sweden called Kindred, but was spun out five or six years ago to take advantage of its potential to grow as a standalone business offering its services more broadly.

If you visit the company's offices, you'll see all the trappings of a technology and software business, but you'll also see a lot of what look like traders, people who are into math and sports who are tasked with setting the odds on sporting events all around the world. Much of it is real-time during an event, say for making a bet on the next shot by a particular golfer, or on the next at bat in a baseball game. That's critical to any online sports betting offer, and Kambi is providing much of the intellectual property for it to its customers. For that it's paid a share – typically around 10% – of the related net gaming revenue generated by the partner.

The catalyst here is that the United States has opened up online sports betting, and Kambi has been quite successful in signing on new partners in what is almost certain to be a high-growth, lucrative market. The company had 11 customers when it was spun out from Kindred, but that number hit 20 in 2018 and 28 in 2019, with much of the growth from signing new regional and local partners in the U.S. like Penn National Gaming, Mohegan Sun and Rush Street Gaming. These companies wanted to compete as quickly as possible as the market opened up and Kambi offered a turnkey solution allowing them to

do so. It's somewhat difficult to track at this stage of the market's evolution, but Kambi is estimated to have, depending on the source, 30% to 60% of the market so far in the U.S.

How would you describe the economics of the business?

EA: It's a nicely profitable business even at the company's current scale – revenues last year were €92 million – but the incremental margins on new business are very high. If you've already invested in building out a technology platform, in covering all

INVESTMENT SNAPSHOT

Kambi Group
(Stockholm: KAMBI)

Business: Provider of sports-betting information, technology and services used in support of third-party online gambling offerings in Europe, Latin America and the United States.

Share Information

(@6/29/20, Exchange Rate: \$1 = 9.33 SEK):

Price	SEK 199.80
52-Week Range	SEK 58.10 – SEK 210.00
Dividend Yield	0.0%
Market Cap	SEK 6.19 billion

Financials (TTM):

Revenue	€92.3 million
Pre-Tax Profit Margin	14.8%
Net Profit Margin	11.3%

Valuation Metrics

(@6/29/20):

	KAMBI	S&P 500
P/E (TTM)	43.9	27.1
Forward P/E (Est.)	n/a	25.0

Largest Institutional Owners

(@3/31/20):

Company	% Owned
Swedbank Robur Fonder	8.1%
Keel Capital	8.0%
Fidelity Mgmt & Research	7.8%
Bodenholm Capital	5.0%
Andra AP-fonden	4.6%

Short Interest (as of 6/15/20):

Shares Short/Float	n/a
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KAMBI PRICE HISTORY



THE BOTTOM LINE

The company has been successful in signing new customers in what is likely to be a high-growth, lucrative market for online sports betting in the United States, says Eric Almeraz. Based both on a multiple of his 2022 earnings estimate and a on his discounted-cash-flow analysis, he estimates the stock's fair value at closer to SEK 300 per share.

Sources: Company reports, other publicly available information

the sports, and in the regulatory and security infrastructure necessary to operate in a wide variety of jurisdictions, the added expense of bringing on a new customer is relatively low. In our models we see the company's operating margins within the next few years reaching 30%, versus around 20% today.

Is the biggest competitive risk from companies deciding to do this in house?

EA: It is a risk. DraftKings in the U.S. has been a customer, but it announced at the end of last year it was merging with a company called SBTech, a Kambi competitor. Our basic view is that apart from the biggest online gaming operators, it doesn't make sense for them from a cost or strategic standpoint to build out the full turnkey capability Kambi provides. The market took Kambi's stock down 30% on the news of the DraftKings deal, but it's come back from that and from another big hit from the coronavirus to recently trade at an all-time high.

Does that mean the story's already out and baked into today's share price of 200 Swedish kronor?

EA: Looking through a near term that is obviously difficult because of Covid-19's impact on sports, we think with revenues growing 20%-plus per year at high incremental margins that Kambi by 2022 can earn something like SEK 12.00 in EPS. With its growth profile, profitability and ability to generate free cash flow, a 25x multiple wouldn't at all be unreasonable, which would result in a share price of SEK 300. Our DCF valuation is similar. So while this may not be as off-the-radar as it was, it's still a small company from far away in a market in the very early stages of growth. We think the results will speak for themselves.

Can you generalize about the types of short ideas that interest you?

DB: We've probably done best on the short side trying to take advantage of our global

purview in secularly challenged industries. One past example would be newspaper companies, where the disintermediation of the business by the Internet played out at different rates around the world. We started out shorting ideas in the U.S., then Europe, then some markets in Asia. I would add here that these ideas were often optically very cheap – in the U.S. we

ON SHORTING:

High-fixed-cost companies with too much debt whose top lines are shrinking – that's magic for a short idea.

were shorting companies early on whose stocks had 20% free-cash-flow yields. You might wonder how in the world you can short something with a 20% yield, but the reality was that these were high-fixed-cost companies with too much debt whose top lines were shrinking. That's kind of magic for a short idea.

Another more recent example is movie-theater companies, which we were short even before Covid-19 came along. Many of these chains were stuffed with high debt and were being milked for cash flow as their top lines, again, were shrinking. We maybe got a bit lucky on these due to the coronavirus' impact on movie-going, but we think that just accelerated a trend that was already well underway. We've actually covered most of these positions as they become more bankruptcy/bailout plays, where we don't think we bring any special edge.

We've also had success on the short side with frauds or fads where the fundamental case seems to be relatively straightforward, but they aren't widely recognized because the market caps are too small to move the needle for most institutional investors. Covid-19 actually brought a few of these out, where the playbook can often be similar. Dress up a product as a potential "cure," with resulting open-ended potential for upside. Next,

hire a public relations firm to create promotional "news" articles about how great the product is, which if done well will lead to even semi-legitimate media picking up the story, often using the share-price reaction as validation. If the story then goes "viral" – excuse the pun – maybe even a few quant "algos" start buying. With the share price now massively inflated, issue more stock or sell shares acquired prior to the campaign. With the play over and reality setting in, the shares are free to fall, with retail investors typically left holding the bag.

I'd rather not name and shame in these cases, but we found three of them to short during the crisis. The most egregious of the bunch saw its share price go from \$2 to \$12 in one day on the announcement of a purported large Covid-19 test agreement. This firm, which had two employees and a temporary New York City office, was claiming it would purchase \$26 million per week of tests from an Australian company and then resell them through another U.S. company. Among the cast of characters involved was our short's CEO, who has been convicted of felony tax evasion, and the Australian supplier's CEO, who is a convicted rapist. Fortunately, we were able to get into a small short position ahead of the S.E.C. suspending the company's shares.

Explain why you expect the market to inflict further pain on the shares of the U.K.'s Royal Mail [London: RMG].

EA: Publicly traded mail carriers have been a theme of ours on the short side for a number of years. Physical mail, which companies like Royal Mail were built to deliver, is obviously in secular decline, with volumes typically falling at a mid-to-high-single-digit rate. At the same time revenues are declining, these are high-fixed-cost businesses with a great deal of physical assets and employees, both of which for historical and political reasons prove to be very difficult to cut. That's a tough combination.

Many of these companies, including Royal Mail, have tried to diversify into

parcel delivery, which actually has a secular tailwind due to the proliferation of e-commerce. What they've found, however, is that parcel delivery is a different business than legacy mail delivery, with bigger-scale and better-established competitors and requiring significant investment in automation. Royal Mail has spent a lot on buying their way into parcels, with very little in the way of profits to show for it, resulting in writedowns on a number of their parcel assets.

This seems cut and dried. Why wouldn't the bad news be reflected in the shares?

DB: That's a good question, for which we don't have an obvious answer. I think part of it may be people's natural inclination in modeling out a business to generally expect some sort of eventual recovery. We've watched this as earnings expectations just keep coming down. For Royal Mail, at the end of 2018 consensus analyst estimates for 2021 were around 40 pence per share. That's now down to 11 pence – and we think that's still too high.

How are you looking at valuation here with the shares currently trading at just over £1.70?

EA: Dan mentioned earlier the free cash flow yields on the newspaper companies we were short, and this is also an idea that hardly looks expensive. The P/E on trailing 12 months' earnings is less than 10x. The trailing EV/EBITDA multiple is only 4.2x. But we don't think that should be much comfort for a business we believe has consistently declining profitability. We see the operating margin declining here to 1% or lower over the next three years, if they're lucky.

This is a fairly leveraged company, with approximately £1.4 billion in net debt against a roughly £1.6 billion market cap. So if, as we expect, EBITDA gets cut in half to £400-450 million in the next two to three years, and the EV/EBITDA multiple gets closer to 3-4x – which you often see in distressed situations like this – you're looking at a dramatic decline in the equity.

Sometimes on the short side it's these quietly fading industries that work out beautifully. In retrospect it always looks like people should have seen it coming from a mile away, but for whatever reason they just don't.

Is anything in particular about the current market environment keeping you up at night?

DB: We've structured our funds over time so that while we're by no means running market neutral – net exposure is generally 20-60% in our Flagship Fund – we do want the quality of our stock picking to be what drives most of the total return. We absolutely believe that's the right strategy over time, but in environments that are more speculative and tend to be risk-on/risk-off – as we'd argue is the case today – the strategy works a bit less well. Things happen that do literally keep me up at night.

Luckily, we're only in those kinds of periods maybe 10-15% of the time. I've also been around long enough to learn that if you've done your job and use the volatility of those periods to position yourself well, these are the times when you set yourself up for your next good run. VII

INVESTMENT SNAPSHOT

Royal Mail
(London: RMG)

Business: Describes itself as “transforming from a U.K.-focused letters business that delivers parcels, to a parcels-led, international business that delivers letters in the U.K.”

Share Information
(@6/29/20, Exchange Rate: \$1 = £0.81):

Price	£1.72
52-Week Range	£1.19 – £2.59
Dividend Yield (TTM)	14.2%
Market Cap	£1.65 billion

Financials (TTM):

Revenue	£10.84 billion
Operating Profit Margin	2.9%
Net Profit Margin	1.5%

Valuation Metrics

(@6/29/20):

	RMG	S&P 500
P/E (TTM)	9.8	27.1
Forward P/E (Est.)	n/a	25.0

Largest Institutional Owners

(@3/31/20):

Company	% Owned
Schroder Inv Mgmt	14.8%
RWC Asset Mgmt	5.0%
Norges Bank Inv Mgmt	2.9%
Threadneedle Asset Mgmt	2.6%
Aberdeen Asset Mgrs	2.6%

Short Interest (as of 6/15/20):

Shares Short/Float	n/a
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RMG PRICE HISTORY



THE BOTTOM LINE

Eric Almeraz believes the company's attempts to diversify away from a legacy mail-delivery business in structural decline will prove to be too little and too late. If EBITDA is halved over the next two to three years as he expects and the EV/EBITDA multiple shrinks further in response, "you're looking at a dramatic decline in the equity," he says.

Sources: Company reports, other publicly available information

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* MSCI All Country Index (with dividends net of taxes) – a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of December 2019, it covers more than 3,000 constituents across 23 developed and 22 emerging market countries. An index does not include deductions for fees or expenses. An investment cannot be made directly in an index. Accordingly, comparing results shown to those of such indexes may be of limited use.