Hidden Value Stocks

From Hedge Fund Alpha (Formerly ValueWalk Premium)

Welcome to the Q3 2024 ISSUE

Welcome to the Q3 2024 issue of Hidden Value Stocks from Hedge Fund Alpha (formerly ValueWalk Premium). We're still going to publish four quarterly issues this year, but we're kicking it up a notch by making them advance issues that hit your inbox as soon as the quarter begins (as opposed to the end of the quarter).

Some big things are happening here at HFA. We're still busy behind the scenes, rolling out significant improvements for the site. If you haven't been on the site recently, you'll notice some significant improvements in design, speed, and functionality since we launched the new site in March.

We have also added Hidden Value Stocks to the Hedge Fund Alpha site so that subscribers now have a single login for all subscription content on the site and for our quarterly newsletter. If you do not have your password or have any questions, please reach out to us. We're excited to roll out the other new features we're working on right now, so stay tuned for those.

We hope you enjoy this issue of Hidden Value Stocks. Please contact us at info@hedgefundalpha.com with any comments, questions or suggestions.

This issue features Daniel Barker and Eric Almeraz of Apis Capital and Quentin Velleley of Third Avenue.

Now without further ado, here's more on the firm and their top two under-the-radar value picks.

Jacob Wolinsky, Founder, Hedge Fund Alpha

Michelle deBoer-Jones, Editor-in-Chief, Hedge Fund Alpha

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Introduction to Daniel Barker, Eric Almeraz and Apis Capital

Daniel Barker and Eric Almeraz launched Apis Capital in 2004. With about $550 million in assets under management, the boutique firm focuses on taking advantage of cross-border inefficiencies in global small- and mid-cap equities with a market capitalization below $5 billion.

The firm manages two distinct long/ short strategies and one long-only strategy. The average market cap in Apis' Flagship strategy is around $3 billion, while the firm's Deep Value strategy holds companies with an average market cap of around $200 million to $300 million. The long-only Global Discovery strategy is a carve-out of the hedge fund's long positions.

Barker has been immersed in the stock market since 1987 and has benefited from working with some exceptional mentors. For 10 years, he worked at the General Electric Pension, and he said that even in the early 1990s, GE was forward-thinking with a sizable portion of its assets in international equities.

Barker credits GE with taking a chance on him, first as an analyst covering European stocks and eventually as a portfolio manager responsible for a range of strategies. He feels the diverse experience he got at GE honed his skills and prepared him for the challenges of the hedge-fund industry.

After GE, Barker managed some mutual funds focused on emerging markets and smaller global companies at J&W Seligman, where he met and initially worked with Almeraz, who had been working on Wall Street since his first internship at age 17.

In high school and college, Almeraz read everything about investing he could find, including Jack Schwager's *Market Wizards* and *One Up on Wall Street* by John Rothchild and Peter Lynch.

"The notion that I could identify a company, buy a piece of it, and earn a living doing that seemed incredibly cool to me," Almeraz said. "I knew that one day I would want to have my own firm, but I was incredibly fortunate to meet Dan as early as I did."

For Almeraz, a big part of joining Barker for the launch of Apis Capital was that he enjoyed working with him at Seligman.

"Funds fail for many reasons, but the biggest is probably people issues," he added. "I was lucky to find a great partner in Dan, and I knew (even 20 years ago) that this factor would be more important to our success than probably any other."

For Barker, starting Apis Capital was about doing something more with the talents and contacts they had.

"The main impetus for starting Apis Capital was a desire to hang up a shingle and do something more entrepreneurial," he said. "… It was an opportunity to take the best bits of our investment process unhindered by some of the institutional constraints, which in our view, can get in the way of returns. To run money on a truly global basis unrestrained by benchmarks was an opportunity I couldn't pass up.

Barker also credited their "great team of 'moneymakers,'" who made him confident that they could deliver excellent results. He added that starting a hedge fund specifically allowed them to do what they're good at: "picking stocks without being overly concerned about market direction."

As such, since the portfolio is hedged, Barker and Almeraz were comfortable putting all their personal net worth into the fund, aligning them fully with the fund's clients.

Barker and Almeraz feel their strategy at Apis Capital is unique because of something they observed while working together at Seligman. They frequently witnessed situations in which something that happened in one country significantly impacted customers, suppliers, or competitors on the other side of the planet.

What they observed was often very material, and they felt no strategy was in place to take advantage of those opportunities. Even now, 20 years after starting Apis, Almeraz and Barker are amazed that so few funds have employed their approach in what "proven to be an evergreen alpha-generating strategy."

They feel the current opportunity set for their approach is just as rich now as it was 20 years ago, so they anticipate "many more decades of great returns."

Apis Capital's Flagship long/ short strategy is up 14.9% net year to date through June, while its Deep Value strategy has returned 13.5%. The long-only Global Discovery strategy has gained 7.6% year to date. The firm's long/ short strategies use the MSCI ACWI World Index as their benchmark, while the long-only strategy uses the MSCI ACWI SMID Cap.

Apis Capital's Top Picks

Daniel Barker and Eric Almeraz of Apis Capital selected Osaka Titanium (TYO:5726) and E Ink Holdings (TPE:8069) as their stock picks. The companies' market caps are ¥104.25 billion (US$660.7 million) and NT$273 billion (US$8.4 billion), respectively.

Long thesis for Osaka Titanium

Q: Please tell us briefly about Osaka Titanium.

A: Osaka Titanium specializes in the manufacture and production of titanium sponge, a critical material for aerospace and defense ("A&D") applications. The company's business model involves the complex transformation of raw titanium ore from rutile and ilmenite into titanium sponge. This product is then sold to customers who use it for various end uses after melting and alloying.

Osaka Titanium is the second-largest aerospace-grade titanium-sponge producer globally (behind VSMPO in Russia). The company is over 80 years old with roots in steel manufacturing, but the company in its current form was listed on the Tokyo exchange in 2002 as Sumitomo Titanium Corporation. It changed its name to Osaka Titanium in 2007.

This was right in the middle of the last cycle, when global titanium-sponge production capacity was still very limited, but the growing demand for air travel led to Boeing and Airbus' annual deliveries growing by 75% over five years.

Similar to today, the new generation aircraft of the time contained more titanium than previous generations, which led to a dramatic increase in demand for titanium sponge. Business was so good that eventually every player in the industry significantly increased capacity all at the same time, and when the GFC hit and demand slowed, the industry found itself with a massive oversupply of titanium sponge production capacity.

The supply-and-demand balance was just beginning to balance when the COVID-19 global pandemic hit.

Q: What initially drew your attention to this stock?

Industrials/Cyclicals have always been one of the global sectors of focus for our strategy, so we're always looking to identify opportunities resulting from supply/demand mismatches. In the case of Osaka Titanium, we were involved in the previous cycle as there had been underinvestment in titanium sponge capacity for several years in the early 2000s. This led to favorable supply-demand dynamics for the titanium sponge makers when aerospace demand accelerated around 2004/2005 (e.g., Boeing/Airbus deliveries grew 75% over five years).

Like the current situation, newer generation aircraft at the time contained more titanium than previous models, so the increase in demand was even greater. Osaka Titanium saw its share price increase by more than 15x from the trough in that cycle. While not all cycles are identical, our experience from that period makes the potential for this one just as attractive.

Q: Please share your thesis in more detail. What's unique about this company?

A: Making titanium sponge is difficult and requires a complex and energy-intensive process. The titanium that goes into aerospace and defense applications must also undergo a rigorous and lengthy qualification process that takes at least three years to get qualified and as long as five years for engine parts.

China is the largest source of titanium sponge globally and accounts for half the world's production, but none of it is qualified for A&D applications. Since the last cycle, the U.S.-based sponge producers have all shut down their facilities, leaving a handful of companies in Russia, Japan, Kazakhstan, and Ukraine as the only remaining sources of titanium sponge.

With Russia's invasion of Ukraine, a third of sponge production capacity has effectively been removed from the Western market, leaving the two Japanese companies as the only suppliers. At the same time, Boeing and Airbus are ramping up production on near-record order books for new-generation aircraft that contain two to three times the amount of titanium as previous generations.

We believe the titanium sponge market could be set for another multi-year run like the last cycle.

Q: What is your target price for the stock and why do you think it's undervalued?

If Japanese titanium sponge export prices can increase just another 25% from where they are today (still 20% below previous cycle highs) and titanium ore prices continue to normalize, the company should be able to generate over ¥650 in EPS. A peak cycle multiple of 10x gets you to our target price of ¥6,500 for the stock.

Q: What are some of the most common uses for titanium that most people don't think about?

A: Besides A&D, titanium has a broad range of use cases: things like medical devices, golf clubs, and watches, among others. For instance, the iPhone 15 Pro is made of titanium to make the phone lighter.

Q: Which industries does Osaka Titanium address that you think will be the most important for its long-term growth and why?

A: Aerospace and defense make up 70% of the demand and are the primary driver of the company’s long-term growth prospects.

Q: What are some of the unique opportunities or risks for Osaka Titanium in the struggling aerospace industry?

A: Osaka Titanium is heavily exposed to the aerospace industry. The planes in Boeing and Airbus’ order books need to be made, and if these companies fail to ramp up production to the rates they are communicating to the market, titanium sponge demand will likely be lower than expected.

While Boeing’s 737 MAX production issues are part of this risk, it is the wide-body planes that contain the most titanium and would meaningfully impact titanium sponge demand.

Q: How much is Osaka Titanium benefiting from the Ukraine war, either through sanctions against Russia or through Russia cutting off certain countries/ customers?

A: The company benefited significantly from the Ukraine war. Russia accounts for a third of the aerospace-qualified titanium production. Titanium has not been sanctioned yet, but Boeing has already pledged to stop buying Russian titanium, and Airbus has stated that they intend to follow suit.

Q: Seeing some comparisons between Toho Titanium and Osaka Titanium… So why Osaka over Toho? Are there any other competitors that should be mentioned and if so, what makes Osaka better than them?

A: Osaka Titanium is the only titanium-sponge pure-play. Toho, on the other hand, generates a quarter of its revenue from its Catalysts and Chemicals businesses that are not tied to the titanium sponge supply/demand story.

Outside of a few smaller companies in Kazakhstan and Ukraine, there are no other titanium sponge producers besides the Japanese and VSMPO in Russia. ATI, in the U.S., has a facility in Utah that is mothballed, but we believe it is unlikely to be started up again. Sponge prices would need to increase significantly just to return to the price where ATI decided to close the facility because it was unprofitable.

Q: What are some of the potential risks for this company?

A: If titanium sponge coming from China were to ever be qualified, it could be a significant addition to supply. We view this as unlikely, given the length and rigor of the qualification process.

Furthermore, considering the current geopolitical climate, we question whether Western companies would be comfortable sourcing critical raw materials like titanium sponge from China. Another potential risk is the peaceful resolution of the war in Ukraine, which could lead to the reintroduction of Russian titanium into the market. Any combination of these potential risks could significantly affect the supply-demand imbalance that currently gives Osaka such favorable pricing power.

Q: Do you have anything else to add about this stock that's important for investors to know?

A: These cycles usually take years to play out, with long-term agreements limiting the ability to raise prices quickly. The last cycle saw four consecutive years of 24%+ top-line growth as margins expanded from under 20% to nearly 50%. Compared to the last cycle, we are still in the early innings.

Long thesis for E Ink Holdings

Q: Please tell us briefly about your stock pick:

A: E Ink holds a near-monopoly position in ePaper technology ("EPD" or electrophoretic display), a type of display that consumes energy only when changing the images on the screen. Unlike LCD (liquid crystal display) or OLED (organic light-emitting diodes), ePaper does not emit light from the panel, making it power-efficient, easy on the eyes, and visible under sunlight.

The company manufactures and supplies the ePaper materials to system integrators and panel manufacturers to assemble ePaper display modules, which are then sold into various end markets, including consumer and retail.

E Ink Holdings encompasses the combined E Ink Corporation, which was spun out of the MIT Media Lab in 1997 to commercialize electronic ink and EPD technology, and Prime View International, which was established in 1992 as the first Thin Film Transistor (TFT) LCD company in Taiwan, focusing on high quality small-to-medium-sized TFT LCDs.

In 2009, Prime View acquired E Ink Corporation to further integrate and expand the EPD supply chain, and the new combined companies were branded as E Ink.

Q: What initially drew your attention to this stock?

A: COVID-19 presented a unique challenge to the retail industry, driving a severe labor shortage. In this context, Electronic Shelf Labels (“ESL,” which represents 60% of E Ink revenue) emerged as a solution. These labels allow retail stores to remotely update prices and product information on the shelves, leading to higher efficiency.

We saw Walmart's announcement last year to roll out ESLs in its U.S. stores as a major catalyst for accelerated adoption in the U.S. market, where the penetration remains below 5%. In more mature markets like France, the penetration rate is over 50%.

We estimate the U.S. Walmart opportunity alone represents half of the global installed base, and E Ink has a significant runway for growth here, demonstrating its resilience and adaptability in the face of a global crisis.

Q: Please share your thesis in more detail. What's unique about this company?

A: The technology is protected by patents acquired through E Ink's past acquisitions and its in-house R&D. The company has shown the ability to create new product categories based on its proprietary technology and has built the ePaper supply chain through partnerships that would take years to recreate. This is a quality growth stock with a healthy margin expansion driven by the business mix shifting towards the ESL business.

Q: What is your target price for the stock and why do you think it's undervalued?

A: There is ample growth ahead for E Ink based on the existing businesses, and we see another 50% upside for the stock. What is more exciting is the optionality in the new product categories with larger TAMs, such as outdoor/ in-store advertising and fashion retail.

Q: Can you please explain the applications for E Ink's technology? What is it used for and what does the market for these applications look like currently?

A: Today, ePaper is primarily used in eReaders/ eNotes like Amazon Kindle (40% of E Ink's 2024 revenues) and ESLs. Growth in the eReader/ eNote market is accelerating after five years of flattish growth, driven by new product launches as the technology transitions from black and white to color.

The ESL business had a negative growth year in 2023 after tripling revenues from 2020 to 2022, primarily due to E Ink transitioning from three-color to four-color technology. Revenue from Walmart is expected to materialize in the 2H of this year and provide a meaningful growth tailwind over the medium term.

Q: E Ink is said to be nearing the end of its inventory-clearance phase. What does this mean for the company and what opportunities does it present?

A: The ESL business experienced some pull-in demand in 2022 due to an ePaper shortage during COVID. The oversupply was in the three-color ESL products, and the issue was exacerbated by the company’s transition from three-color to four-color ESLs, which led to customers delaying orders to wait for the four-color ESLs. The inventory has largely normalized as of Q2 and is unlikely to weigh on growth going forward.

Q: What are some of the most important markets E Ink is exposed to and why? Are eReaders all that popular anymore?

ESL is the most important market for E Ink because the segment carries a significantly higher margin. eReader/ eNote products are popular in China for educational purposes, and the transition to color is driving growth acceleration in the segment. Amazon is also expected to launch its first color Kindle products in the coming quarters.

Q: E Ink said earlier this year that they expect their revenue to recover this year. What problems caused the company's revenue to fall and do you agree with management's expectations? And if so, why?

A: The negative growth in 2023 was driven by the ESL segment. We see this technology transition as a one-off event and expect growth to recover in the segment. Two of E Ink's ESL customers, representing 50%+ of the ESL market, have indicated 20% to 30% CAGR over the medium term, and the Walmart roll-out is a major part of this growth. The company has already received orders from Walmart, and growth should re-accelerate in line with the broader ESL market.

Q: What are some of the key risks for this company?

A: Given the size of Walmart's contribution to the ESL business, any potential delays or cancellations would be a key risk. Revenue could be bumpy quarter to quarter depending on the order timing and product launches, which could create short-term investor concerns.

Q: Does E Ink face off with any important competitors and if so, why do you think E Ink has greater opportunities?

Q: E Ink's color technology is protected by patents, and there is no direct competitor. However, there is competition from incumbent display technologies and emerging technologies. The unique qualities of ePaper make it superior to incumbent display technologies like LCD/ OLED for applications that require low-power consumption and/ or visibility under certain environments. Other emerging technologies like MicroLED and ElectroWetting Display are promising but still too early for commercialization.

Q: Should investors be concerned after E Ink revised its forecast?

A: While it is not ideal for any company to revise down its forecast, we are not concerned about E Ink's growth prospects going forward.

The forecast revision is primarily related to the company transitioning from three-color to four-color ESLs. During the transition, some key components in the supply chain were delayed, hampering growth in the ESL business. The issue is largely behind the company, and the ESL business is expected to return to strong growth into 2025 and beyond.

Q: What's your valuation for E Ink?

Before 2020, most of E Ink's earnings were coming from the mature e-reader business and the declining LCD royalty business that appears under non-operating income. However, fast-growing ESL now represents more than 50% of total profits, and we expect a continued shift towards the ESL segment. This change in the business composition is the driver behind the stock valuation doubling from a low double-digit P/E to approximately 25x P/E since the COVID-19 pandemic.

We are optimistic about the potential for further re-rating of E Ink, especially considering the introduction of new product categories that could significantly grow the company's TAM. We maintain a target price of NT$350/share, which is supported by our DCF analysis and a multiple approximately 40% lower than a similarly positioned peer, Universal Display.

Q: Do you have anything else to add about this stock that's important for investors to know?

A: Other opportunities in advertising and fashion retail are likely to start contributing to E Ink's revenue in the next couple of years and can accelerate overall growth even further.

All charts are via TradingView

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Apis Global Deep Value, LP ("Deep Value" or "Deep Value Fund") launched on 11/01/05. Investment returns since inception shown apply the currently offered fee structure for an unrestricted (new issue eligible) investor net of all fees and expenses, which includes a management fee equaling 2% and an annual performance allocation equaling 20% of the net appreciation in the investor's capital account. This fee structure began being offered in June

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MSCI* refers to the MSCI ACWI Index: the MSCI ACWI Index captures large- and mid-cap representation across 23 developed markets (DM) and 24 emerging markets (EM) countries. With 2,897 constituents, the index covers approximately 85% of the global investable equity opportunity set.

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