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One-man value band

If all goes according to plan, the assets under management of Ballina Capital, LLC, Manhattan Beach, Calif., will shortly sextuple, an event that will open the door to an eventual increase, perhaps a doubling, in the size of the firm's staff. At this writing, Ballina's AUM stands at $6 million and its headcount at one.

Kevin Durkin, 51, founder and chief investment officer and, indeed, chief cook and bottle washer, of Ballina, is that one. He opened the fund in 2017 after a 15-year stint at Causeway Capital Management, LLC, which, at the time of his departure as a senior portfolio manager, had $40 billion under its wing. This is the story of one man's quest to make a living in the United States by investing outside the United States, deploying his money (and, for the time being, his money alone) in neglected value stocks in Germany, China, Britain and, especially, Japan. Thumbnail sketches of a trio of Durkin's portfolio companies are featured below.

Why anyone would choose to seek investment opportunity outside of America's deep, monetarily well-lubricated, exceptional, accessible and upwardly thrusting (for the most part) stock market is a question that, for the Graham and Dodd devotee, answers itself, though others may require a word of explanation.

First and foremost, the S&P 500, though 13.4% cheaper than it was at its all-time high on Jan. 3, 2022, nonetheless trades at 29.3 times its cyclically adjusted price-earnings ratio, a level surpassed only three times: in 1929, during the millennial dot-com boom and at the peak of the prior bubble, in 2022. Compare the average p/e multiple of the Ballina International Small Cap Fund, which is 8, or the average p/e multiple of the Ballina International All Cap Fund, which is 9.2.

Besides, says Durkin, America is deficient in the kind of company that nobody cares about. In contrast, when he rings up a foreign management, the response is sometimes a self-effacing, "Why are you interested in us? No one else is."

The father of a pair of teenagers, Durkin says that Ballina holds 50% of his net worth. Since its Nov. 14, 2017 start date, his small-cap fund has generated a 25.2% return and his all-cap fund a 30.1% return, handily outpacing the 15.5% return of the Vanguard Total International Stock ETF. Another relevant point of comparison is Durkin's alma mater, Causeway. A big, successful asset manager, it's a holder of big, liquid international stocks. Causeway has little choice but to invest in household names, Durkin says, liquidity being "very tough" overseas. "So their funds are very benchmark. When we started out in 2001, we didn't want to be. We wanted to be value-focused and off-the-radar."

Certainly, Durkin has avoided both the radar and the pitfall of large size. His point of investment focus, he tells colleague Evan Lorenz, is the international equity "underclass," i.e., companies with little to no analytical coverage that have "disappointed for five to six years. You reach out to these companies, and they're really excited to talk to an investor in the United States because they've disappointed people for so long."

Sitting in a room by himself, managing nobody's money but his own and screening for obscure value names in foreign parts is perhaps not what Durkin envisioned for himself while he was earning his MBA from the University of Chicago. Upon leaving Causeway in 2015, Durkin relates, headhunters came knocking at his door. "What it reinforced for me was that international value was an underserved marketplace. I started Ballina because I felt like this could break out."

The firm gets its name from the Irish town from which Durkin's paternal grandparents emigrated in the 1930s. "I chose the name," says the grandson, "because I wanted something with some heritage, meaning, authenticity." Training in credit early in his career supplied Durkin with a constructive awareness of the authenticity of competing claims on corporate assets in a bankruptcy proceeding. Equity investors, their eyes fixed on the upside, often lack an "acute understanding of the downside and who holds the primary claims on the assets," he observes.

Thus, his search for investment candidates with lots of tangible assets, such as real estate and net cash. "I like free cash flow," Durkin elaborates. "And you can come across a lot of businesses that have very strong free cash flow, but there aren't assets behind it. It's based off a franchise; it's based off a reputation, customer relationships, things that can disappear if you go out of favor. They can disappear quite quickly. We all have blind spots. We all have had industry changes or macro condition changes that we missed. I don't want to run myself into the situation where this great free-cash-flow company runs into more difficulties than I expected. And as cash flow gets downgraded, it's coming down, and the stock is coming down even more than that, and there's just no protection."

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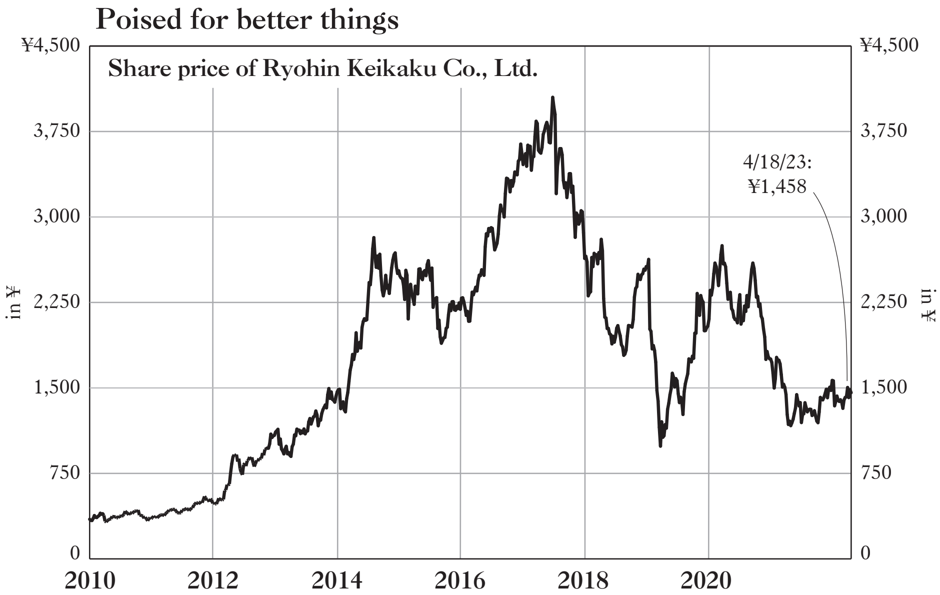

source: The Bloomberg

For much of the past two decades, Japan has been home to stocks that not only were cheap but also doggedly remained so. In 2015, in a bid to animate the marketplace, the Japanese government enacted a code of corporate conduct to encourage the unwinding of cross-shareholdings, the publication of target rates of return on capital and the creation of independent boards of directors.

The Tokyo Stock Exchange (TSE) is also pulling an oar in the cause of better governance. In January, it issued a notice directing companies whose shares are trading below book value to come up with capital-improvement plans. In response, Citizen Watch Co. and Honda Motor Co. announced sizeable buybacks. As 889 of the 1,832 in the TSE's top Prime Market listing continue to trade below book, there may be more such initiatives.

There are more public Japanese equities than you can shake a stick at. The Vanguard Total International Stock Index ETF, for example, counts 1,422 Japanese stocks in its 7,895 holdings. In fact, there are more Japanese stocks in that fund that do not have forward earnings estimates (379 in total; an indication of little to no analytical coverage) than there are total stocks from Australia (298) or the U.K. (285). "The large number of relatively small, poorly covered companies makes it a rich hunting ground for a confident, global investor," Durkin writes in his latest letter.

"You can find value in almost any sector in Japan," the man from Ballina tells Lorenz. "That's not at all true in places like Europe," where cheap stocks are clustered in "deep cyclicals. You've got to dig into financials, materials and even some consumer cyclical companies.... Investors that sit in London, Paris or Germany look to the U.S. frequently. When they see, for example, big tech outperforming, they look for like companies in Europe. Because there's a scarcity of them, they bid them up."

The readers of *Grant's* already know a little something about the opportunities in Asia's former bubble economy. The issue dated Feb. 7, 2020 highlighted trading-house giant Mitsubishi Corp.—eight months before Warren Buffett invested in the stock—and the closed-end Nippon Active Value Fund. In December, we circled Nintendo Co., Ltd. as a pick to click, and, obligingly, this month *The Super Mario Bros. Movie* logged the biggest global opening of any animated film, taking out prior record-holder *Frozen II*.

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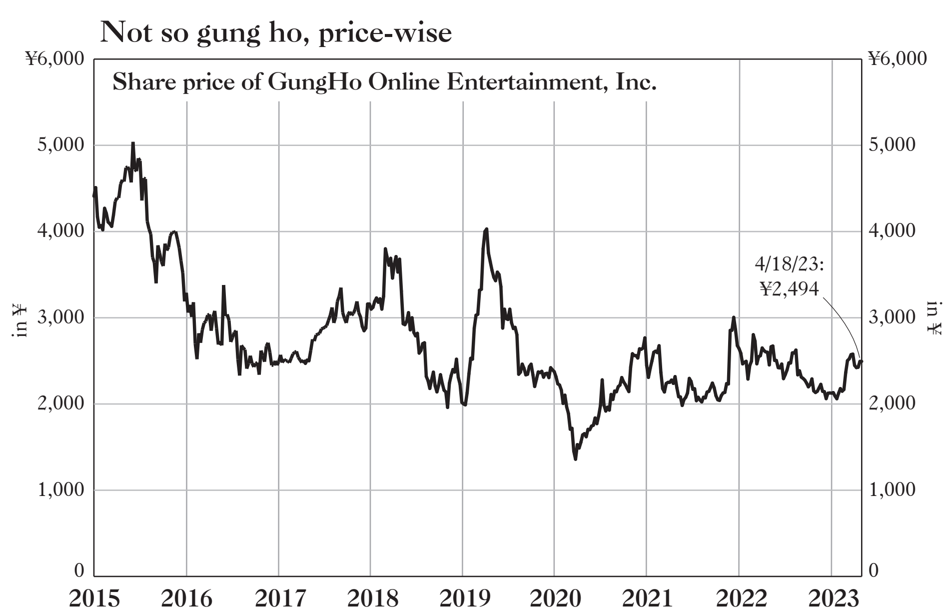
Durkin's latest letter lays out the bull case for a trio of Japanese stocks, the first of which, Ryohin Keikaku Co., Ltd. (7453 on Tokyo), sells a wide range of household goods, clothing, food and other items at 1,144 stores under the MUJI banner. MUJI's M.O. is to sell high-quality, company-branded products at affordable prices with a minimum of fuss and customer distraction.

That value proposition has evident global appeal, having propelled sales at a 6.6% compound annual growth rate over the past eight years in dollar terms. For comparison, Walmart, Inc. compounded its top line by 2.9% over the same span. In the six months ended Feb. 28, sales in Japan accounted for 59% of Ryohin's total with the balance from East Asia (mostly China) at 29%; Europe and the Americas, 6%; and other parts of Asia, the remainder.

While Ryohin does not at first appear cheap at 19.1 times estimated earnings for the fiscal year ending Aug. 31, 2023, this is the result of a collapse in profit-



source: The Bloomberg

ability rather than of a bullish investor base chasing the stock higher. Operating margins dropped to 3.6% in the six months ended Feb. 28 from 12% of sales in fiscal year 2018, driven by product miscues in Japan, a weak yen, China's Covid-zero policy and inflation in the cost of goods sold.

With China reopening its economy, one problem has already been fixed—same-store sales in the People's Republic rose 13% in January, 17% in February and 35% in March. "They understand the things they have to do better," Durkin says. "They revamped the apparel selection, and we haven't seen the benefits of that yet. Their goals, coming back to the governance code, is to get operating margins back above 10%." To reach that target would require almost a tripling of margins, implying an attractive opportunity at today's share price.

Despite the plunge in profitability, Ryohin is only lightly leveraged, with net debt and lease liabilities of ¥3.8 billion versus trailing Ebitda of ¥41.5 billion. The company also ticks good governance check boxes, including a board of eight, comprising three women and five independent directors.

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GungHo Online Entertainment, Inc. (3765 on Tokyo) is a curious stock with ties to an avatar of the previous bull market. Founded as a video-game developer by Taizo Son, the younger brother of SoftBank Group Corp. founder Masayoshi Son, GungHo is best known in Japan for Puzzles and Dragons, an 11-year-old mobile game with 60 million Japanese downloads.

While SoftBank and GungHo once did manage a joint venture together, the two companies went their separate ways in 2016. Taizo retains a 26% stake in GungHo but relinquished his position as chairman, also in 2016.

The shares appear cheap and the company well-financed. In keeping with a lukewarm analytical consensus (one buy, two holds and one sell), the stock trades at 7.4 times 2023 estimated earnings. As of Dec. 31, 2022, the balance sheet showed a net cash balance of ¥126.7 billion versus a market cap of ¥217.6 billion. As only three of the nine board members are independent and not one is female, GungHo is in the process of upgrading its governance.

Deploying its significant free cash flow, GungHo has repurchased ¥175.9 billion's worth of shares since 2015, an amount close to the current market cap. Revenue essentially flatlined between 2019 and 2022, but a bit of growth is not out of the question. GungHo holds a 59% stake in U.S.-listed Gravity Co. Ltd., the publisher of the game Ragnarok Online. Following new updates to that game franchise, Gravity's fourth-quarter revenues surged by 71.9% from the September end period and 82.2% from the final quarter of 2021.

Nor does everything depend on a revitalization of the dormant GungHo top line. On Monday, Sega Sammy Holdings, Inc. announced the acquisition of Rovio Entertainment Oyj, the publisher of the mature game franchise Angry Birds, at a price of 1.9 times sales and 14 times Ebitda. For reference, GungHo trades at 1 times sales and 3.7 times Ebitda.

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Tosoh Corp. (4042 on Tokyo), Durkin's third value idea, is a diversified chemicals producer with interests in five basic material segments, including chlor-alkali (34% of revenues in the nine months ended Dec. 31, 2022), petrochemicals (26%), specialty (21%), engineering (11%) and the residual "other" (8%). End products associated with these units span the gamut from monomers to polymers to caustic soda to cement and even laboratory equipment.

Tosoh is buffeted today by weak demand from the sputtering global industrial economy and by inflated prices in energy and key commodity feedstocks. As a result, operating income fell to ¥58.9 billion in the nine months to Dec. 31, from ¥106.9 billion in the same period in the prior year.

Nevertheless, Tosoh's balance sheet shows just ¥64.1 billion in net debt versus ¥139 billion in trailing Ebitda. Tosoh has been unwinding cross-holdings to the extent that the remainder accounts for less than 5% of total assets. Four of the nine board members are independent, and one is female.

Despite cyclically depressed profits, Tosoh trades at 6.3 times trailing earnings per share, eight times the estimate for the fiscal year ending March 31, 2024 and pays a 4.5% dividend yield.

"They're struggling right now," says Durkin. "So they're feeling the economic downturn already, and I'm getting in at a level where I feel like they are under-earning. In the last cycle, they did a really good job running the business. I feel like I may be a little early in timing, but I'm in the right company for the longer term. It's not super well-covered, so you have to spend some time to understand it."

"I want to buy companies that have good free cash flow, and I also want to buy companies that are under-earning," Durkin continues. "I don't always get that. For me, it's better value because it protects me from the situation where they're over-earning and it's peak profitability. And regardless of what the valuation might be, it's going to be a hard ride as investors get used to the idea that profitability is headed down. . . . I don't know if these are going to end up being the value stocks that over a number of years go up three- or fourfold, but I'm setting myself up for that kind of potential."

In the new Ballina Capital pitchbook, Durkin lists a half-dozen "near-term priorities." The first is to "onboard first institutional client with the help of Compliance Consultant." As mentioned, this great event is pending. The final bullet point reads as follows: "Founder willing to commit resources to support the business through 2030."

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