Interview #85 : Kevin Durkin (Ballina Capital)

Buying out of favor assets trading at cheap prices

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For this issue we have the pleasure of interviewing Kevin Durkin, Founder and Portfolio Manager, of Ballina Capital.

Hi Kevin, thanks so much for taking the time out to do this interview.

Can you please tell readers about your background, and how you got involved in investing?

First of all, thanks very much for reaching out, and the opportunity to interview with you.

Like many that eventually become Portfolio Managers, I was always analytical by nature. I studied business in undergrad, and securities markets were already very interesting for me as I did a thesis paper on the Junk Bond market.

After graduating, I went to Wall Street where I was trained in credit analysis at Chase Manhattan. Later I was fortunate enough to move to Lazard Frere, and work on research of leveraged and in some cases distressed companies. And I got to work around some very smart people and clients, and gain a sharp appreciation for capital structure, valuation and scenarios.

I wanted to strengthen those tools, so I got an MBA from the University of Chicago, and I became more intrigued with looking for thriving businesses, which is more of an equity pursuit than a credit one.

I made my way to the buyside, but in public equities. And interestingly, with this group, based here in Los Angeles, we were focused on International companies.

While I had a little bit of experience investing Internationally, this was a real eye opener for the world beyond American shores, and the complexity of investing successfully. I had a real passion for stocks, still do, and was a go getter, so I climbed the learning curve.

We started a firm, Causeway Capital, in 2001, my responsibilities grew, and I had great impact on our performance for clients. The firm expanded, and I received meaningful financial rewards.

Later, I decided I would rather leave and start my own firm, one that would be known for, more than anything else, passion for investing, integrity and putting clients needs first. And thus Ballina Capital was formed in 2017.

Previous to starting Ballina, my personal account activity was conservative. Today I have meaningful skin in the game. A substantial part of my wealth is invested in Ballina strategies.

Could you provide a brief overview of Ballina Capital - and in particular what strategies do you employ?

As far as principles of the firm, clients needs are first. We believe in having passion for investing in stocks; we want to remain employee owned; honesty and transparency are crucial.

We aim to have the right kind of culture, an apolitical one. Alignment is important; I should have a significant part of my wealth invested alongside clients.

Ballina has three employees today. Sue Baumer is our Operations Specialist, and Jackie Paolinelli is our Business Development Specialist. As we grow we hope to remain as close to 100% employee owned as possible.

We believe there's a relationship between ownership and performance. And we are certain that our financial future is tied to the investment performance we can generate for our clients.

As far as how we build portfolios, we're value managers. We prefer to buy assets that happen to be out of favor and are trading at cheap prices. Assets go out of favor because of behavioral biases, and this causes the stocks to be off the radar screen of many large investors.

We utilize a fundamentally based, research intensive, bottom up approach to stock selection. Portfolios are limited to a maximum of 45 securities.

Today at Ballina, we manage about $14 million. And roughly half of that is my own money. This is about to change. We have an Institutional account that we are onboarding in the next few weeks that will take us over $100 million of AUM.

We essentially have two strategies, International All Cap Value (minimum market cap of $500 million), and International Small Cap Value (market capitalizations between $500 million and $5bn).

There is significant overlap between those two. An institution wanted a version of these with a meaningful restriction on Emerging Markets, so we offer that today. This is why you will see that we have four composites.

What type of businesses do you like to invest in? Are there any specific metrics, business models, or industries you focus on?

All new stock ideas must successfully pass through our front end screens. Stocks have to pass all of the parameters of the screen, which include Quality, Valuation and Tangible Asset Intensity.

From that set of companies, we do some high level risk analysis to make sure there are not binary risks to be concerned about. If still interested, we do the deep dive.

We aim to understand economic drivers, and build a proprietary financial model. In that work, stylistically, I look for more resilient businesses based on the balance sheet, cash flows. And then, most importantly, I prefer to let the valuation and where the margins or returns could be, as opposed to where they currently stand, create a positive risk reward for me.

Many of these companies have disappointed. I believe that valuation can be a powerful motivator. It just takes longer for some boards and management teams, especially in international markets.

We'll look at any type of business. We build portfolios from the bottom up, and country and sector weights are a byproduct of that approach.

In each of your four strategies the word 'value' is used, so it's important for you to not overpay for a business. There are many ways to skin a cat. What's your favorite methodology for valuing a company?

We're investing internationally. This means we have more conglomerates, family owned companies, and even companies with Government stakes, than you would find in the United States.

Some of this impacts your valuation approaches. You err more towards the conservative approach. Sum of the Parts very often provides some very helpful insights. When we're digging in on valuation, we believe there are opportunities to add some insight.

International companies, in particular, the ones that are out of the spotlight, it is easy for investors to miss the detail or the nuance. We've invested in a company called Ackermans & van Haaren. It is a Belgian family controlled conglomerate that goes back more than 100 years. It is covered by three analysts.

A screen will tell you it is an Industrial. But the largest part of it's earnings and value are in their Financial Services businesses. Is it a financial? Is it an industrial? How do you value those pieces?

Sometimes when we do work on this type of company we find that the current share prices make very little sense to us. It is in some of these cases where we have made some of our very best returns.

I do like looking at EV/Sales on more pure play companies. Many International companies have surplus financial strength. I find that much more interesting than the company that is already geared to the most efficient level.

I think it is important to note that within our process we have two components that we believe help us to avoid value traps. I already mentioned the front end screens have a Tangible Asset component.

We believe that investors will punish stocks less where they can see that assets can be liquidated or sold in difficult times. That is at the front end. At the back end, we have a sell discipline.

Our view is that if we have 35-45 securities that we really like, then we should not allow ourselves to be bogged down with one security.

We don't profess to be perfect on timing. We can trim or exit, and focus on the rest of our portfolio that we very much like. Together we believe these make us a bit unique and protect us from value traps.

You have been bullish on Japanese equities. Many stock prices in Japan have gone up like a rocket over the past 12 to 18 months - is there still value to be found in Japan?

In our Japanese stocks, absolutely! I wrote about our Japanese names in March of 2023. And that newsletter was picked up on.

With Buffett investing in some of the Trading companies, and some foreign investor interest, the market has taken off since that time.

Japan was suddenly getting mentioned all of the time. And of course everyone mentions the Corporate Governance changes.

But from what I can see, at least in terms of value names, the money has flowed to larger companies (above roughly $12bn of market cap), and often times, to companies where the Returns on Equity, that important barometer, was already at adequate levels.

Marubeni and Mitsui (two of the trading companies that Buffett bought), for example, they trade at 1.3-1.4x book value today, and their ROE expectations are in the range of 12-13%.

To me these sound like companies that are already in the comfort zone, and not under pressure. And these companies bring a lot of commodity exposure, and last I checked, the share prices of Rio, BHP, Glencore, Anglo American, they were not doing very well.

And all of that is confusing to me, because if you're present in Japan to benefit from the Corporate Governance drive, it makes more sense to me to invest in the low ROE companies trading below book value.

It suggests to me that we're in the early innings, dipping our toe in the water portion of whatever this is to become. This makes sense because many Western investors have been Underweight Japan for many years. They don't know many of the companies there very well.

Our set of Japanese holdings can very much earn more than they currently are. It is a question of whether they will achieve that, and or will they use some of their fortress Balance Sheets. And they largely trade for less than book value.

We may own 1-2 companies that trade above book value. Some of our larger, better covered companies have done well. The smaller ones (we have many between $1bn and $2.5bn) have mostly been range bound, and underperformed this rally.

If anyone out there has still not dug in on the Japanese story, there is much to go for. There is tremendous variety of companies available, with value available across all sectors. And this "rocket" as you describe it, has not impacted many of the thousands of smaller Japanese stocks.

If this time is different, and investing in Japan is going to reward us for years to come, then we will end up in a decade or so with far fewer Japanese companies. And that consolidation will occur at the smaller end.

Apart from Japan, are there any other countries where you're currently finding good value?

The United Kingdom is our second most important market. And many quote how cheap the UK is, but they make reference to the FTSE 100, which has always been a strange amalgamation of large, mostly global companies. And many of these companies do not deserve high multiples. We don't own FTSE 100 companies.

We mostly own domestic UK companies that are present in the FTSE 250. Look at the history of that particular benchmark, and you can see a horror story that includes more severe reactions from Brexit, Liz Truss, and the recent heightened inflationary period.

The FTSE 250 is at the same level as five years ago. And while the smaller UK equities may not have the diversity of the Japanese market, there are very attractive bargains in our opinion.

Can you talk about two specific companies in your portfolio you're bullish on? What was the thesis for investing?

💡 Yancoal Australia (YAL)

Yes, first one I will mention is Yancoal Australia. It is actually dual listed in Australia and Hong Kong. Market cap of roughly $5bn U.S. dollars. They have interest in 7 coal mines in Australia, primarily on the east coast.

They produce met coal and thermal coal, and basically all of it is exported on the seaborne market. They have a low cost position of slightly less than 100 AUD/Tonne.

They've paid down debt in recent years, and with strong cash generation, they now have about 1.4bn AUD of cash, with minimal debt, and that is an attractive high teens % of the current market cap. At a price to book of 1x, your downside is protected in a number of ways.

And while the management do not appear to be interested in repurchasing shares, they have been generous with the dividend. The dividends will fluctuate with profits, but given what they announced in regard to 2023's dividend, you are getting about an 11% dividend yield.

We're attracted to the balance sheet and the free cash flow. And while the commodity price is hard to predict, we do like that the business trades at a discount to the historical range.

Margins are volatile, given the commodity, but over time it is probably conservatively a business with mid to high 20's EBIT margins, and yet today it trades for about 0.7x EV/Sales, when over the last five years it averaged about 1.1x.

Australia is a good home base for an investor in the commodity space in that there is clarity about rule of law, property rights, tax, etc…

While some would avoid the coal sector given long term energy transition challenges, Yancoal is more for those interested in shorter duration plays. And as far as thermal coal, many of the countries that will be importing thermal for some time to come are located closer to Australia.

💡 Societe Bic (BB)

The second that I will mention is Societe Bic. This is the French company that manufactures lighters, writing instruments and mens and womens shaver products.

It has a market cap of about $3bn U.S. Bic has been around a long time, and this is a bit of an example of a kind of "underclass" of company that we often find in our portfolios.

In some of these "underclass' examples, investors know the company, but the company has badly disappointed them. And with these type of stocks, we find that people give up.

Those that supported the company in the past either express permanent regret, or they've experienced worse than that, career risk. And it is effectively taken off of the radar.

In Bic's case, starting in 2016, the financial performance trailed off badly. The dividend was reduced on two occasions. Given that it is a family-owned company, with a family member as CEO, one can understand it coming off of the investor's radar. The detail is that the shaver and writing instrument segments were the source of disappointment. Lighters continued with first class margins.

By 2021, they had a restructuring program in place, and this has borne fruit. Manufacturing costs were reduced, and more importantly Bic invested in innovation. The top line is now in much better shape, with long overdue investment in ecommerce initiatives.

Financial performance has improved significantly, and thus it is a prime example for us that with International companies the motivation to increase shareholder value is there, it just takes longer to come through.

Some of the attractive attributes here with the Bic equity story sound quite a bit like those that we mention about Yancoal actually. That is not a coincidence. We're attracted to Bic's free cash flow, the balance sheet (Net Cash), and valuation.

The business is more defensive than that of Yancoal. And while the coal price will be difficult to call and we will not try, Bic is more in control of their destiny and we believe they can continue to execute and earn more (get group EBIT margins back to 15%).

Bic has traded for higher multiples in the past, and we believe a bit of a re-rating can be earned on top of the improved earnings power. On EV/Sales, Bic is on a 40% discount to the French market, and until about four years ago it had previously been on a premium.

Bic has always been generous with dividends and buybacks, and this continues today. We like the risk reward. From our perspective, the stock is worth at least 80 EUR a share on a two year view.

What are your future plans for Ballina Capital?

We've established a repeatable process, and the portfolios have been consistent since day one. We believe we can add value in the International Equity space.

To do that, we need to continue to tell our story. Find investors that understand how we invest and are comfortable with the risk and reward of an Emerging Manager.

We have assets coming in that will take us over $100 million, and then we will be SEC registered. This should help expand our awareness, and our ability to be included in searches.

And then hopefully we can grow the team with likeminded professionals that are passionate about stocks, and excited to build a firm that puts client's needs first. I believe a lot of good changes are coming in 2024.

Where can readers go to find out more about yourself and Ballina Capital?

We have quite a bit of content on our website ballinacapital.us

To access much of it you have to be approved as a site member. You apply for site membership at our Newsletter page.

For allocators, once we have contact details, we send out monthly updates.

Thanks Kevin for a great interview.

Disclaimer

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Comments

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