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Value Investor INSIGHT

The Leading Authority on Value Investing

In the Extreme

Kopernik Global Investors' David Iben has a long history as an investor of going against the grain – painful as it may be at times. True to form, the two primary categories of opportunity he sees today are not particularly à la mode.

INVESTOR INSIGHT

David Iben
Kopernik Global Investors

"The difference in how companies we own are valued and how everybody's favorite stocks are valued is really quite stunning."

Editor's Note: *After a long and market-beating tenure as CIO of Nuveen's Tradewinds Global Investors and a short stint running Vinik Asset Management's global long/short value portfolio, David Iben struck out on his own in 2013, naming his firm Kopernik Globval Investors after the Renaissance scientist and philosopher known in the West as Nicolaus Copernicus. The Polish-born Copernicus is credited with the original conception that the universe revolved around the Sun rather than the Earth, which to put it mildly was not a popular notion in the 16th century. "He was an independent thinker, courageous and determined to understand the world around him," says Iben. "Not a bad model for an investor."*

We spoke recently with Iben about his understanding of today's investment world and how he's positioning his portfolios – Kopernick currently manages $3.3 billion in assets – as a result. Not surprisingly, his views often don't reflect the conventional wisdom.

You've said that now could be one of the best times ever to be an active investor. Why do you think that's the case?

David Iben: I've been doing this for almost four decades now, and I don't think I've ever seen the market anywhere near this divorced from fundamentals. There seem to be two basic schools of thought. One that predominates – and has for some time now – is that the central banks and governments of the world have succeeded in eliminating the economic cycle, interest rates are low forever, and you should just buy a passive fund and go along for the ride. That's made the passive vs. active cycle as pronounced as it's ever been. The growth vs. value cycle is as pronounced it's ever been. Within value, business quality vs. Graham-and-Dodd asset value is as pronounced as it's ever been. Favoring the U.S. vs. non-U.S., same thing. Financial assets vs. real assets, same thing.

The other school of thought, to which I adhere, is that cycles haven't been eradicated and that the kicking of the can down the road by fiscal and monetary authorities has only prolonged the types of cycles I'm talking about, and that will make their inevitable reversals even more pronounced. If that's a fair representation of the world going forward, that should indeed favor the fundamentals-driven active investor.

So we imagine you're finding value today in places that aren't particularly popular?

DI: Most everything we own today falls into one of two categories. The first would be high-quality companies in countries most investors want nothing to do with, primarily emerging markets. The second would be situations where cash flows are latent, residing in real rather than financial assets. The difference today in how companies in these two broad areas are valued and how everybody's favorite stocks are valued is really quite stunning.

Let's start with high-quality companies in emerging markets. What types of opportunities are you finding there?

DI: We as investors have never thought of growth and value as philosophies. We consider value a prerequisite, paying less for something than it's worth is an obvious necessity. Growth is a very nice attribute, as is business quality. So if people ask if we favor high-quality growth or value, we say, well, both. We'd argue that in emerging markets today you don't have to choose between the two because they are one in the same.

Fifteen or 20 years ago we used to own almost every railroad in the U.S. They had a long history of underperforming so the stocks were very cheap. Since then the industry has evolved, the stocks have performed well, and to own a U.S. railroad today you'll have to pay something on the order of 6x book value. But today we can buy a railroad whose main line goes from Hong Kong to Shenzhen, China, Guangshen Railway [Hong Kong: 525], at less than a third of book value. Earnings have taken a hit because of the coronavirus and what's going on between Hong Kong and China, but it's a solid company in a growing market and the stock trades at a fraction of book value.

In the U.S. people probably correctly view utilities as a bond-market proxy, and with the bond market as expensive as it's ever been, it makes sense that utility stocks are relatively expensive. The Dow Jones Utility index trades at about 20x earnings, a not-bad 5% earnings yield. But in emerging markets we have something like Brazil's Eletrobras [Sao Paolo: ELET3] – which has the biggest hydro-electric franchise in the world – trading at 8x earnings, a 12.5% earnings yield. No greenhouse gases. Very low-cost electricity. Growing market. You wouldn't expect to be able to buy that at a single-digit P/E and a 25% discount to book value.

If you're willing to venture into Russia you can do even better. RusHydro [Moscow: HYDR] also has a large hydro-electric franchise and low costs, and here you also pay 8x earnings but just over half of book value. These are world-class companies with dominant market shares and low costs – they just happen to be in markets that aren't high on people's lists of where they want to invest.

Concerns over things like geopolitical and currency risks likely have quite a bit to do with the valuations in emerging markets. How do you think through those?

DI: Twelve years ago the markets were saying you had to own BRIC stocks, in Brazil, Russia, India and China. We bought that argument, but also recognized that emerging markets are famously more volatile, with less-defined rules of law and more corruption. How do you balance the higher growth potential and a lot of other good things against a lot of bad things? In general, in places like Russia and China and India and Brazil we've tended to deal with that by saying we want half off the price we have to pay. If we think a company is worth 10, in one of the BRIC countries we want to pay no more than 5. Twelve years ago that was extremely difficult. Today it's not.

Describe your broader investment case along these lines for China Telecom [Hong Kong: 728].

INVESTMENT SNAPSHOT

China Telecom
(Hong Kong: 728)

Business: With China Unicom and China Mobile, one of the three large national telecom operators in China offering subscription fixed-line, broadband and wireless services.

Share Information
(@7/30/20, Exchange Rate: $1 = HK$7.75):

Price	**HK$2.29**
52-Week Range	HK$2.01 – HK$3.81
Dividend Yield	5.5%
Market Cap	HK$186.14 billion

Financials (2019):

Revenue	RMB 375.73 billion
EBITDA Margin	31.2%
Net Profit Margin	5.5%

Valuation Metrics
(@7/30/20):

	728	S&P 500
P/E (TTM)	8.3	30.6
Forward P/E (Est.)	9.0	25.5

Largest Institutional Owners
(@3/31/20 or latest filing):

Company	% Owned
GIC Pte	9.0%
Templeton Global Adv	5.1%
Thornburg Inv Mgmt	3.8%
Vanguard Group	3.5%
BlackRock	3.0%

Short Interest (as of 7/15/20):

Shares Short/Float	n/a

CHINA TELECOM PRICE HISTORY

THE BOTTOM LINE

The company in many ways – industry makeup, business mix, technology infrastructure and value to customers – is quite similar to its American counterpart Verizon, says David Iben. Among those attributes on which they differ, he says, are that China Telecom's future prospects are better, while the current valuation on its stock is considerably worse.

Sources: Company reports, other publicly available information

DI: This is another case where we can start with a simple comparison, between Verizon [VZ] in the U.S. and China Telecom in China. Both operate in essentially tri-opoly markets. The mix of business between fixed-line, cellular and broadband is roughly similar. They both sell a highly valuable service, next to food the last thing people would cut out of their lives. Both have leading-edge technology and excellent infrastructure. One differentiator would be that China Telecom, in a less mature economy, has better underlying growth potential.

Then turn to the stocks. Verizon is arguably cheap today at 12-13x trailing earnings. China Telecom trades at 8x, half of book value, and pays a 5.5% dividend. That to us is an aberration.

Is there anything in China Telecom's performance that might explain at least part of the valuation discount?

DI: It is true that the company's net margins over the past six or seven years have gone from an industry-average level to a below-average one. You can identify some line-item reasons for that, but our basic position is that there is no structural reason for their margins to lag industry standards. We think it's unlikely margins go much lower, so earnings for a growing business in a growing country can at least increase along with revenues in the future. And while we don't at all need this to make our investment case, it's possible margins increase 20% or so to the norm. That would be free extra money for us.

What kind of upside do you see in the shares from today's price of around HK$2.30?

DI: We generally base our decisions on current earnings and current cash flows rather than try to guess what we think is going to happen in the future. If we can buy at a price that's too cheap – in this case 8x earnings and 50% of book value – we'll do that. If the company is under-earning when we buy it cheap, even better.

For an oligopoly business in a growing industry and a growing country, we can make a reasonable case for the P/E to be twice the current level and for the stock to trade at least at book value, even at a premium. Yes, it's in China. On the one hand, we love the growth potential, the educated population and the economic infrastructure. We don't like so much the geopolitical turmoil, the corruption, or that there's less rule of law and weaker property rights. It wouldn't be where we'd keep all our money. But if a company like China Telecom in the U.S. would trade at twice this price, we think we're being more than compensated for being there.

Let's turn now to the types of situations you're finding interesting where cash flows are, as you put it, latent. What are some examples there?

DI: Here we always point out that for a building or a tanker or a commodity, when its price goes below the equilibrium cost that will incentivize people to add supply as fast as demand is depleting it, eventually the price goes up. So if a building trades at half what it costs to build a new one, or an oil tanker is valued at a 75% discount to what a new one costs to build, or corn is selling for less than it costs to grow, the prices may be very volatile, but that volatility will be around that equilibrium incentive price.

We've been buying companies with hard assets. For example, we own shares in a small-cap shipping company called Diana Shipping [DSX], whose tankers carry dry-bulk goods like iron ore, coal and grain. It's a classically cyclical business. Ten years ago, driven by China's voracious demand for commodities of all kinds, demand for these tankers was huge. Everybody orders new supply and by the time it comes along, China slows down, there's massive oversupply of tanker capacity, and shipping rates fall off a cliff.

The down cycle has gone on for years, but there are early signs that supply and demand are coming into better balance and dry-bulk shipping rates have tentatively started to increase. Investing in something like this is not for the faint of heart – there are losses at the bottom of the cycle, companies have debt, and getting timing right is problematic – but we

INVESTMENT SNAPSHOT

Newcrest Mining
(Sydney: NCM)

Business: Develops and operates gold mines located in Australia, Canada and Papua New Guinea; existing gold reserves represent more than 25 years of production at current rates.

Share Information
(@7/30/20, Exchange Rate: $1 = A$1.39):

Price	**A$34.92**
52-Week Range	A$20.70 – A$38.87
Dividend Yield	0.9%
Market Cap	A$29.37 billion

Financials (TTM):

Revenue	$3.80 billion
Operating Profit Margin	25.8%
Net Profit Margin	14.7%

Valuation Metrics
(@7/30/20):

	NCM	S&P 500
P/E (TTM)	35.0	30.6
Forward P/E (Est.)	19.3	25.5

Largest Institutional Owners
(@3/31/20 or latest filing):

Company	% Owned
Orbis Inv Mgmt	10.4%
BlackRock	4.6%
Van Eck Assoc	4.6%
Vanguard Group	2.7%
First Eagle Inv Mgmt	2.4%

Short Interest (as of 7/15/20):

Shares Short/Float	n/a

NCM PRICE HISTORY

THE BOTTOM LINE

As is the case with many commodities, argues David Iben, their value in the ground today is at an unwarranted discount to their current price. In this particular case, he believes if the company liquidated, including mining and then selling all its gold reserves still in the ground, the realized net value of doing so would be around twice the current market cap.

Sources: Company reports, other publicly available information think it's legitimate to value such a company on what it would cost to buy new ships. When we do that today, the shares of Diana [at a recent $1.40] trade at a 75% discount to that value.

Another area in which we've been very active is uranium. The price of the commodity over time has been in the $20s per pound on the low end and over $135 on the high end, and we believe the equilibrium price which incentivizes companies to build new mines as fast as the existing ones are being depleted is somewhere between $60 and $90 per pound. Inventories that were once way too high have been dropping for years, to the point where the price of uranium has increased from its low a few years ago of around $18 to today's $33.

Given that we still expect the price of uranium to double or triple from here, we like the big and profitable publicly held uranium producers, Cameco [CCJ] and Kazatomprom [London: KAP]. There's even more upside in NexGen Energy [Toronto: NXE], which owns 300 million pounds of uranium in Canada – and likely much more – but it doesn't have a mine yet and won't for at least three years. The market today pays more for a commodity like this when mines are in operation, making the cash flows more visible. If we have to wait a few years to dig it out, so be it. We would rather wait some years and sell things at two or three times the current price than sell it at a huge discount today.

Gold as a commodity has certainly gotten the attention of some investors. Walk through your investment case for gold-miner Newcrest Mining [Sydney: NCM].

DI: Gold is still our biggest sector holding. Because the industry is challenging, we own a number of companies with a lot of mines and with different management teams operating in different geographies. But if you wanted one large, stable and well-run company, Newcrest would be our first choice. It's one of the biggest players in the world, with high-quality assets mostly in Australia and on an island in the far northeastern part of Papua New Guinea. There's current cash flow, the balance sheet is solid, and management's capital-allocation decisions have generally made sense over time.

With the latest run-up in the gold price [to around $1,950 per ounce], it's close to the point where people are incentivized to bring on supply. That's treating it as a commodity. As a store of value, given the inflation risks inherent in unprecedented monetary-authority money printing, we could make the case that as money, gold is worth 2-3x today's price. We have a number of scenarios.

At the same time, the dynamic for gold is similar to what I described for uranium. If an ounce of gold above the ground is close to $2,000, even with big producers you can buy that gold in the ground for hundreds of dollars less per ounce, even after accounting for the costs to mine it.

How are you valuing the shares, now trading at around A$35?

DI: Newcrest's market cap today is just under 30 billion Australian dollars. If the company just said it was liquidating – pull all the gold out of the ground, pay all the related costs, pay off all suppliers and pay off all debt – we estimate shareholders would be left with around twice that market cap. That's at today's gold price. We think that indicates how investors today still don't like gold-mining companies.

If the price of gold goes up another $200 per ounce, we think the shares are worth at least another A$10 per share, taking it into the A$80s. Just for fun, if the price of gold went to $3,000, we'd be talking about a share price of A$140. To pay up for that type of optionality when you lose money in your downside case is risky. But when you still think you make money if you're wrong, having the optionality that the stock could go up 4x is pretty nice. VII