GLOBAL VALUE ADVISORS
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Investment Insight

GVA's Fundamental Research and Stock Selection Process

By Todd Bassion, Portfolio Manager

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GVA's competitive advantage is based on a proprietary quantitative process which we believe has a proven ability to identify a structurally advantaged subset of the universe. Fundamental research is used to select companies that we believe will remain in the advantaged subset over the next 3-5 years.

Portfolio managers at GVA are "100% model compliant," meaning they can only pick from stocks that the model recommends. For the International Small Cap product, the model typically recommends roughly 200 names and the team selects exclusively from this list to build each fundamental portfolio.

The biggest limitation to the model is that it is backward looking. The model can correctly identify companies with strong fundamentals over the previous 7 years, but it has no opinion on what the next 3-5 years will look like.

Fundamental Research

"Investing is about the future, and to make reasonable predictions, we start with companies that have distinguished themselves in the past. Then we seek to determine if the future is likely to be consistent with the past." ***Todd Bassion, Co-Founding Partner & Portfolio Manager***

Competitive Analysis	Financial Durability	Management Discipline
Purpose:	**Purpose:**	**Purpose:**
Evaluate the sustainability of competitive positioning, business model, end-market attractiveness and threats.	Evaluate the sustainability of Free Cash Flows, financial strength and ability to flourish in a variety of environments.	Ensure capital allocation discipline is focused on business operations, growth financing and returning capital to shareholders.

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What We Buy

GVA's Four Investment Pillars:

1. High and sustainable Free Cash Flows
2. High and sustainable Shareholder Yield

> over the prior 7 years and expected to continue

3. Strong balance sheets
4. In the cheapest 20% of our universe - undervalued due to non-structural, short-term factors

We prefer constrained capital allocation focused on shareholders through dividends, buybacks and debt reduction.

We prefer steady, mundane businesses where we don't pay up for growth.

Red Flags: secular headwinds, cyclical risks, idiosyncratic risks, empire builders.

"Internally financed operations is a key attribute of the businesses we like."
Philippe Rolland, Chief Investment Officer

GVA's fundamental research is always looking for factors that could negatively impact a company that has historically operated a healthy business.

1. Secular Headwinds

Secular headwinds typically originate from a change in the competitive environment that would limit a company's ability to generate future FCF. A good example of this is a company or industry facing digital disruption. GVA's model is currently recommending several names in the retail industry around the globe. The model likes the cheap valuation, strong balance sheets, consistent FCF generation, and high shareholder returns. Unfortunately, the model has no opinion on a changing competitive landscape.

Not all companies in the retail industry are created equal. GVA analyzes each company from a bottom-up perspective. We are specifically looking for companies who have an attractive distribution model and strong online presence. There should be limited signs of structural pressure from digital disruptors, such as Amazon or new technologies. If a retailer is executing well, it will show up the fundamentals of the business through consistent organic growth, stable market share, steady or expanding margins, positive EPS growth, and high ROE.

Conversely, we will avoid retailers who have a weak competitive position. These companies have often generated strong FCF over the last 7 years, but pressure on the business is showing in more recent years. If a company is behind the curve in their online presence or has an unattractive distribution model (ie mall operators), it will show up in the fundamentals of the business. A new disruptive technology will also impact results. Organic growth will turn negative, market share will erode, margins will be flat to down, and balance sheet ratios will deteriorate. Unless we have a strong reason to believe that management can turn the business around, we will avoid the name. Past FCF generation is not likely a good indicator of the company's ability to generate future FCF.

AVOID example: Cmc Magnetics Corporation (2323-TW)	
Cmc Magnetics is based in Taiwan and manufactures CDs, DVDs, and Blue-Ray discs.	
Model likes:	**GVA eliminates based secular headwinds:**
• High FCF generation. • High shareholder returns. • Solid balance sheet. • Cheap valuation.	• The business is in secular decline from digital disruption with EBITDA growth declining on a 1, 3, 5, and 10 yr basis. • Over the last 10 yrs sales have declined at an 11% CAGR and EBITDA has declined at a 23% CAGR. • The company consistently loses money on an EBIT basis. • EPS is negative.

2. Cyclical Risk

Cyclical companies or industries can produce misleading results in the model. GVA's model is specifically looking for companies who generate high and consistent FCF over the last 7 years, which is the typical length of a business cycle. If a company or industry is at the tail end of a 7 year or longer expansion, the model will likely find the name attractive. As the end market price grows higher, the model will typically see stronger FCF generation and cheaper valuation. Unfortunately, if the cycle is at or near peak levels, then past FCF generation is not a good indicator for what the future holds. The model has no opinion on where we are in the cycle or if we are close to peak levels.

GVA pays close attention to cyclical risks through fundamental analysis. We are currently seeing high cyclical risks in several housing markets around the world, various commodities (ie steel), and multiple markets in the global auto space. Although we won't avoid cyclical risk entirely, we are cognizant on where we are in the cycle and where the cycle is heading. With that in mind, we then analyze each company on a bottom-up basis. We are specifically looking for names that have solid balance sheets (often net cash), allowing them to weather the downturn. We also have the ability to analyze the competitive position and compare how fundamentals performed through previous downturns. Companies that are positioned at the low end of the cost curve will emerge stronger after a downturn. Any companies with weak balance sheets are eliminated, as the entire business model could be at risk during a downturn.

AVOID example: Nippon Steel (5401-JP)	
Nippon Steel is the world's second largest steel producer	
Model likes:	**GVA eliminates based on cyclical risks:**
• High FCF generation. • High shareholder returns. • Solid balance sheet. • Cheap valuation.	• Nippon's fundamentals have been flattered by strong steel prices over the last 7 years. • Recent steel prices have rolled over, with high amounts of supply on the market and slowing global demand. • Input costs (iron ore and coking coal) are rising. • Debt level leaves little room for error. • EPS is expected to decline 65% in 2019.

3. Company Specific Risk

Company specific factors are also closely analyzed. We are once again looking for a company's ability to generate FCF over the next 3-5 years. A good example of a type of name we will avoid is a pharma company with a high patent risk and a limited pipeline to make up for the shortfall. In a case like this, historical FCF generation is unlikely to be repeated. We will also avoid companies with a high concentration of sales to a single product or client, if the outlook is unfavorable.

Balance sheet gearing is another area we closely monitor through fundamental research. GVA's model eliminates names that fall in the lowest 20% debt to equity. Fundamental analysis allows us to dig deeper on the balance sheet by looking at all balance sheet ratios, credit rating changes, debt maturity schedules, and off-balance sheet items. We also scrutinize the company's debt distribution by currency to identify potential sources of risk. Lastly, GVA has the ability to see large M&A deals that have been announced, but have not yet closed. If the balance sheet ratios will deteriorate materially from the deal, we will avoid the name. The model is only backward looking, potentially making current balance sheet ratios misleading.

AVOID example: Indivior PLC (INDV-GB)	
Indivior is a UK drug maker, selling the leading treatment for opioid addiction (Suboxone Film).	
Model likes:	**GVA eliminates based on company specific risks:**
• High FCF generation. • High shareholder returns. • Solid balance sheet. • Cheap valuation.	• 80% of Indivior's sale are tied to Suboxone Film and the drug went off patent in June 2018. • Strong historical growth is unlikely to be repeated. • Current pipeline is not enough to offset patent cliff. • Indivior has been indicted by the DOJ for illegally increasing prescriptions of Suboxone Film through false marketing. • FCF is likely to drop significantly as EPS falls to zero.

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