

If It's Broken, Fix It!

Stockholm (HedgeNordic) – Many high-quality businesses are likely to face severe challenges at some point in their business lives. Some problems are short-lived and solvable, whereas others are more structural and can bring a business into the ground. Stockholm-based **Origo Quest 1** scouts the Nordic small- and mid-cap space for inexpensive, high-quality businesses with solvable shorter-term issues and engages in active ownership to fix the problems and unlock hidden value.

Hunt for Struggling High-Quality Businesses

Struggling businesses often sell at cheap share prices, but most of them are cheap for a reason. Finding great businesses with genuine short-term issues (rather than long-term structural problems) with inexpensive valuations is no easy task, according to Stefan Roos, who co-manages Origo Quest 1 alongside Carl Rydin. “That is the hardest part of our job,” exclaims Roos, who points out that “it is easy to stumble into value traps.” Roos then offers a piece of advice on how to avoid value traps.

“Do not start with the valuation of a company,” says the founder and chief investment officer of Origo Capital. Instead, “start with fundamental analysis and get to know the business really well by following the company for a long time.” Using this tactic, the two fund managers aim to identify high-quality businesses with good cultures and strong market positions in the Nordic small- and mid-cap space. Whereas quality can mean different things to different people, Roos describes a quality business as one that has a “pretty strong market position, good track record and some uniqueness in their business model.”

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Carl Rydin, who joined Origo Capital in mid-2017, explains that “if you look at some of our long-term holdings, one common characteristic is that they are the top players within their niches.” Their business operations are not “overly scattered around,” argues Rydin, who says that Origo’s holdings “are usually more niche players.”

The ability to earn money in cash rather than just deliver accounting earnings represents another common characteristic of Origo’s positions. “There are a lot of companies out there today not really earning any cash,” says Rydin, who adds that “the visibility for these companies to earn cash in the future is fairly limited.” Ideally, the Origo team searches for businesses that are “able to generate cash and grow operations without investing too much.” Roos emphasizes that generating cash nowadays is not enough. “We also need to anticipate growth in cash flows, so that we are not stuck with value traps,” argues Roos. “Some companies are making a lot of cash today, but we need to have future growth in cash flows as well.”

An essential aspect of Origo’s stock selection process involves assessing the quality of management teams. The quality of management is crucial in smaller companies, according to the duo, who spends a lot of time trying to understand the quality of each management team. “To identify a good management team, you have to follow them for a while, pay close attention to what they are saying, how they are acting and whether they are delivering on their promises,” explains Roos. “Our approach is to meet management teams very often to get to know them more than one can learn

about them by just reading annual reports.” Rydin points out that they “like management teams that are fairly humble, but professional and focused on what they do.”

Active Engagement, Net Exposure and Short Bets

Origo Quest 1 engages with the management teams and boards of their portfolio companies in an attempt to steer those businesses in the right direction. “Engaging with companies is what makes us different from other players in this space,” argues Rydin. With around 15 to 20 names in the long book at any given time, the Origo team usually acts as “an extra-active owner” in about half of these holdings. The top five holdings usually account for between 40 to 50 percent of Origo’s long book. “If you look at our high-conviction cases in the past years, those have been the ones we engaged with more,” points out Roos.

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Origo’s active approach to investing comes hand in hand with a long-term view. Having a long-term perspective is another crucial aspect of Origo’s approach, reckons the duo. “We allow ourselves to have a long-term view than most others,” argues Rydin, who says that “there are some examples in the fund’s history where after three to five years, the business and investment case looks totally different than they did initially.” Origo tends to invest in the type of businesses that “one would probably not invest in if you ask the question of how the company is going to do in the next six months.” The typical holding period in the fund’s long book averages between four-and-a-half to five years. “We might have been too early in some of our previous investments,” reckons Roos, “but they start to pay off after a while.”

“Actually, we have a quite long horizon for our short positions as well,” exclaims Roos. “Seven years back, at the beginning of the fund, we thought we had to have a short-term vision on the short book,” says Roos. “But looking back now, we maintained short positions for long periods.” Origo Quest 1 maintains a similar number of short positions as long positions, usually between 15 to 20. “Short positions are more equal in terms of sizing,” according to Roos. Origo Quest 1 usually maintains an average net market exposure between 30 percent and 50 percent, and ended the month of July with a net exposure of 51 percent.

“If we were to put our short positions in clusters, one type of shorts we do involves finding high-conviction cases with specific catalysts on why a stock should go down in price, and another type covers theme-based shorts,” explains Rydin. Short candidates in the first type of shorts include companies with some accounting irregularities, where their cash profiles differ from the accounting earnings displayed in the income statement. The second type includes short positions in companies operating in industries that are in a structural decline. The Origo team looks for companies “that have to invest a whole lot just to stay competitive.”

What is Value?

“Value is a very complex theme to discuss,” reckons Roos, who next asks the question of what is value? Just as with the term “quality,” the “value” term means different things to many people. “As I think about value, a value opportunity could be both a growth company or a non-growing company implementing the right type of actions,” explains Roos. “And in the end, all good investing is value investing. I consider myself a value investor, but I may have a different view from others of what value means.”

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“A value investment for us means that the price we pay is clearly lower than the value of the company,” says Roos. “We do not have one super-formula to calculate the value, but we use a mix of formulas instead.” Free cash flow and owners’ cash flow in combination with long-term growth in cash flow are important metrics for the Origo team.

Explaining the underperformance of so-called value stocks versus growth stocks in recent years, Roos considers that ultra-low interest rates explain most of the relative underperformance. “Investors have been willing to pay more for stocks with high-growth potential,” he explains, adding that “this is a typical pattern in bull markets where risk appetite is high and flows into passive funds and momentum stocks are massive.”

Cheap money has been the key driver for growth stocks, but Roos expect this to turn around at some point in time. “The environment today looks very similar to the market conditions back in 1999 prior to the tech-bubble,” says Roos. “When investors once again go into a risk-neutral or risk-off mode, I think value will make a great comeback,” he concludes.