CITYWIRE PRO BUYER

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Bill Hench: End of ‘free money’ era could revive shrinking small-cap universe

The veteran small-cap manager talks about his turnaround strategy, regional banks and the possible end to the ever-shrinking small-cap universe.

BY JOHN COUMARIANOS

Small caps have had a rough time of it.

While large-cap indices are soaring this year, thanks to the outperformance of a few mega-cap tech names, small stocks have had a bumpier ride, which included the regional bank crisis and ensuing selloff.

The S&P 500 was up about 12% for the year through Monday, June 5, 2023, while the Russell 2000 was up about 3%, with most of that gain coming from a rally over the last few days. Through the end of May, the small-cap index was marginally negative and the S&P had put in one of its best five-month performances against the small-cap index in 20 years, outperforming the Russell 2000 by 9.69 percentage points, 9.65% to -.04%.

Citywire spoke with Hench about his US Small Cap Strategy, which includes a success with Ruth’s Chris Steakhouse and a failure with Texas banks early this year.

Citywire (CW): Give a successful example of your strategy at work – where you spotted the potential or catalyst for a turnaround or a hidden asset that became properly valued.

Bill Hench (BH): Our strategy seeks out companies that not only have ‘cheap statistics’ — such as low price-to-sales or price-to-book ratios — but also a catalyst for the potential normalization of these statistics and thus an increase in price. Ruth’s Hospitality Group (RUTH), which operates the Ruth’s Chris Steakhouse chain, is a good recent example of our strategy at work. Like many restaurant stocks, RUTH was struggling with the residual demand effects of Covid-19, as well as mounting inflation and fears of recession. We thought RUTH’s earnings would recover once macro dislocations were worked through and normal customer patterns resumed. We obviously were not alone in expecting a rebound, as Darden Restaurants recently agreed to acquire RUTH at a premium to its market price.

CW: Give an example where you were unsuccessful – perhaps the catalyst was harder to spot or the hidden asset wasn’t worth what you thought it was. What did you learn from the experience?

BH: While we try to make money on every position, we do not always succeed. Executing a corporate turnaround is challenging, even when the economic backdrop is favorable; doing so in a difficult macro environment leaves little room for error. For example, we invested in two regional banks we believed to be attractively valued and whose Texas markets offered what in our view was the most appealing combination of business and population growth in the US. We thought rising interest rates would enable the banks to improve their net interest rate margins in the near term, driving improved earnings and better market valuations. Parts of our thesis didn’t play out as expected, and the timing of our investment proved particularly inopportune given the broad selloff in US regional banks earlier in 2023. We ultimately sold these positions.

CW: There were over 7,000 publicly traded companies two decades ago, and there are less than 4,000 now. Is it getting harder to find opportunities?

BH: While there clearly are fewer small-cap companies for us to consider, I don’t think it’s made our job any easier or harder. Ample liquidity as a result of years of near-zero interest rates enabled private companies to go public much later in their life cycles than previously had been typical, resulting in fewer small-cap names being introduced to the market. We may be at an inflection point here, however; with ‘free money’ no longer a thing, smaller companies may again need to tap the public markets to finance their growth.

CW: How big, in terms of market capitalization, are the companies you target, and how big can your strategy get?

BH: We will look at companies that have a market cap that is equal to or less than the biggest names in the Russell 2000 Value index. That being said, the median market cap of the strategy typically is much smaller than the largest names in the index. Currently, our median market cap is about $1.5 bn; the biggest stocks in the index run about $6bn. Our strategy has about $1.1bn* in assets under management right now. In the past, we managed the strategy with about $4.5bn, and we think that is about the practical limit.

CW: Louisiana-Pacific has delivered desirable returns. What's in need of improvement there? Some people say wood processing companies are doing so well (because of consolidation after the GFC) that they're killing the parties on either end of them in the chain –the tree-growers and new home buyers. Is that true?

BH: We purchased and still own LPX because it appears cheap on a statistical basis. We view the stock as an asset play, not a turnaround opportunity, as LPX has a respectable track record of using its cashflow to return capital to shareholders through stock buybacks and dividends. We often find value in cyclical stocks while understanding that there are often varied opinions on the timing and nature of the investment. Housing-related stocks, in particular, seem to be the frequent subject of spirited debate between their bulls and bears. But we think the structural need for more housing in the US should provide a supportive backdrop for a company like LPX that historically has done well by providing good products to its customers and good returns for its owners.

CW: You have less than 1% of the portfolio in regional banks, according to Morningstar data. Are you gearing up to make investments there, or staying away?

BH: Our bank holdings are now and historically have been lighter than the benchmark; looking back, our largest bank exposure probably came in the aftermath of the global financial crisis. As value players, we like to buy banks when they have a lot of reserves on the books. The recently ended period of near-zero interest rates has left banks with very small reserves for losses or bad debt, limiting our interest in the space. We are always on the lookout for good investments, however, and it's possible we could find some opportunities to invest in banks if these reduced reserve levels lead to further cheapening, especially if real estate becomes an issue.

**As of March 31, 2023*

As of March 31, 2023 the First Eagle US Small Cap Strategy held: Ruth's Hospitality Group (RUTH) 0.31% and Louisiana-Pacific Corp. (LPX) 0.70%.

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Bulls and Bears: jargon that stock-market traders use. A bull is someone who buys securities or commodities in the expectation of a price rise, or someone whose actions make such a price rise happen. A bear is the opposite—someone who sells securities or commodities in expectation of a price decline.

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