



# Pup Research

## *Small Cap. Investing Philosophy*

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### Contact:

**W:** [www.pupresearch.com.au](http://www.pupresearch.com.au)

**E:** [info@pupresearch.com.au](mailto:info@pupresearch.com.au)

**T:** +61 3 9214 2000

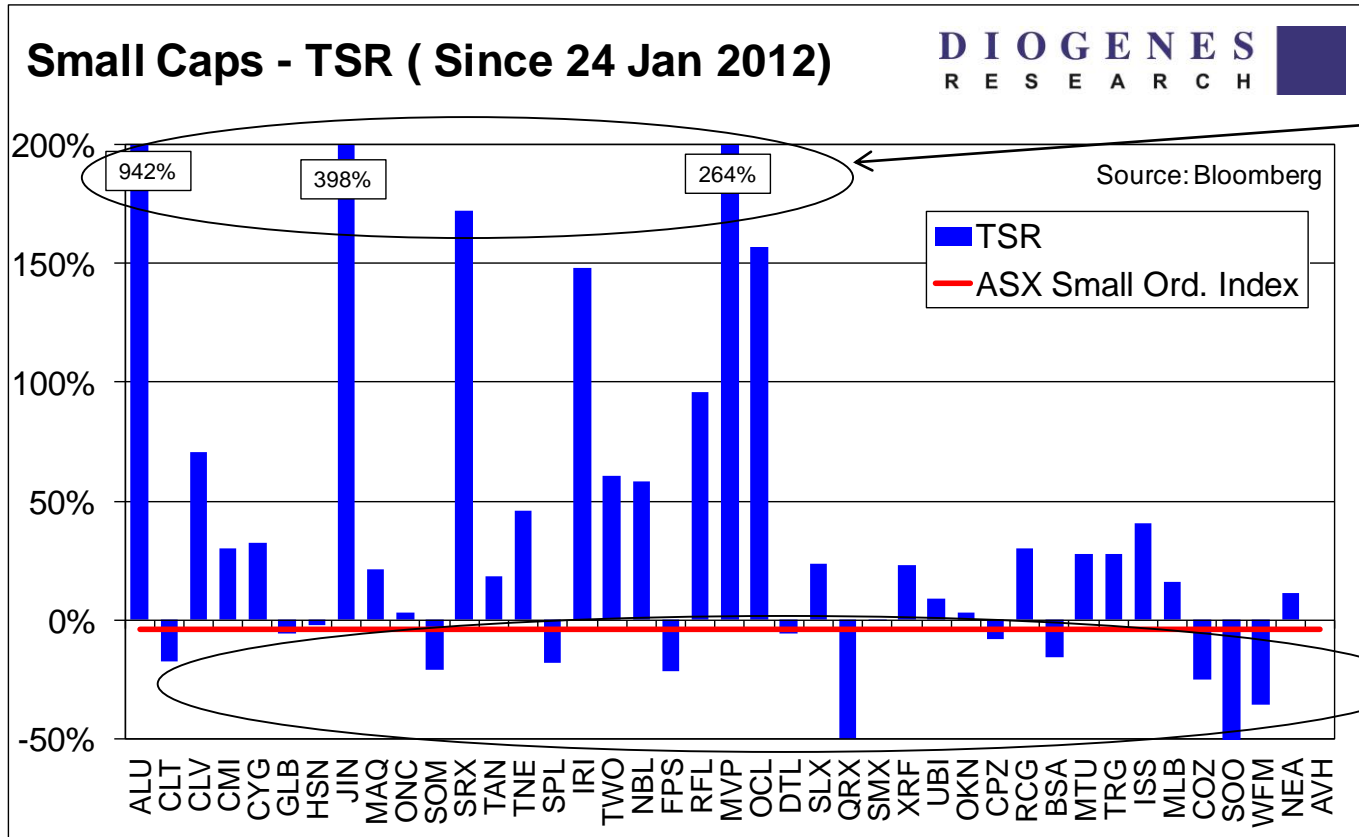


## Small Cap Investing – Key Observations

- Investing is probabilistic – minimise risk and maximise reward.
- This is particularly true of small cap investing where both risk and reward are higher.
- We use the following strategies to improve the risk/reward equation:
  - Diversify – number of stocks, factors, strategies;
  - Search for winning attributes rather than winning stocks;
  - Adopt different investing strategies to understand the importance of different attributes;
  - Portfolio management:
    - » Bigger positions in better risk/reward;
    - » Observe who is winning, rather than predicting who will win.
- We use a screening system to keep track of potential opportunities.



# Small Cap Investing – The Importance of Diversity



Diversity has two benefits:

More chance of including winners ...

... Mitigates impact of losers.



## Look for winning attributes rather than winning stocks.

- The winning attributes we search for are:

<b>Attribute</b>	<b>Reason</b>
Strong Balance Sheet	Avoids dilution if timing takes longer; Provides optionality to execute
Good earnings quality/cash conversion	Indicative of good management Self screening for high ROE
High Returning Business	Ensures that benefits of growth create value for shareholders
Large Potential Market Opportunity	Provides both real upside and potential for exuberant re-rating
Growing Industry	Makes market share gains easier
Corporate Governance	Ensures benefits of growth flow to shareholders not management
Valuation	Look for fair to good valuation



## Small Cap Investing – Winning Attributes

- Obviously a stock with all these attributes is rare to find. Therefore, trade offs need to be made. In general:
  - We are happy to trade off valuation against business and management quality. I.e. A cheap enough valuation can turn a bad company into a good stock
  - We will not trade off a bad balance sheet for valuation.
- Different attributes have different weighting depending upon the investment strategy being pursued:

<b>Strategy</b>	<b>Description</b>	<b>Important Attributes</b>
Deep Value	Buy existing assets cheaply	Valuation; Balance Sheet
Cyclical	Buy expecting return on existing assets to improve	Valuation; Management;
Growth – Organic	Ability to deploy capital organically at high rates of return	High return on capital; Large Market Opportunity
Growth - Acquisition	Ability to deploy large amounts of capital via acquisitions at good rates of return	Earnings quality; Return on Capital; Management



## Small Cap Investing – Portfolio Strategy

- We apply a portfolio/trading strategy that has two elements.
- Bet size is determined by risk/reward equation.
  - As risk is reduced due to observed operational performance – we aim to buy more.
  - As reward improves due to declining valuation – we aim to buy more.
  - If the balance sheet or earnings quality deteriorate – we aim to sell/reduce position
- Trading strategy is also determined by investment strategy

Strategy	Trading Strategy
Deep Value	Sell at NTA or move stock to cyclical category.
Cyclical	Sell when re-rating has occurred.
Growth – Organic	Sell only on extreme re-rating/valuation.
Growth - Acquisition	Sell on evidence of poor earnings quality/change in acquisition strategy - “the last acquisition”



# Small Cap Investing – Screening for Attributes

- To identify overall positive risk/reward propositions we screen for six factors (three risk & three reward)

## Risk Factors

Score	Balance Sheet	Operational & Governance	Earnings Quality	Total Score
Each factor is scored between 2 (V good = low risk) and -2 (V Poor = high risk)	(i) The level of debt and other on and off balance sheet liabilities (eg operating liabilities, associate leverage etc) (ii) The nature of the companies earnings (cyclical, sustainable etc) cash generation and capital commitments.	(i) <u>Operational</u> - Riskiness of company's cash flows having regard to track record, volatility & sustainability of returns (ii) <u>Governance</u> - whether operating performance will flow to shareholders, management or misallocated.	(i) use of discretionary accruals to manipulate short term earnings  (ii) use of non- discretionary accruals that reflect the underlying capital intensity of the business	If minimum score is <0, the lower of minimum score or sum of scores. If minimum score is 0, sum of scores.
<b>V Good</b>	Significant surplus cash or other assets.	Track record of profitability & sustainable returns. Good gov.	Excellent earnings quality. Earnings conservatively stated.	
<b>Good</b>	Undergeared, some distributable surplus.	Track record of profitability but query sustainability of rtns. Fair gov.	Good earnings quality; Earnings fairly stated.	
<b>Fair</b>	Appropriately geared for nature of business.	Profit history ok, but reasonable risk to earnings. Ave. gov.	Ave. earnings quality; consistent with peers.	
<b>-Poor</b>	Fully geared	Patchy profit history/major risk to earnings franchise. Gov. concerns.	Some concerns re earnings quality - level or trend.	
<b>-V Poor</b>	Over-leveraged - cash flow will be directed to debt holders.	Early stages of commercialisation / start up. Major gov. concerns.	Major concerns re earnings quality - level or trend.	



# Small Cap Investing – Screening for Attributes

## Reward Factors

Score	Current Value	Potential Value	Momentum	Total Score
	Valuation of current assets and operations of the business having regard to through the cycle returns and nominal growth rates	Ability to create value through reinvestment of capital at high rates of returns or by de-risking future growth options & cash flows	Direction of earning/operating trends (rather than level). High share price to fund capital growth.	Sum of scores

<b>V Good</b>	<50% of assessed fair value.	Potential Value > Current Value &> 2x Share Price	Current operating and earnings momentum is strong.
<b>Good</b>	50-75% of assessed fair value.	Potential Value > Current Value but < 2x Share Price	Current operating and earnings momentum is solid.
<b>Fair</b>	75 - 125% of assessed fair value	Potential Value > Current Value but < Share Price	Business is steady
<b>-Poor</b>	125-150% of assessed fair value	Potential Value = Current Value	Operating/Earnings momentum has peaked.
<b>-V Poor</b>	>150% of assessed fair value	Potential Value < Current Value	Operating/Earnings momentum is poor.

Reward Opportunity	Valuation Method	Valuation Method	Description
<b>Deep Value</b>	P/NTA	n/a	Buy existing capital cheaply
<b>Cyclical</b>	EV/Sales; P/NTA	n/a	Opportunity to improve return on existing capital
<b>Growth - O</b>	EV/Sales	Price scenarios	Opportunity to organically deploy capital at high rates of return.
<b>Growth - A</b>	EV/Sales	Price scenarios	Opportunity to acquire assets at high rates of return.



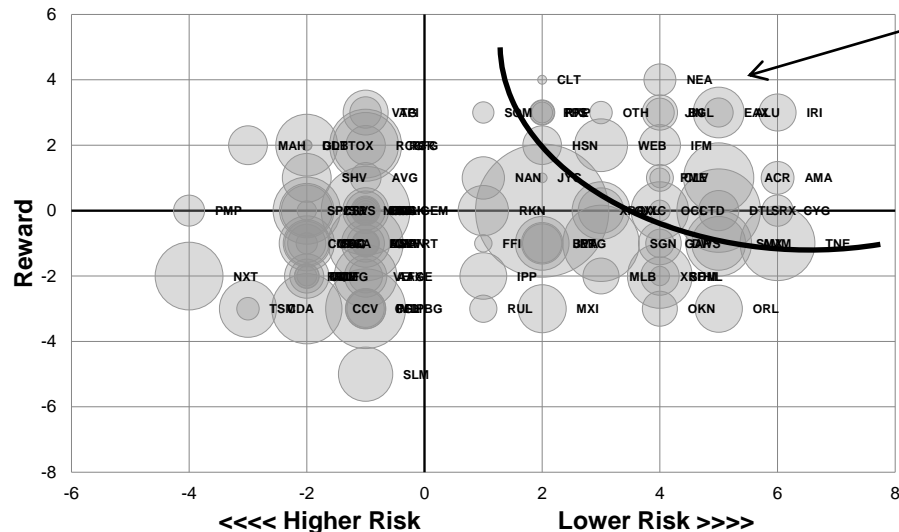


# Small Cap Investing – Screening for Attributes

- So in summary:

Risk	Balance Sheet; Operational & Governance; Earnings Quality
Reward	Current Value; Potential Value; Momentum

Pup Research Screening Model - Risk/Reward



- Obviously, we are looking for stocks in this area of the screen.
- However, no screen is perfect. Sometimes the weighting of one factor can outweigh potential positives and negatives in other areas.
- As noted, these issues are managed by:
  - Adopting different investing strategies for different stocks.
  - Focussing on different attributes for different strategies.
  - Adopting different portfolio weights for these strategies.
  - Adopting different trading strategies for these strategies.



## Conclusion

- Search for winning attributes:
  - Balance sheet strength
  - High returning business model
  - Good earnings quality
  - Fair valuation
- Observe performance
- Diversify
  - By Stock
  - By Strategy



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