KayneCast

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First Quarter 2017 Review of the Small Cap Quality Value Portfolio

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Hello, this is Julie Kutasov, Portfolio Manager for Kayne Anderson Rudnick's Small Cap Quality Value strategy. Today, I am here to provide a first quarter 2017 review and highlight some of [our] portfolio holding changes and stocks that have contributed positively as well as negatively to the overall performance.

Stock market returns were solid in the first quarter with the S&P 500 Index advancing over 6 percent and the Russell 2500 Index up nearly 4 percent following a robust second half of 2016, which was driven by investor post-election enthusiasm, oil markets' recovery and improving economic growth.

The failure of the Obamacare repeal, however, has led to questions about how much of President Trump's agenda will actually be enacted by Congress. As a result, cyclical stocks, which have the most to gain from the passage of that agenda, lagged defensive segments (such as utilities) in the first quarter and those segments that benefited the most from Trump's election win (such as banks) cooled off and lagged. The Russell 2000 Value Index (which holds over 20 percent in banks) posted a slight 13 basis points decline in the first quarter, bringing the trailing-twelve-months return to a still very impressive 29.37 percent.

Although high-quality names underperformed low-quality names during the quarter (clearly not a favorable environment for us as high quality investors), our Small Cap Quality Value portfolio outperformed the Russell 2000 Value Index during the quarter by over 500 basis points, primarily due to strong stock selection in the consumer staples, producer durables and consumer discretionary sectors.

The two positions that contributed most positively to performance during the quarter were National Beverage (ticker FIZZ) and SiteOne Landscape Supply (ticker SITE), a new holding.

Some of you may recall our discussion of National Beverage in prior quarters. The company was our top contributor in 2015. It is also the second highest contributor for us for the trailing-five-year period. As a reminder, National Beverage manufactures and markets flavored beverages, including soft drinks, juices, teas and sparkling waters. It is that latter category with the company's sparkling water, LaCroix, brand that has been driving National Beverage's robust growth recently in the environment where consumers have been shifting away from carbonated soft drinks to healthier beverages. Some of you may have read an article about the company in a recent issue of the Wall Street Journal which noted that sales of LaCroix "grew 47 percent last year making it the 'number one brand' of flavored bottled water in the U.S." This robust growth was certainly evident in the company's most recent reported quarter with total revenues up 20 percent driven by an over 50 percent increase in LaCroix sales.

Added to the portfolio in the first quarter, SiteOne Landscape Supply is the largest and only national wholesale distributor of landscape supplies (such as irrigation supplies, outdoor lighting and nursery goods). The company serves a highly fragmented market of landscape professionals who specialize in design, installation and maintenance of lawns, gardens, golf courses and other outdoor spaces. Despite being the largest (four times the size of its largest peer and larger than the number two through ten competitors combined), SiteOne holds a modest 10 percent share of this highly fragmented marketplace, providing ample opportunity for growth. Importantly, the company's size allows it to exert pricing pressure on suppliers while at the same time commanding premium pricing versus local competition. Strong organic sales growth in the most recent quarter and solid double-digit earnings growth guidance provided for 2017 have helped propel the stock price higher. Shares are still trading at a discount to other high-quality distribution businesses, however, while the opportunity for industry consolidation remains superior.

The stock that detracted the most from the quarter's performance was Sally Beauty Holdings (ticker SBH), a distributor and retailer of beauty supplies, which was added to the portfolio in the third quarter of 2016. Sally, along with other retailers, saw its traffic in the core retail stores slow in the first quarter. In addition, investors were worried that growth at the company's professional stores could also slow in the coming year. The company continues to work on initiatives to improve store traffic and customer loyalty, but these efforts could take time to drive better results. The position is currently under review.

As I mentioned on the last quarter's podcast, we initiated two new purchase programs at the end of the fourth quarter that were completed in the first quarter. One of these is SiteOne that we have just discussed, and the other is Anika Therapeutics (ticker ANIK). We also initiated and completed purchases of Lincoln Electric Holdings (ticker LECO) and Watsco (ticker WSO) this quarter. And we sold our position in CEB (a leading provider of best practices research, executive education and decision support tools to business executives) early in the quarter following the company's January 5th announced that it was being acquired by Gartner in a cash-and-stock transaction, representing an approximately 25 percent premium to the previous day close.

Let me provide some color on the new holdings.

Anika Therapeutics develops, manufactures and commercializes therapeutic products for tissue protection, healing and repair that are based on hyaluronic acid (or HA), a naturally occurring biocompatible polymer found in the body. Anika holds an impressive over 20 percent market share (second only to Genzyme) in the visco-supplementation market. Importantly, the company has a solid position in the treatment of osteoarthritis, a large and growing market driven by aging population as well the need for greater alternatives to knee replacement surgery. Given favorable clinical outcomes that Anika's products have enjoyed over time, they have firmly established themselves as a premium priced product with no discounting. Gross margin has reached an impressive high 70s, and the company's balance sheet remains pristine with plenty of cash and no debt.

Lincoln Electric is not entirely new for us. We held the stock in the portfolio for nearly 12 years (from 2002 through 2014). The company is a global leader in the design, development and manufacturing of welding products, such as welding power sources, plasma cutters and robotic welding packages serving industrial markets in more than twenty countries worldwide. In North America, Lincoln holds the leading market share, accounting for nearly a third of industry sales. The company has a unique cost structure providing it with the ability to flex labor hours up and down depending on the economic environment, thus, reducing any margin pressure during recessionary periods. Lincoln is a solid free-cash-flow generator, returning excess cash to shareholders in the form of dividends and share repurchases. We expect the company to continue growing faster than peers due to its solid first-mover positioning in the automation segment, which is projected to grow twice as fast as the underlying welding industry.

Watsco is the largest HVAC (heating, ventilation and air conditioning) products distributor in North America, serving both residential and commercial customers. Roughly three quarters of revenues come from replacement (much of it understandably urgent especially in winter and summer months) bringing stability to the company's earnings stream. Watsco's scale provides the company with a competitive advantage on product availability and breadth (both highly important to the company's contractor customer base). Over the past 10 years, Watsco posted a solid 15 percent average return on invested capital, and grew revenues at a 12 percent annualized rate having taken share from smaller competitors. With its capital-light business model, the company has been a reliable free-cash-flow generator and a disciplined capital allocator, returning excess cash to shareholders in the form of quarterly dividends.

In summary, we are very satisfied with the portfolio's current positioning both in absolute terms and versus the Russell 2000 Value benchmark on all of the quality, growth and value metrics that we monitor and manage to. Five-year average return on equity for our companies stands at an impressive 21.5 percent versus just 8 percent for the Russell 2000 Value Index. Importantly, it is derived from solid underleveraged balance sheets with Debt-to-EBITDA ratio for our companies of less than 2 times versus nearly 7 times for the Index. Diluted earnings per share compounded annual growth for the past 10 years (which includes the Great Recession) for us stands at a solid 10.4 percent versus 4.7 percent for the Index, and our companies have grown quarterly cash dividends per share at an impressive compounded annual growth rate of nearly 10 percent over the past 10 years versus less than 2 percent for the benchmark.

We remain fully committed to our high-quality discipline and focused on the long-term outlook for our companies and our portfolio. We also remain confident that investing in high-quality businesses will yield superior risk-adjusted returns over the longer-term. In fact, our discipline of being a high-quality investor has been proven through our long-term alpha generation.

Thank you again for taking time to listen to this recording today, and as always, if there are any questions or comments, please do not hesitate to reach out to us.