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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Profiting from Inefficiencies in International and Emerging Markets Small Caps

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SECTOR — GENERAL INVESTING

TWST: Could you tell us about the firm and your role?

Mr. Kim: Kayne Anderson Rudnick is a Los Angeles-based investment firm founded in the 1980s by Ric Kayne, John Anderson and Allan Rudnick. John Anderson is well known for being the benefactor of the UCLA Anderson School of Business. Today, we manage about $60 billion in assets, with the majority of the assets being in domestic strategies.

I am part of the international team, where I co-manage the international and emerging market strategies with my partner Craig Thrasher. The international team currently manages around $4.5 billion in its strategies.

There is one unifying investment philosophy across all of our strategies, and that is to focus on high-quality businesses. Our goal is to find exceptional businesses that can generate strong business results over a long period of time and to let the business results generate our investment results over time.

The longer a business can prosper, the better long-term investment results we can generate for our clients. And in order to have longevity in business, you need to have some sort of a competitive protection, because chances are, if you have an attractive business, sooner or later you will attract people who want a piece of your pie.

So we think of high-quality businesses as being companies with a durable competitive advantage. And in our research process, we focus on determining whether a business is truly differentiated and protected, and we assess how sustainable that protection is.

TWST: Could you tell me about the strategies that you work on?

Mr. Kim: Sure. I co-manage the international small cap and the emerging market small cap strategies at Kayne Anderson Rudnick.

These two strategies follow the same investment philosophy that we follow on the domestic side at the firm, which is really to focus on high-quality businesses. International and emerging markets small cap are both large and inefficient spaces. With our strategies, we try to take advantage of those inefficiencies and try to find great businesses at attractive valuations.

TWST: And how do you ensure that there's minimal risk? With some foreign investments, especially in certain countries, there can be some risks to investors. How do you make sure that that risk is minimized?

Mr. Kim: For us, I think the main risk that is associated with owning a business, because investing is really about owning a business, is the business risk. Our approach of focusing on high-quality businesses leads us to companies that are competitively protected, have healthy balance sheets, and have a relatively stable earnings profile. Focusing on these types of businesses, we believe, really mitigates the majority of the business risks and financial risks that you expose yourselves to by owning some of these businesses.

I would add, that as a U.S.-based investor, one could worry about the currency depreciation in some of these countries, especially emerging market countries. But typically, currency depreciation comes along with, or is preceded by, inflation. But if you own high-quality businesses that have pricing power, oftentimes, even if there is inflation, the business that you own can pass on that inflation to customers and thereby mitigate the risk of inflation, which ultimately results in relatively benign currency risk because your business's nominal growth reflects the inflation and the currency depreciation.

TWST: And did you want to give an example of a company that you find interesting now?

Mr. Kim: Yes. The first company I would mention is a registrar and transfer agent ("RTA") to Indian asset management companies. To some extent, its business model is comparable to that of U.S. mutual fund service providers.

RTAs maintain detailed records of investor transactions and mutual funds. They manage things like account creation and KYC — Know Your Customer — documentation, regulatory reporting, and processing of trades and transactions. Mutual funds outsource all these functions to an RTA, enabling them to save on costs and time, and focus on their core business of raising assets and investing. RTAs also handle all communications with the investors in mutual funds, for example distributing periodic statements. This particular RTA has a dominant position with a 73% share of the industry's assets under management — AUM.

This is a business with high switching costs, as RTAs are deeply integrated into the daily operations of their customers. Switching vendors can be very disruptive and costly for an asset manager. And in addition to that, the fees that customers pay to this company is small — at around 4 basis points of AUM on average. So given these dynamics, this RTA loses fewer customers. In the last five years, I think it has lost maybe one client to a competitor. But this was really because the client's business was acquired by a company that uses the service of a competitor. However, the competitor is much smaller and there are really only two players in this industry.

It has attractive financial characteristics with return on capital in the mid-40s and operating margins of 30%-plus. While the stock has run up quite a bit recently, and valuation is not necessarily cheap at the moment, we believe the company has a long runway for growth, which in our view will allow us to generate reasonable returns over time.

Highlights

Hyung Kim discusses the international and emerging market strategies at Kayne Anderson Rudnick. He says that the international and emerging markets small cap spaces are both large and inefficient, and that his team tries to take advantage of those inefficiencies and find great businesses at attractive valuations. According to Mr. Kim, if you own high-quality foreign businesses that have pricing power, often, even if there is inflation, the businesses can pass on that inflation to customers and thereby mitigate the risk of inflation, which ultimately results in relatively benign currency risk. Mr. Kim recommends several underfollowed, small-cap international companies, including India's largest registrar and transfer agent; the largest operator of automobile auctions in Thailand; and a manufacturer and distributor of disposable diapers operating primarily in Vietnam and Cambodia.

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Indian households historically put a large portion of their savings into physical assets like gold and real estate, but this is increasingly being allocated into financial assets such as mutual funds. But the penetration of mutual funds measured by AUM over GDP is still just 12% — around 12% in India versus a global average of 65%. So, as the mutual fund industry grows in India, we think this company is very well positioned to benefit from that growth over long periods of time.

TWST: Did you want to mention a second company?

Mr. Kim: Another company that I would mention is a property auction services company. This is the largest operator of automobile auctions in Thailand with around 40% market share.

Before I go into details on the company, I should say that one of the things that we do here at Kayne on the international team to generate ideas, is that we as a firm have been looking at small companies, small high-quality companies, for several decades. So we have accumulated knowledge and data on several small businesses that we have looked at and invested in on the domestic side. We have a good idea of what types of businesses are truly high quality and do well over time and what types of businesses are short lived.

We sometimes look at companies that have been successful investments for us on the domestic side and try to find similar business models in other countries. This company is an example of an idea that we found through that kind of a process. This business model is similar to US property auction companies that we have been shareholders of on our domestic side for many, many years.

So, as I said, this is an operator of car auctions in Thailand. It's the biggest in that country. Commercial banks and leasing companies supply repossessed vehicles for auction, and the buyers who come to auction sites are car dealers and motorcycle dealers in Thailand. The company does not take ownership of the car, and there's no inventory risk. It charges auction buyers a fixed fee of about THB8,000 for four-wheelers and about THB1,500 for motorcycles. And the company has 29 car parks and 13 auction centers across Thailand.

And as you can imagine, when an insurance company or financial institution wants to get rid of a car or sell a car, it wants to monetize the vehicle as quickly as possible at an attractive price. Buyers, on the other hand, want access to a wide selection of vehicles that have been carefully inspected by a trusted third party. So, at 3x the size of its closest competitor, this property auction company attracts the most buyers and the most sellers to its auctions, thereby increasing vehicle liquidity and adding value to all participants as the company grows.

This network has been built up over 28 years and has reached a critical mass, making it very difficult for smaller auctions to compete with them. We think this company has a very strong competitive position.

And lastly, in terms of financial characteristics, this property auction services company has strong financial characteristics. It generates around 30% post-tax return on invested capital, with strong free cash flow generation. Market cap today is around $160 million, so it's a very small company. And there's no global broker that covers the name, only a few local brokers cover it. It's, I would say, a relatively unknown company to foreign investors. In fact, when we first reached out to them, they said we were the first foreign investors they ever spoke to. Because it is less well known, the company is still trading at attractive valuation levels in our view.

TWST: Did you want to mention another company?

Mr. Kim: Sure. It's a personal hygiene company whose main line of business is manufacturing and selling disposable diapers, and it is one of the first companies to manufacture and introduce disposable diapers in Cambodia and Vietnam. The business is listed in Taiwan, but has operations mainly in Vietnam and Cambodia.

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It is the third-largest player in Vietnam with around 12% market share, and it is the leading player in Cambodia's baby diaper market with around 45% market share — more than 45%. It is the only company with local manufacturing presence in Cambodia actually. Key to this business in Vietnam, especially, is distribution, and its large distribution network is what gives them some protection from competitive forces in our view.

So large scale, modern format supermarkets are still in very early stages of penetration in Vietnam and the vast majority of consumer good sales still happen at local, small-sized, mom-and-pop stores. If one wants to sell diapers in Vietnam, one would have to travel around the country, knocking on each store's doors and ask to put their product on their shelf. And the company works with 37,000-plus mom-and-pop stores nationwide, and it literally took the management team years, if not a decade or more, to establish these distribution relationships with mom-and-pop stores located throughout the country. This distribution network is very hard to replicate.

What's more interesting is that the disposable diaper use penetration rate in Vietnam and Cambodia is only at around 25% to 30%, whereas in developed countries that number should be close to 100%. So over time, as the economy grows and people become wealthier, we believe the penetration rate will naturally go up and the company can benefit from that over time. And this, again, is a very small company that has essentially no analyst coverage at the moment.

TWST: And did you want to mention one final company?

Mr. Kim: Sure. I would mention a leading online classifieds group that operates several leading online classified portals in the Baltics. They are headquartered in Lithuania, but they also have operations in Estonia and Latvia. They have the leading classifieds portals across different verticals in the three countries. They have the number-one generalist classifieds in Lithuania and Estonia, and they also have leading classifieds portals in the auto, real estate and job verticals.

Online classifieds is a classic example of a business model that has a network effect. Supply would go to the place where there is the most demand and demand will naturally be attracted to where there is the most supply. And in this business, it is also important that you are the most established number-one player with high consumer mindshare, so that your portal is the go-to place for people. For example, when you think of browsing real estate, a company would want its real estate portal to be the first thing that comes to consumers' minds. And having the largest classifieds ensures that consumers feel that going to that portal will enable them to see the widest selection of supply.

Most of their portals are orders of magnitude larger than the closest competitor, so they have a very strong competitive position. And this is reflected in their strong financial characteristics. They are profitable and capital efficient, and the business is still in early stages in terms of monetization, relatively speaking. If you look at the cost of the listing for the customer versus the value of the car or the house that is being listed, it's still very low and we believe that there is room for the business to grow over time as they continue to create value for consumers.

TWST: And as we talk about these different companies and the strategies, what role might the strategies play in a diverse portfolio for an investor?

Mr. Kim: I think, oftentimes, investors in the U.S. do not have exposure to emerging market equities. And if they do, it is most of the time exposure to passive ETFs or large-cap managers. But if you look at the large-cap EM index or holdings of large-cap EM managers, you see many companies that actually generate a meaningful component of their revenues and profits from outside of the emerging markets, primarily from developed countries. Electronic companies in Taiwan and South Korea are examples of that. So you don't really get a true emerging market exposure.

Our portfolio would give investors exposure to interesting, high-quality small businesses that are really geared toward what's going on locally, and benefit from the interesting developments that are happening in these countries locally. Whether its digitalization or internet penetration growth or consumption growth or the rise of the middle class, we think that our portfolio gives investors a true exposure to those types of developments.

TWST: And are you and your colleagues watching any particular trends about the U.S. or global economy that could impact your fund?

Mr. Kim: Yes. We are obviously aware of what's going on in terms of the global economy and we pay attention to macro factors. But I should say that our investment decisions are not driven by macro factors or top-down views. It's much more driven by a bottom-up research process.

The way we think about the macro or global economy, or what's going on at a high level in the U.S., is the same way as a small business owner would think about those things. When we see headline news about U.S. GDP or inflation or any news about the global economy, the first thing we think about is: OK, what does this mean for my business, for the businesses that I own? Does it have a meaningful impact? Does it permanently change or damage my business or my future prospects? So that's the way we think about macro factors, and that's the way we try to analyze when we see those types of items in the media.

TWST: And anything we haven't talked about you care to bring up?

Mr. Kim: Yes. I think what we like to tell our investors is that when you invest in our strategies, whether it's emerging markets or international or domestic strategies, do not consider this investment as some sort of a random exposure to a certain asset class. Rather, think of it as a small part ownership of a collection of very interesting small businesses that have interesting future prospects.

TWST: Thank you. (ES)

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