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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Value Investing in International Small-Cap Stocks

BEN FRANKLIN, CFA, Vice President and Portfolio Manager, joined Intrepid Capital Management, Inc. in 2008. He is the Lead Portfolio Manager of the Intrepid International Fund (ICMIX) and the separately managed Intrepid International portfolio. Prior to researching international companies, Mr. Franklin focused primarily on small cap stocks, then high-yield fixed income investments as the co-lead portfolio manager of the Intrepid Income Fund. A CFA charterholder, he received his MBA in finance and BBA degree in management from the University of North Florida.

SECTOR — GENERAL INVESTING

TWST: Does the Intrepid International Fund (ICMIX) have a unique philosophy?

Mr. Franklin: The overall firm has a philosophy, and we have expanded that to international securities. And the firm philosophy is based on investing in companies that we can value with a high degree of confidence and then buying them at a discount of at least 20%. Ideally, these companies generate consistent free cash flow, have strong balance sheets and are run by solid management teams. But most of these types of firms are not trading at a large discount if they aren't dealing with some sort of issue. So many of the companies we invest in end up having some hair on them.

We must be confident that the troubles are either temporary or that the problems are more than priced into the stock. We'll also invest in companies trading at a discount to the net asset value; however, we'll generally require a larger discount when doing so. Our products tend to be fairly concentrated in 20 to 30 positions and are able to hold larger amounts of cash.

The International Fund is a little different. For example, we have to deal with currencies. And it's typically hedged when cost effective. We have the flexibility to invest in many different areas within international equities, but we have found the most value investing in small undercovered securities in developed markets. The small size of the fund allows us to invest in areas that others simply can't due to liquidity reasons. This means fewer investors looking there, less competition for us, which is something we work to exploit.

Highlights

Ben Franklin discusses managing his firm's international small-cap fund. Mr. Franklin says he has found the most value investing in small under-covered securities in developed markets. He is liberal when looking at stocks but conservative regarding purchasing them. He says the fund's small size gives it the ability to buy companies that are overlooked by competitors.

Companies discussed: Balda AG (ETR:BAF); GUD Holdings Limited (ASX:GUD); Stallergenes Greer PLC (EPA:STAGR) and ALK-Abello A/S (CPH:ALK-B).

Also, there really aren't that many international small-cap funds out there, yet there are about four times as many total international companies to research as there are in the United States, so plenty to look at. My historical work experience includes working on domestic small-cap stocks and high-yield bonds. And that historical work experience, researching junk bonds, was helpful. Ben Graham has said that bond investing is the negative art, which it is, because you typically know what the upside is — the yield. So most of the research is focused on finding potential pitfalls, which is a similar approach I take when investing in stocks.

The search for statistically cheap companies may provide a long list, but the value added is doing the work on the negatives which results in passing on most stock ideas we research. I'm liberal about what stocks I'll look at but conservative regarding what stocks I end up purchasing. This also means that asking me what companies that we like to look at results in a list that's almost limitless. More important is focusing on things that we'll avoid, and the primary companies we'll avoid are expensive ones. We are a value shop, and we look at the price relative to the cash flows the companies throw off when determining whether they are expensive.

Other companies that we'll avoid are those that are overleveraged, have too many inputs or are too complex. We also frown on companies that are cyclical or have lumpy cash flows, but there are certain times when these might be attractive, and that's when they are trading at what we consider dirt-cheap prices. We avoid relative valuations and most outside opinions including sellside research. But really, I think most of our distinct offering right now has to do with our size and ability to buy some of these companies that are overlooked by most of our competitors. But once we've done our homework, when we get an understanding of what the underlying investment is and why it's undervalued, that's one part of the equation and an important one.

An equally important and maybe even more important part is the emotional discipline of going against the grain. A lot of investors claim they are contrarian. I think we can be very contrarian, but I prefer to say we are independent, which typically means buying as others are selling, but only if we disagree.

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TWST: Did you want to highlight one stock that you find interesting?

Mr. Franklin: Balda (ETR:BAF) is a German company. It's a German company that recently sold off all of their operations and is using a large portion of the proceeds to pay a dividend that will be treated as a return of capital, meaning there will not be any taxes. The security is currently trading at 25% discount to the net cash alone on the books, and this discount actually increases to 35% after the company pays out their dividend. I'll get to that part in a second.

But we believe that it's overlooked in part due to the large cash balances not showing up on financial software services like Bloomberg, and the reason for this is twofold. First, while the deal for selling the operation is completed, the cash has not actually hit **Balda's** books as of their latest report. Secondly, much of their current cash is in AAA commercial paper, but the company reports it in odd line items like "other current assets" and "financial assets," which Bloomberg has historically ignored when they calculate total cash.

The future of the enterprise is being decided by the 30% shareholder and Chairman Thomas Van Aubel. The primary risk is that he destroys value by acquiring another business, overpaying for it with the cash that will be left over after the dividend. However, we think that risk is mitigated by a few factors. First, Thomas has a history of being very conservative with acquisitions. One of the reasons the operations were sold was because the CEO of those operations wanted to acquire, but Thomas felt all of the options were too expensive and thus the CEO had his hands tied.

Secondly, the company has over 50 million euros in tax loss carry-forwards that could shrewdly be used to offset taxes in a high cash flow business and not some sort of risky startup or a company with lumpy or uncertain cash flows. Lastly, even if he does overpay for an acquisition, he'd have to do so by a very large margin considering the discount that's already priced in to the stock.

The story gets a little bit more interesting when you consider what the stock will look like after they pay the dividend. Assuming the stock price, which is currently at about 2.50 euros per share, adjusts for the dividend, which is about 90 cents per share, the discount will grow from 25% to 35%. And this is just simple math and one reason why we've taken a larger position than normal in the company. As Wayne Gretzky said, "Skate to where the puck is going to be, not where it has been."

TWST: Did you want to highlight a second company?

Mr. Franklin: GUD Holdings (ASX:GUD) is an Australian holding company, and it has businesses in consumer products, automotive parts, water products and industrial products. The focus of most investors has been on their struggling consumer products business, but their automotive business is now the largest and most important one, and a diamond in the rough. It has high returns on capital buffered by high barriers to entry. One important reason for the higher returns on capital is that very little is required to reinvest in the business, so the cash flows it does generate are available for investors.

The legacy automotive business operates in the filtration category: oil and air filters. And Australia is a an interesting market whereby they have 50% more types of automobiles than are being sold in the U.S. despite only being one-tenth of the size. **GUD** supplies auto parts for all of the types of cars, which is difficult to compete with. This competitive advantage was recently solidified when one of their largest competitors left the market because they were not able to reach the critical mass in their product range.

1-Year Daily Chart of Balda AG

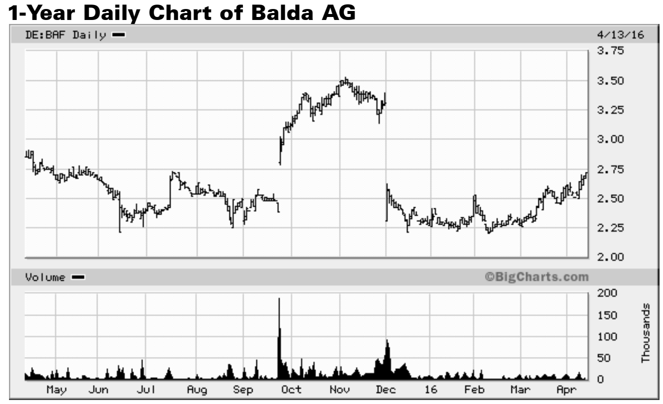

Chart provided by www.BigCharts.com

One concern investors have is that the weak Australian dollar will cause expenses for this importer to increase and earnings thus decline. However, we believe the automotive business has significant pricing power. This is evidenced by their dominant place in the market and their prior ability to raise prices. We believe they will be able to continue to do so and easily pass the increased costs on.

The company recently acquired another business in the automotive segment with very similar economics. The acquired business is a leading supplier of automotive aftermarket lighting, electrical and battery products. However, the combined results have not shown up in the reported results, so that's one reason investors may overlook it. The company trades at about nine times pro forma EBITA, 60% of which comes from this automotive segment. The consumer products businesses, Sunbeam and Oates, have been struggling from competitive pressures. So the consolidated EBITA is a little bit depressed in our opinion, and management is making inroads on righting that ship.

Recent results have been improving, and we've been happy with the steps management has taken, but these actions have also caused financials to get a little messy, which make it tough for investors to understand the underlying economics. However, we still think the stock is trading at discount to our estimated intrinsic value even if those weaker businesses never recover.

TWST: Did you want to mention a third company?

Mr. Franklin: Stallergenes Greer (EPA:STAGR) is a European company headquartered in London, but listed on Euronext Paris exchange. It operates in the stable and growing allergen immunotherapy industry. The company produces products for the treatment of allergies such as allergy shots, liquids and tablets. They are one of the two dominant players across the globe, the other being a Danish company, **ALK-Abello** (CPH:ALK-B).

Stallergenes recently merged with their U.S. business partner, **Greer**, to make the combined company **Stallergenes Greer**. And this is another case of reported financials not telling the true story. This time it is because the only report so far shows the results of a holding company prior to the combination of the two companies due to the timing of the deal and when the company reported. This means neither **Stallergenes** nor **Greer** results are presented; however, the pro forma results are in the footnotes. And **Stallergenes** has a long history of public financials from being independent prior to the merger.

1-Year Daily Chart of Stallergenes Greer PLC

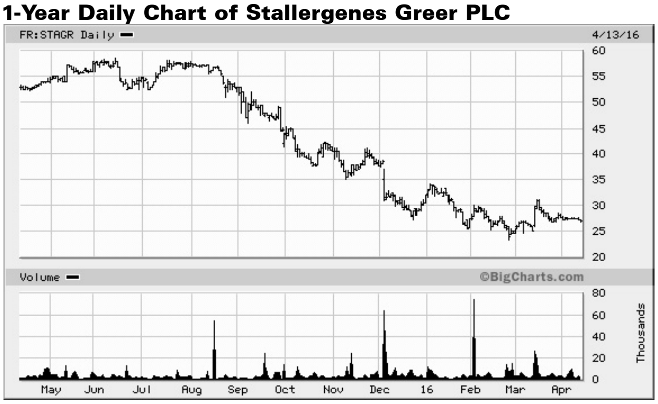

Chart provided by www.BigCharts.com

Mr. Franklin: We do think there are some areas where we will avoid and we would recommend others avoiding. We think the International Accounting Standards for the most part are at up to par, but there are areas where you just can't trust what's on the books or there is too much political risk. One area with too much political risk for us has been Russia, where we have seen how cheap the stocks have gotten. But the political risk is just too high. And in China it is difficult to understand if the cash on the books — if that's even there. Those are places people should avoid.

TWST: Financials from an overseas company could be complex to be looking at. So would it take someone that really understands financials to go through it?

Mr. Franklin: I would agree that it can be complex. International Financial Reporting Standards — IFRS — are adopted in most places, in most of the developed world which is where we are looking. And back when I switched from looking at domestic companies — with GAAP — to international companies — IFRS — it took a good bit of investment of my time and effort learning the differences. But overall I'd say that international reporting is pretty good.

TWST: Should people put together their portfolios to include something that is international or a few items that are international to balance out their portfolio?

Mr. Franklin: I do think it's important. That amount, I think, varies by investor. One important thing that we stress is the larger number of potential investments internationally than there are domestically. It really expands your investment universe when you have 40,000 potential companies to invest in and may have been ignoring. In our opinion, domestic stocks are expensive, domestic stocks are expensive, and we even think most large-cap international companies are rather expensive. But when you have that many stocks to look at, it's a higher chance of finding something that you think is undervalued.

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Stallergenes alone historically has traded around 10 times EBIT, which was far below their competitor **ALK's** 30x EBIT. A discount has been warranted, though, in our opinion, due to being 85% owned by another firm. However, once **Stallergenes** combined with their partner **Greer** — and we believe it's an even stronger company — the combined firm with a new ticker traded at half of their historical multiple. This didn't make sense. Although it is important to note that we never value companies based on relative multiples; we found it cheap on an absolute basis.

But the picture got a little more complicated a little later when there was a recall of their products due to complications at their primary manufacturing facility when they were installing a new ERP system — those projects never seem to go well. No patient was hurt by the recall, although **Stallergenes Greer** did lose some market share. Since then the plant has received authorization, and it is back up and running.

TWST: We have been talking about international companies. Are there some special precautions an investor should take if they are starting to look at possibly investing into international companies?

TWST: Do you think, just in general, that there are certain trends an investor should keep their eyes out as the year continues to unfold?

Mr. Franklin: Yes. Obviously across the globe we've seen some negative interest rates, which don't really make sense to us. If you think of speculation versus investing, an investment should really have promise of safety of principal and a satisfactory return. If you are guaranteed a negative return, there is no real investment there, it's just sort of speculating on what other market participants are going to do. So I think that adds an effect on the overall market all the way from government bonds to stocks. And we think investors should be very careful about the price they are paying for stocks in the market today because of that.

TWST: Do you get a sense that companies and citizens of other countries look to the United States for leadership in the economy?

Mr. Franklin: I think central bankers are all looking at each other right now trying to see who can go the lowest in regards to interest rates. That tends to be a trend between Japan, Mario Draghi, and now we are not raising rates here it doesn't look like in the near term, so it's sort of a race to the bottom. But macroeconomics is not where most of our focus is.

TWST: Do you think the fact it's a presidential election year is going to impact the market either domestically or internationally?

Mr. Franklin: I think it could. I think that's an uncertainty that you just have to accept being an investor. But again, I don't think anybody can say with a high degree of confidence what's going to happen in the near term.

TWST: And do you think the companies overseas are looking at the presidential election to get an idea of where the United States might be heading?

Mr. Franklin: Are companies?

TWST: Yes, companies or even central banks.

Mr. Franklin: I haven't really seen many companies looking at that. Central banks probably are. But like I said, we are not economists and don't aspire to be. Really there is a lot of that going on; there is plenty of news about that, but that's not where we are going to add value. We study the hazards, and today the most important data point is the price paid for stocks.

TWST: Any basic advice you'd have for investors as they look toward 2016?

Mr. Franklin: I think everyone, including and maybe in particular the most intelligent, would probably have better investment results if they invested time into evaluating their own emotional mistakes and work to protect against making those again in the future. Rather than picking up your next investment book, maybe pick up a psychology book.

TWST: What would that give you, somebody picking up a psychology book?

Mr. Franklin: Insight into the psychological hazards and pitfalls people make. There is only a limit to the extent of — the limits of your own psychology, and it's important for people to recognize where those limits are and when they should reflect on the decisions they've made and the decisions they are going to make.

TWST: Thank you. (ES)

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