ValueInvestor INSIGHT

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Beyond the S&P 500

Following the crowd has been a good place to be in the stock market for some time. On the chance that one day changes, we spoke with eight highly accomplished, crowd-avoiding investors about where they are finding opportunity today. Among areas of interest: energy, small caps, metals and mining, shorting, non-U.S. stocks and, of course, bargain prices.

INVESTOR INSIGHT

Rezo Kanovich
Artisan Partners

"Many of our companies have grown revenues and earnings significantly while seeing valuation multiples compress."

You invest primarily in smaller non-U.S. companies, which haven't been in fashion in the investing world for quite some time. Has that impacted at all what you're finding interesting today?

Rezo Kanovich: Our focus hasn't changed. We try to identify high-quality businesses generating high returns on capital, which will also benefit from structural growth themes that increase the likelihood that they can compound value over long periods of time.

We see many of the same areas of dislocation everyone does. Particularly relevant to us, there's been a dash to highly liquid U.S. stocks, such that non-U.S. small caps trade at the largest discount to the S&P 500 that they have over the last 20 years. Even internationally, large caps are trading roughly in line with their 20-year average P/E, while small caps on the same basis trade at a 300 basis-point discount.

What that has meant at the top of our portfolio is that companies have grown revenues and earnings significantly over the past several years, only to see their valuation multiples compress, by as much as half in some cases. One would think growing businesses deserve a premium for their scarcity value, particularly when that's backed by pricing power, low leverage and competitive differentiation. This current dynamic cannot go on forever. In an otherwise low-growth market, at some point growing, quality companies – even if they're smaller and outside the U.S. – will be valued more appropriately. We believe our portfolio should fare relatively well when that happens.

Describe your investment case today for U.K.-based ConvaTec [London: CTEC], one such company at the top end of your portfolio.

RK: This a high-quality medical-products company, operating in four business segments. Number one is ostomy, providing pouches, skin barriers and other accessories for people who as a result of surgery need alternative ways to divert waste products from their body. The second business is continence care, which includes products like urinary catheters for people with incontinence issues. Third is advanced wound care, which are high-end dressings, foams and other products that are used to treat serious burns and wounds. The final business is infusion care, selling primarily infusion pumps that deliver medications and nutrients into a patient's body in a controlled manner.

There are obviously variations across the businesses, but in general ConvaTec is one of the top two or three players in its global markets, benefits from well-developed sales and distribution organizations, and has highly competitive technology for promoting efficacy and comfort. Many of the conditions treated are chronic, so customer relationships tend to be enduring and people show little propensity to switch from vendor to vendor. That makes the business overall stable and predictable. There are also areas of compelling growth, one key one being in the infusion-pump business where more diabetes patients are moving to pumps to deliver insulin rather than the traditional method of multiple shots during the day. We think ConvaTec should be a meaningful winner as that conversion continues – as would a company called Insulet [PODD], which we also own.

The company has suffered somewhat over the years from multiple changes of ownership that ended up overburdening the balance sheet or stunting research and development, or both. We always liked the business, but we got most interested when Karim Bitar took over as CEO in late 2019. He's proven to be an excellent operator, significantly reducing administrative costs while investing in both research and development and in go-to-market capabilities. While the financials have already improved, we believe the investments made are really starting to bear fruit – including a resurgence in the ostomy business, the company's traditional crown jewel – and will result in accelerating revenue growth and operating leverage driving margins higher. Management is guiding to mid-20% operating margins going forward, from a mid-teens level currently.

From today's price of £2.60, how do you see this translating into shareholder upside?

RK: The stock today on consensus estimates trades at about 20x forward EPS, while the closest peer, Coloplast [Copenhagen: COLO], trades at 28x. Even without a re-rating the shares should do well if the company can grow on the top line at 8-9% annually while also expanding operating margins. If they get even close to management's profitability goals, a business of this stability and quality should trade for more than 20x earnings.

You've been active investing in Japan. Describe the upside you see in flavorings company Ariake Japan [Tokyo: 2815].

RK: Japan has long been a source of good opportunity for us, but our exposure has increased of late due to what we consider the extreme bifurcation in how stocks are valued relative to market cap. To start the year, the Japanese market as a whole was trading at a 40% premium to its 20-year average multiple, but if you separated out small caps, they were trading at a nearly 15% discount.

Ariake makes a wide range of food flavorings, including bouillon, consommé and broths, using natural ingredients like meat, seafood and vegetables. It's a B2B business, selling to restaurants and food companies, and Ariake has a well-known and respected brand that has translated into a very high domestic market share of close to 70%. Given the high regulatory and market requirements for product quality and safety, the business has proven to be very defensible.

Covid caused a heavy pull-forward of demand as at-home food consumption took off, and the company significantly over-invested in capacity expansion. As things normalized, post-Covid indigestion resulted in revenues falling short of expectations and operating margins decreasing from what we consider a more normal 20% level down to as low as 12%. The margin compression was exacerbated by an inflationary shock in raw materials and energy costs, and by Ariake being slow to adjust prices.

We are now on the other side of all those things and revenue growth has accelerated as the company has benefitted from Japanese consumers demanding more mixes and prepackaged products as food-cost inflation has taken hold. Domestic revenues are growing at a higher-than-normal rate, benefiting also from the company exercising its pricing power. This is a new dynamic in Japan, where price increases have historically been taboo.

Are there any corporate-governance issues to discuss?

RK: Ariake was a founder-led company for a long time, but now there's a professional CEO and roughly half the board is independent. There is a lot of net cash – around 25% of the current market cap – and valuable real estate on the balance sheet, and there is pressure from some investors for a big share buyback. I am not a huge fan of that and have recommended instead that they focus more on consistently and materially increasing the dividend payout, to give investors better visibility into long-term capital return. I have also suggested they adopt a stock-option program for employees in order to attract and retain the best people, and that they improve investor relations to attract more sell-side analyst coverage. I think they're listening to me on both fronts, but time will tell.

How are you looking at valuation from the current share price of around ¥6,370?

RK: These types of businesses globally tend to be valued very highly. Bigger firms like Givaudan [Zurich: GIVN] and Symrise [Frankfurt: SY1], trade at enterprise-value-to-EBIT multiples in the 20s, while Ariake – which is growing faster and has so much cash – trades at an EV/EBIT multiple of closer to 13x. If the company's financial performance continues to improve as we expect, there has to be some narrowing of that valuation gap. We're not saying this deserves the multiple of bigger players with larger competitive advantages, but there's a lot of daylight between 13x and where global peers trade.

You've written about finding opportunity in defense-related stocks. Given geopolitical realities of late, are you more or less enthusiastic about that particular theme?

RK: Our thematic work in defense has been less focused on picking winners and losers based on the use of weapons or machinery in combat today. We generally don't feel we can appreciate that better than the next guy.

We're more interested in companies that are well positioned for the digitization of military capability, particularly around things like radar, electronic-warfare systems, surveillance systems and communication systems. This is where we expect significant incremental money to be spent as militaries replace outdated capabilities and add new ones. One of our biggest investments in this area is Hensoldt [Frankfurt: HAG], formerly Airbus's defense-electronics business that was bought by KKR in 2017 and came public in September 2020. We believe it's very well positioned to benefit from the digitization theme we consider a megatrend in the space. The fact that it's a German company is also interesting if Germany and other large European countries start spending a lot more on common European defense. The stock [at a recent €63] has done extremely well this year, but we see this as a positive story that plays out over a much longer period. VII

Rezo Kanovich is a portfolio manager for Artisan Non-U.S. Small-Mid Growth Strategy. This article represents the views of John Heins of Value Investor Insight and Rezo Kanovich as of 31 March 2025 and do not necessarily represent those of Artisan Partners. The views and opinions expressed are based on current market conditions, which will fluctuate, and those views are subject to change without notice. While the information contained herein is believed to be reliable, there is no guarantee to the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Artisan Partners is not affiliated with Value Investor Insight.

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