Small & Micro-Cap Value Investing

JOHN E. DEYSHER, BERTOLET CAPITAL LLC

JOHN E. DEYSHER is President of Bertolet Capital LLC, advisor to the Pinnacle Value Fund, a diversified, SEC registered mutual fund. He is responsible for the Fund's daily investment activities and has over 25 years' experience in the investment management business. From 1990 until late 2002, Mr. Deysher was a Portfolio Manager and Senior Analyst with Royce & Assoc., an investment firm specializing in the securities of small cap companies. Mr. Deysher began his investment career with Kidder Peabody in 1983 where he managed equity and fixed income portfolios for individuals and small institutions. He holds a Bachelor's degree from the Pennsylvania State University, and Master's degrees from Indiana University, Bloomington (Business) and University of California, Berkeley (Science). He is a Chartered Financial Analyst.

SECTOR – GENERAL INVESTING

(AAT503) TWST: Why don't you start by telling us about your firm and your investment philosophy?

Mr. Deysher: The Pinnacle Value Fund is an SEC registered mutual fund that launched April 1, 2003 with a mandate to invest in the securities of small and micro-cap companies that we feel are undervalued relative to their earnings power or asset values. Many of these stocks are overlooked in the marketplace and trade well below the radar screens of large institutions. Our purchases are ones of deep discount value and we seek the most compelling opportunities with the best risk reward characteristics. Because we seek deep value, the stocks must be absolutely cheap not just relatively cheap. We are risk averse and try to maintain an adequate margin of safety. Finally, as bottom-up stock pickers, we look at a lot of lumps of coal in order to find one diamond.

Highlights

John E. Deysher invests in small and micro-cap companies that are undervalued relative to their earnings power or asset values. He identifies companies that offer deep discount value and purchases the most compelling opportunities with the best risk/reward characteristics. The stocks must always be absolutely cheap and not just relatively cheap. He is risk averse and tries to maintain an adequate margin of safety. Back in March there were plentiful new lows and very few new highs, but it is slim pickings right now. The market volatility allows him to buy stocks when prices are low and sell when prices are dear. His purchases generally fall into one of four themes: undervalued assets where the stock trades at a discount to liquidation or private market value; turnaround situations; growth at a reasonable price; and special situations like spin-offs, reorganizations and liquidations. On the qualitative side he examines the dynamics impacting the business – who are the chief competitors, customers and vendors.

Companies include: Nobility Homes (NOBH); Hardinge (HDNG); Flexsteel (FLXS); First Acceptance (FAC).

TWST: March of this year must have been the best time for for your investing approach. How has the volatility in the market impacted your investing?

Mr. Deysher: You are right. Early in 2009, we were fairly consistent buyers and going into March we were buying virtually every day. Stocks were being priced at very compelling valuations and we took advantage of that. Sure enough, that window closed fairly soon as the world became convinced that the economy was no longer falling off a cliff and appeared to be bottoming. Investors started looking to the future and an economic recovery. This was aided by the prospect of significant government monetary and fiscal stimulus that sent stocks rising almost as quickly as they declined. Back in March, there were lots of new lows and very few new highs, these days there are lots of new highs and very few new lows. It's slim pickings today. We view volatility is our friend, allowing us to buy stocks when prices are low and sell when prices are dear.

TWST: You clearly took advantage of the early part of this year when opportunities were ripe for you. What is your investment process and what criteria do you look for in potential holdings?

"We like Nobility because they're well positioned in the market. They sell mostly in Florida, which is a big magnet for retirees who often buy a manufactured home and put it on a chunk of land in a warm climate to retire in. Nobility Homes has a very strong balance sheet and is run by a father and son management team, the Trexlers, who're big owners."

1-Year Daily Chart of Nobility Homes

Chart provided by www.BigCharts.com

Mr. Deysher: We like to tell people we are looking for either good companies at great prices or great companies at good prices. Our purchases normally fall into one of four themes. The first being undervalued assets where the stock trades at a discount to liquidation or private market value. The second theme would be turnarounds or companies rebounding from depressed operating results. Third would be what we call growth at a reasonable price where companies growing at a reasonable pace can be acquired for reasonable prices. Like most investors we like growth companies, we just don't like paying up for them. Fourth would be special situations like spin-offs, reorganizations and liquidations. On the quantitative side, we look at balance sheets, income statements, and cash flow statements. Generally, a company must have low financial leverage since we are dealing with smaller companies and they need a strong balance sheet to get them through whatever short-term issues or problems they might face. Typically they have shown historical levels of sales and profits, although there may be a temporary setback, which is why we are interested. The stock price is down and it's our job to figure out whether the situation is permanent or temporary. If temporary, when might profits rebound and how high might the stock price get?

On the qualitative side, we try and understand the dynamics impacting the business — who the major competitors, customers, and vendors are. We try to get our arms around understanding the industry and how our company operates within it. Finally in terms of management, we try to get a read on the key people and whether they are moving in the right direction on strategic, operating and financial priorities. We apply a pretty intense due diligence checklist to all of the companies we are evaluating.

TWST: When you are looking for deep discount, how do you avoid being stuck with the value traps? Are there qualitative measures that you adopt to look for catalysts like management performance?

Mr. Deysher: A value trap is a cheap stock with a business that's losing value. They're sometimes referred to as leaky boats, they're cheap but the water is coming in fast! How do you avoid them? First and foremost is staying with a strong balance sheet which provides the flexibility to survive and prosper. We look for viable business models with capable managers. Are the managers hands on, honest, intelligent, and energetic? Do they act as owner operators and not caretakers? You can learn a lot of this just by reading the SEC filings including the proxy statement, which includes how much stock the insiders own, what their prior experience is and what their compensation package is. Read the shareholder letter that accompanies most annual reports- is it an honest assessment of how the company actually did, good or bad? There are many things you can look at initially to identify red flags and avoid value traps. It's not always easy, but it's worth the initial effort to try to avoid them.

"The industrial firm we like is called Hardinge Corp and has a market cap of $62 million. The average price of a Hardinge machine is $50,000-$70,000 so it's a major capital expenditure. Consequently, recent sales and profits are down substantially. As a result Hardinge is taking aggressive steps to right-size their cost structure like closing plants, reducing headcount, and lowering expenses."

TWST: What are some of the firms that you can tell us about that you found to be deep discount stocks earlier this year?

Mr. Deysher: Earlier this year, we did a lot of work in the closed-end fund area. As you know, the closed-end funds offer the ability to own a basket of stocks within a particular industry or country. Unlike open end funds, the asset base is fixed and not subject to redemptions and purchases. Normally in times of market distress two things happen. First, the closed-end fund NAV declines because the underlying portfolio value declines. Second, the market price trades at a wider discount to Net Asset Value (NAV) than normal. Six months ago, the discounts was fairly wide and the NAVs

were down significantly. So we were active buyers of a variety of closed-end funds including country, financial, high yield and biotech funds. Since then, the underlying portfolios have appreciated so the NAV rose and also the discount returned to normal. So we got a double whammy on the upside. Most have done very well and we've scaled out of some, but that was one area where the market was giving away good merchandise at reasonable prices and we took advantage of it.

"The financial company we like is First Acceptance Corp with a market cap of $120 million. The weak economy has hurt First Acceptance, because some of their customers lost their jobs and dropped their coverage. But those who have jobs and continue to pay their premiums are actually better drivers than those that have fallen away. So while revenues are down, profitability is up because management is doing a good job at managing expenses and claims."

TWST: Any other companies that you feel are representative of your investment style and approach?

Mr. Deysher: We can talk about a few of them since your readers are probably more interested in hearing about what we think is currently attractive. The first is **Nobility Homes** (NOBH), which is an Ocala, Florida based producer of manufactured homes with a $40 million market cap.

TWST: I have not heard anyone recommend a housing company in a long time!

Mr. Deysher: It's very interesting, because as you know, housing is in the doldrums and manufactured housing even more so. It's hard to believe, but back in 1998, the U.S. industry as a whole produced about 373,000 units. In 2009 that number will probably be about 50,000 units. That's a decline of 86%. Now, a very smart investor in Omaha owns a company called Clayton Homes which is the largest player in manufactured housing. Clayton has been making acquisitions of smaller players to build out their network. Mr. Buffett appears to see good potential here when the housing market rebounds and we like **Nobility** because they're well positioned in the market. They sell mostly in Florida, which is a big magnet for retirees who often buy a manufactured home and put it on a chunk of land in a warm climate to retire in. The quality is very good since they must be built to the same codes as conventional site-built homes. As the housing market improves, a lot of buyers who got credit through subprime financing and other methods to buy conventional homes may be shut out of conventional homes since that type of financing is no longer available. Manufactured housing offers a viable alternative to them. **Nobility Homes** has a very strong balance sheet and is run by a father and son management team, the Trexlers, who're big owners. They're a survivor and should do very well when the cycle turns.

The industrial firm we like is called **Hardinge Corp** (HDNG) and has a market cap of $62 million. Based in Elmira, New York they were founded in 1890. It's been my experience that when a company survives 120 years they are generally doing something right. Hardinge makes machine tools like lathes, grinding machines and other equipment used to cut and shape metal parts and components. Their customers are mostly small job shops that serve cyclical industries like auto, appliance and aerospace. The average price of a **Hardinge** machine is $50,000-$70,000 so it's a major capital expenditure. Consequently, recent sales and profits are down substantially. As a result **Hardinge** is taking aggressive steps to right-size their cost structure like closing plants, reducing headcount, and lowering expenses. Eventually, their customer base will have to order replacement machines or upgrade existing machines and there is a lot of operating leverage when the cycle improves. They have a strong balance sheet and the insiders think like owner operators so this could be a big stock if you are patient and buy it at the right price.

1-Year Daily Chart of Hardinge

Chart provided by www.BigCharts.com

TWST: What about a financial company?

Mr. Deysher: The financial company we like is **First Acceptance Corp** (FAC) based in Nashville, Tennessee with a market cap of $120 million. They sell, underwrite and service non-standard auto insurance for customers who can't get insurance from traditional carriers, generally because of poor credit scores or driving records. They usually pay on a monthly basis at any of **First Acceptance's** 420 storefront locations in 12 southern & midwestern states. The weak economy has hurt **First Acceptance**, because some of their customers lost their jobs and dropped their coverage. They'll pay rent and utilities before they pay their auto insurance. But those who have jobs and continue to pay their premiums are actually better drivers than those that have fallen away. So while revenues are down, profitability is up because management is doing a good job at managing expenses and claims. The

icing on the cake will be when employment improves and their customers not only reinstate their coverage, but also take additional coverages beyond the minimum liability they take now. Also, improving employment will drive vehicle purchases which, if financed, must be insured. The insiders own a good chunk of stock, they have a conservative balance sheet and they've been managing the downturn well.

"Flexsteel is an Iowa based producer of furniture for residential, commercial, and recreational vehicle (RV) markets. All of those markets are down but Flexsteel remains profitable on a much lower sales base. They have a strong balance sheet, are conservative operators and are well known for their selection of furniture with over 1,000 fabrics and 300 styles to choose from."

Our consumer play is a company called **Flexsteel** (FLXS) with a market cap of $55 million. It's a Des Moines, Iowa based producer of furniture for residential, commercial, and recreational vehicle (RV) markets. As you can imagine, all of those markets are down but **Flexsteel** remains profitable on a much lower sales base. They have a strong balance sheet, are conservative operators and are well known for their selection of furniture with over 1,000 fabrics and 300 styles to choose from. They have fast turnaround using their own trucks, good service and their plants are in low-cost Mid-Western locations. During the downturn they reduced their cost footprint to match the lower level of revenues. That's our play on consumers feeling more confident and replacing their worn out furniture and buying more RVs. In the meantime the yield is 2%.

TWST: What kind of catalysts turn a company you don't invest in into something worth looking at?

Mr. Deysher: We look for any of several potential catalysts. One catalyst might be new CEO or management team the Board brings in to fix the company. The new CEO or team has a mandate to fix the company and the authority to make things happen for the better. Another catalyst might be an active acquisition or a divestiture program. Acquisitions are a logical growth vehicle for many companies that can lead to higher profits. Conversely, many companies can become more profitable by divesting underperformers or rationalizing the existing organization. Another catalyst might be the introduction of new products, distribution channels or cost reductions. A further catalyst might be significant insider stock purchases which's good to see. Option purchases are less attractive than insiders who buy on the open market like we do. Another catalyst, which I think is a common theme throughout the names we just talked about is cyclical rebound in earnings. The stock price is down because the earnings are down and the P/E multiple has contracted. The question is whether this is a permanent or temporary situation? If temporary, when will the earnings rebound and by how much? So we look for catalysts, but if a company doesn't have a catalyst and it's cheap, we'll normally go ahead and buy it because usually a catalyst will eventually materialize.

TWST: What does trigger an exit from your portfolio? What is the sell discipline?

Mr. Deysher: We generally sell when one of four things happens. The first is the stock reaches our sell trigger. For each stock, we have a buy trigger and a sell trigger which're adjusted over time. When it reaches the sell trigger and becomes fully valued, we generally start to scale out of it. The second reason we sell is if we've made a mistake in our facts, reasoning or logic. Once we recognize this we try to exit before the damage becomes too great. The third reason would be if an expected catalyst doesn't materialize after a few years and we realize that we're sitting on dead money. We'll rethink the position and if, upon doing so, we can't identify a reason to continue holding it, maybe it's time to exit. However if the catalyst does materialize, but the stock price doesn't go up, we'll continue to hold it. We may even buy more because the market price will eventually catch up with the fundamentals. Our fourth reason for selling might be because the insiders are selling in a significant way. Or if there's a change in management or corporate culture we don't agree with. So there are many reasons we might consider selling or scaling back a position.

1-Year Daily Chart of First Acceptance

Chart provided by www.BigCharts.com

TWST: What about merger and acquisition activity in the small-cap arena? Is that something that you look out for and does it impact your investing at times?

Mr. Deysher: Having a company acquired is always nice but it doesn't drive our day-to-day decision making in terms of what we look for. We are buying because of fundamentals not because the company might be acquired although we've had our share of takeovers. These days the merger and acquisition activity in small caps is fairly muted for two reasons. The first is that Earnings Before Interest Taxes & Depreciation/Amortization (EBITDA) levels are coming down because of the economy. EBITDA multiples that buyers are willing to pay have also come down resulting in lower prices. This is good if you are a buyer but even so, transaction financing is still tough to get. Banks and other lenders are still very reluctant to lend for this activity because they don't know how bad the economy is going to get or how soon or strong the recovery will be. Because prices are down, sellers are more reluctant to sell, and even if they are willing, buyers may have trouble getting financing. Private equity firms which've been active buyers of small firms in

the past are largely on the sidelines now. So the M&A environment is a bit quiet, but I am hopeful this will change as confidence in the economy grows and credit becomes more available.

"Small caps are facing declines in their business. They are the first to be hurt in a recession and they are first to recover when the economy gets better. Right now, they are muddling through. A lot of them must renew credit lines and working capital loans over the next couple years, so that's going to be important. But small caps have done quite well over the long-term and as we get through this period, they are bound to come out on the other side in fairly good shape, especially the conservative ones."

TWST: And is it more risky to invest in a deep discount value fund than other funds and how do you tend to control risk?

Mr. Deysher: We don't feel it's more risky to invest in a deep discount value fund and historically, our risk adjusted rates of return has been quite good. We try to control risk in several ways. First, at the portfolio level, we try to be diversified across different industries and different companies to minimize the impact a single mistake might have on the entire portfolio. At the individual company level, we try to buy companies that have strong balance sheets, capable managers and viable business models. We're very disciplined on price, the stock must be absolutely cheap, not just relatively cheap. We've done the due diligence, we like the company, we like the management, and we're trying to buy at a reasonable multiple of earnings, book value, cash flows, and other financial metrics. That's important, because if you pay high valuations for companies, even if companies are doing quite nicely, you tend to get stampeded by the institutional shareholders trying to exit if something goes wrong and there is a disappointment. So we try minimize the risk by buying stocks that are really cheap, that have good prospects and are available at attractive valuations. Finally, we can go to cash if we can't find reasonable priced bargains as we're not required to be 100% invested.

TWST: How many stocks generally do you have in your portfolio and as you say, does the number fluctuate?

Mr. Deysher: We currently have around 50 names and are 55% invested. Ideally, at 100% invested, we'd like to own 100-120 names, but generally the portfolio has fluctuated between 45 and 65 names to this point.

TWST: I know that it's a strictly bottom-up investment process, but what is your outlook for the rest of this year? Is the market in some sort of bubble? Is it overvalued and do you think that deep discount stocks will be around later this year?

Mr. Deysher: Well, we're hopeful for a market decline that might present some bargains. It's a good question because it's pretty clear the economy is no longer declining, at least for the moment. Stocks have reacted accordingly and now appear to reflect the first two years of a robust recovery. Whether that becomes a reality remains to be seen. We're hearing a lot about glimmers of hope and green shoots, but will those green shoots become giant beanstalks?

To justify current prices the economy will need to show meaningful improvement, not just stop getting worse. Corporate earnings are coming in at or better than expected and that's pushing the market higher. But earnings expectations were probably too low to start with and much of the improvement in earnings has come from expense reductions and not revenue growth. Expense reductions can only take earnings and stock prices so far. There is also the question of how much of the stabilization is due to inventory replenishing versus re-ignition of growth. My guess is that if the hoped for growth doesn't materialize over the next few quarters, the market could be vulnerable. If we get to Spring 2010 and investors start to believe 2010 will be a repeat of 2009 in terms of earnings and not significantly better, I think stock prices will react accordingly. The market has gone up a lot recently and we're in a classic tug of war between the bears and the bulls on the economy. We're hopeful for lower prices that would give us the opportunity to use some of our cash.

TWST: What distinguishes your approach to deep discount value investing compared with portfolios at other peer companies? What are you bringing to the table that others might not?

Mr. Deysher: Perhaps a couple of things. First, because most of our companies don't have Wall Street research, we are doing all of the work first hand. Second, we are not relying on research that's been filtered by other parties. We are not afraid to take contrarian positions and go against the crowd if need be. Third, We are not required to be fully invested and may hold lots of cash until we find a compelling idea. Finally, the portfolio manager is the largest shareholder and I come to work every day trying to make money for the shareholders including myself.

1-Year Daily Chart of Flexsteel

Chart provided by www.BigCharts.com

TWST: For investors in this arena, do you foresee any particular headwinds or challenges down the road that they should be wary of now?

Mr. Deysher: A few things, one of which is the strength of the economy and whether current stock prices are justified.

Unemployment and the housing market remain major concerns for most consumers who account for 65-70% of the economy. Until these stabilize, it's hard to see how the economy gets appreciably better. Taxes will probably go up leaving less discretionary income. Finally, as we move from a capitalist society to a more socialist one, P/E multiples will probably contract.

In terms of the small caps, most are facing declines in their business. They are the first to be hurt in a recession and they are first to recover when the economy gets better. Right now, they are muddling through. Most have adopted a wait and see attitude and are not hiring or adding to capacity until the economy improves. A lot of them must renew credit lines and working capital loans over the next couple years, so that's going to be important. But small caps have done quite well over the long-term and as we get through this period, they are bound to come out on the other side in fairly good shape, especially the conservative ones. The one macro aspect that isn't on many people's radar screens right now is the prospect of higher interest rates. The Fed and Treasury have done an effective job in keeping short and long term rates low. At some point short interest rates are likely to rise to keep inflation at bay. And if the Fed were to step away from its purchases of treasury and mortgage backed securities, long-term rates might rise as well. Most investors aren't expecting this but higher interest rates are definitely a negative for stocks. Higher rates give investors fixed income alternatives away from the stock market and increase the borrowing cost of Corporate America. That could mean lower earnings, lower P/E multiples and lower stock prices going forward. We've had a 27 year bull market in bonds and that may have ended in December 2008 when the long bond (30 yr.) yield was 2.5% or so. Interest rates may not go up immediately, but I think they will eventually and that's not good for stocks.

TWST: Is there anything that you would like to add?

Mr. Deysher: In closing the only thing I'll add is that we always make our investors four promises. The first is that we will make mistakes, but try to keep the damage to a minimum. Second is that we'll always keep our shareholders informed with good news and bad. Third, we'll invest on the basis of value and fundamentals, not popularity. Finally, the portfolio manager will always remain the largest individual shareholder, so our interests are aligned with the other shareholders.

TWST: Thank you. (PS)

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