# Hidden Value Stocks

From Hedge Fund Alpha (Formerly ValueWalk Premium)

# Welcome to the Q4 2024 ISSUE

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Welcome to the Q4 2024 issue of Hidden Value Stocks from Hedge Fund Alpha (formerly ValueWalk Premium).

This issue features Anand Vasagiri and Beini Zhou with Artisan Partners.

Now without further ado, here's more on the firm and their top two under-the-radar value picks.

**Jacob Wolinsky,**
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**Michelle deBoer-Jones,**
Editor-in-Chief, Hedge Fund Alpha

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# Introduction to Anand Vasagiri, Beini Zhou and Artisan Partners

Anand Vasagiri and his partner, Beini Zhou, are co-portfolio managers of the Artisan International Explorer Strategy, overseeing the research process and conducting fundamental research together as generalists. The strategy invests in non-U.S. small-cap companies.

## “Boomerangs”

Before they launched the strategy, Vasagiri managed the Global Small Cap Strategy at Paradice, a boutique Australian investment management firm, while Zhou worked as a portfolio manager at Matthews Asia.

Before those positions, Vasagiri and Zhou met while working as analysts for the Artisan International Value and Global Value Strategies, with a three-year overlap between 2007 and 2010. Zhou described himself and Vasagiri as “boomerangs” due to their return to Artisan.

“The opportunity to come back to where I developed professionally and launch a new portfolio was too alluring for me to resist,” Zhou told Hedge Fund Alpha.

## Before investment management

Neither Zhou nor Vasagiri started their career in investment management. Vasagiri originally studied mechanical engineering at M.N. National Institute of Technology in India, where he first became interested in the business.

“I found it fascinating and wanted to study more to understand the theory behind finance and investments,” he said. “Although it took a while for me to get involved in investment management, it was always something I was driven to pursue after my initial exposure.”

On the other hand, Zhou started working as a product manager in the software industry, which required accounting expertise and led to his initial interest in finance.

Zhou enjoys investing because it involves connecting dots to recognize patterns, with each dot being a piece of qualitative or quantitative information that helps gain a clearer understanding of which companies could become long-term compounders.

“This process is what guides our stock picking and capital allocation decisions,” Zhou said. “The universe of non-U.S. companies, especially small caps, is broad. But we draw from our many years of experience connecting dots in different markets, industries and company maturities to make sense of this massive universe.”

## Getting started in investing

Vasagiri started his investment management career as an MBA student and analyst interning with David Samra for the Artisan International Value and Global Value Strategy. Vasagiri said it was a great experience that reinforced his desire to work in the industry.

After graduation, he worked for the global emerging markets team at Pictet Asset Management, where he was an investment analyst. Later, he received the offer to return to Artisan to help launch the Global Value Strategy. Vasagiri described that as “another excellent experience.” However, he realized by the end of 2009 that while he loved stock picking, he wanted more.

“When I got the opportunity to launch and co-manage a small-cap version of the Global Value strategy, it was a very tough decision to make,” he said. “In the end, two main factors contributed to my decision to accept the position. The first… was the opportunity to test myself as an asset allocator and portfolio manager. The second has to do with the fulfillment that I find unearthing value.”

For Zhou, getting started in investing involved reading on the subject and teaching himself about it.

“As I educated myself on the industry around 20 years ago, I read about Warren Buffet,” Zhou said. “His philosophy of buying quality businesses at a discount was intuitive and immediately resonated with me, inspiring me to pursue a career value investing. That’s how I ended up at Artisan the first time around.”

# When everything changed

The Global Financial Crisis in 2007 through 2009 was a pivotal period for Vasagiri. He said that large-scale disruption spread across the markets and impacted companies of all sizes, making it easier to find value even in large-cap names. As the markets started to normalize, Vasagiri felt he would have a better chance to uncover and deliver alpha in small caps.

“That’s truly what motivates me to get out of bed in the mornings,” he added.

With his background in engineering, his natural inclination early in his investment career was to focus on quantitative and technical factors when picking stocks. However, he quickly learned that the fundamental issue with this strategy was that it requires you to ignore the value of what you’re buying and selling.

“This led me to start focusing more on understanding the value of the companies I was investing in, which took me down the path to learn more about value investing,” Vasagiri said. “Over time, I began to feel that, intuitively, it made the most sense to value stocks as fractional ownership of the companies rather than fractal mathematics or trying to project the future in a stock chart.”

As he began to move further into value investing, Vasagiri found the concept of margin of safety to be "very intuitive." As a result, he started to equate a cheap price with a large margin of safety and how quality can compound over time. According to Vasagiri, this means the margin of safety grows over time, although investing in low-quality businesses that look cheap can often lead to depreciating stock prices and tumbling returns on those names. He calls that type of situation "a melting ice cube."

"Those were a couple of the a-ha moments I had as I started working in the industry," Vasagiri explained. "On my very first day in 2004, David also went over the four key characteristics that he looks for in every investment, characteristics that have been guiding his strategy since it incepted in 2002: a good business, a clean balance sheet, a strong management team and an attractive valuation. No matter where I went, I took those four key characteristics with me."

He explained that both behavioral and financial reasons demonstrate why the four key characteristics can work as investment guidelines. Vasagiri added that subsequent research has found that these four key characteristics do increase the risk-reward characteristics of an investment.

One last factor that guides his investment strategy is that he learned early on that he's "wired to be a contrarian investor." As a result, he naturally gravitates toward market dislocations.

"It is in my nature to run towards the location that others are fleeing from to find real value," Vasagiri said. "I have discovered that often when there are market disruptions, investors tend to assume that whatever is happening is structural and permanent. However, in many cases, the factors causing the disruption are cyclical or otherwise temporary."

He believes this creates an opportunity to invest in "great, quality companies at attractive prices to potentially generate strong long-term returns."

A key factor that was pivotal in the way Vasagiri invests now is overcoming his natural attraction to "optically cheap valuations" where it looks like the market has already priced in the potential problems. He admits that he has "fallen victim to the classic value trap," in which stocks look cheap, but management teams can make decisions that further destroy value for minority shareholders.

As a result, Vasagiri has become more thorough in vetting management teams today — to the point that he and Zhou refuse to become involved in a company unless they feel comfortable with the management team.

“Identifying a quality management team can be very difficult,” Vasagiri noted. “Unlike financial metrics, there is no formula you can use on people. The ability to make the distinction between a good management team that will create value and a bad one comes mainly from making mistakes and learning from them.”

Similarly, Zhou also once wanted to buy statistically cheap businesses like those in Japan. However, experience taught him that businesses that don’t grow and compound over time simply melt by losing value over time.

“Consequently, Anand and I avoid businesses that lack sustainable growth prospects, even if they are trading at cheap multiples,” Zhou concluded.

## Returns and top holdings

As of the end of June, Artisan Partners had $159 billion in assets under management, with the Artisan International Explorer Strategy accounting for $326 million of its AUM. In the second quarter, the Artisan International Explorer Fund returned 2.42%, bringing its year-to-date returns to 6.88%. Over the last year the Fund has returned 13.14%.

As of the end of the second quarter, the International Explorer Fund's top 10 holdings were M&C Saatchi, Glenveagh Properties, Despegar, Zuken, Alten, Sato Holdings, Steadfast Group, AlzChemGroup, Kansai Paint, and IQE.

# Q4 2024
# Stock Picks

## Anand Vasagiri, Artisan Partners

As mentioned earlier, Buenos Aires-listed Despegar (BCBA:DESP) and Tokyo-listed Zuken (TYO:6947) are the Artisan International Explorer Fund's third and fourth largest holdings, respectively. Despegar's market capitalization stands at around US$858.2 million, while Zuken's market cap is around ¥77.8 billion (US$533.6 million)

# Long thesis for Despegar

***Q: Please tell us briefly about your stock pick.***

A: Despegar is a listed online travel agency. It offers a platform for people to buy flight tickets, book hotels, or purchase travel packages via its website or app. It is very similar to Expedia and Bookings.com, but it has a specific focus on Latin America.

Despegar was founded in 1999 in Argentina by Duke MBA students Roberto Souviron and Martín Rastellino. On a flight to Argentina, Souviron saw the need for an easier way to purchase flights to and from Latin America. In the coming years, the business expanded to support more countries and to provide services beyond flights.

In 2017, Damián Scokin became the CEO of Despegar. Prior to joining Despegar, Scokin was CEO of multiple Latin American airlines, lending him a strong background in both local markets and the travel industry.

Despegar's main business segments are airlines and travel packages. Historically, airlines were the largest contributor. The value-add from selling flight tickets is minimal.

Selling travel packages, on the other hand, provides a greater opportunity to add value and charge more, thus improving margins. The company has steadily increased travel packages as a percentage of its total bookings, and they now make up about  one-third of its total business.

Despegar's business model is fundamentally the same as any other online travel agency or aggregator. Despegar gets preferential or volume-based pricing discounts from operators, including over 200 airlines and several thousand hotels. When somebody uses Despegar to buy a package, that person gets better rates than booking directly through the operators. Despegar, in turn, charges its consumers a fee. In certain cases, operators pay fees to Despegar since they benefit from having more consistent and predictable demand.

***Q: What initially drew your attention to this stock?***

A: We began researching companies upon our return to Artisan in 2020. At that time, the pandemic led investors to assume travel had no future, and so Despegar was trading at an extremely attractive valuation.

Beini and I also liked the changes the company was making. The moves made it clear that Despegar was run by people thinking like owner-operators. First, management determined it would need a lot of cash on the balance sheet to eliminate the risk of going bust.

Second, management aggressively cut costs due to the lack of revenue and uncertainty around the pandemic's duration and impact.

Finally, once management felt Despegar's future was secure, it looked to use its excess cash position to acquire other travel agencies struggling with the pandemic.

***Q: Please share your thesis on your stock pick in more detail.***

A: When looking at a company, we focus on the quality of the management team, whether it has a good business, balance sheet strength and the stock price.

Despegar has an adept management team that works to consistently build value over time. The company also deals with considerable operational difficulty in servicing all of Latin America, which is often thought of as one homogenous market.

However, increasing market share is a long and slow process because it must be done at the country level. Suppose somebody from Brazil would like to visit Peru. In that case, a travel agency must have operations in both countries due to different currencies and local central bank regulations on how currencies can be exchanged.

Furthermore, transactions are typically smaller than is common in the U.S. or Europe, but the complexity is high. Despegar's expansion requires an extensive local network and footprint in addition to operational intent. This complexity provides Despegar with a moat that gives it a degree of protection from other companies.

We also see favorable structural and macroeconomic factors. The U.S. has a well-developed hotel network. Many U.S. hotel chains get return business that will often book directly thanks to well-built rewards programs and the common quality standard across the network.

Latin America is a much more fragmented market with no large hotel chain that one can easily book. Having a platform for available hotels at different price points and quality can sizably decrease the large search costs involved with booking in Latin America. Therefore, Despegar is able to provide a lot of additional value to its customers.

Over the past several years, various Latin American countries have suffered political and economic challenges. However, many of them are coming out on the other side of these issues. In a similar vein, because these countries are emerging markets, their GDP has been growing. To the extent that wealth creation is occurring, travel tends to become a necessity rather than a luxury, especially air travel and good hotels. As the gateway for travel booking, Despegar benefits immensely as the countries grow and evolve.

***Q: What is the company's current valuation and how does that compare to your target price for its stock? Why do you think it's undervalued?***

A: Compared to peers such as Expedia, Bookings.com and MakeMyTrip in India, Despegar is trading at a very attractive, depressed valuation. Besides believing the quality of the business structure and management team is high, the balance sheet is also in great shape. It has a considerable net cash position, and it benefits from float income where customers pay first and then consume services later.

Its market cap is around $850 million, and it has over $150 million in net cash, adjusting for the float income. Despegar has not yet optimized its float income, but it is working to do so, and we anticipate it will become an additional revenue stream. Yet, the company is trading at just over 1x revenue and just over 5x EBITDA. In the last quarter, gross bookings grew by 37% year over year, which is a phenomenal rate for a business trading such an attractive valuation.

***Q: Why this company over others within the same industry? What sets them apart? And/or are you bullish on their industry as a whole?***

A: We are neutral on the online travel agency (OTA) industry. Some parts of the industry are well-penetrated and highly competitive. In those parts, it's a matter of who is executing well and taking market share. However, Despegar is essentially unchallenged in a minimally penetrated market, thanks to its wide moat. Despegar also has the best technology, the broadest footprint in its market and has executed well operationally. Such a wide moat can support its growth and protect its core businesses for many years to come.

***Q: Are you bullish on Latin America in general and if so, why?***

A: We are bottom-up, fundamental stock pickers. Although we include macro considerations from a risk-management perspective, we generally do not take macro views. Because Despegar operates broadly across Latin America, a diversified mix of countries contribute to its revenues. This helps build a safety net for our investment because we are not taking on the macro risk of any one Latin American country.

***Q: Which countries are most important for Despegar and why?***

A: Despegar is domiciled in Argentina, but its largest market is Brazil, which makes up around 40% of revenues. Mexico is the second largest, followed by Argentina. Although those are the largest markets for Despegar, the company has a pan-Latin America footprint.

***Q: Despegar has debt on its balance sheet. Can you take a deep dive into that debt and the company's cash position and explain how much of a concern they are?***

A: Despegar has a net cash balance sheet, further aided by float income. It does have some debt from a large capital raise made during the pandemic. Despegar raised the capital to have a lot of cash on its balance sheet in order to eliminate the risk of going bust. The debt is all convertible, some of which has already been converted to shares. We are not concerned about its financial leverage, which is one reason we feel so strongly about our investment.

***Q: What risks does this company face and why do you think they are less important than the advantages this company enjoys?***

A: Despegar's top risk lies in execution due to the OTA industry's rapid evolution. Despegar's scale in such a fragmented market makes it difficult for its peers to compete. But this does not preclude the company from having to be nimble, continuously evolving and building its brand. This is an ongoing effort. As an example, it is launching a campaign to build more brand awareness to stay competitive. Just a few weeks ago, it signed Shakira as a brand ambassador.

Despegar also must remain focused on maintaining its growth trajectory. One drawback we mentioned earlier is subpar cash conversion rates. We have informed management of the need to work on this issue, and it is a priority for the company. Despegar has a new CFO who is taking all the right steps to better the situation, so we expect the company to improve on that matter going forward.

Overall, Despegar has been focusing on all the right business drivers and addressing risks.

**_Q: What do you expect this company's growth to look like down the road and why?_**

A: Generally speaking, travel growth rates in many Latin American countries are in the double digits. This is promising in terms of the growth we hope to see from Despegar.

However, currencies have been a headwind to growth. The dollar has been strong, while some Latin American governments have implemented macro policies that depreciated local currencies. This means growth sometimes looks less attractive in dollar-adjusted terms than it does in local currency. However, structural tailwinds (such as low penetration of services and growing purchasing power of the population) offset some of these cyclical challenges. We expect Despegar's top line to continue to grow even in U.S. dollar terms at a double-digit rate.

Furthermore, as Despegar transitions to selling packages where the company gets a bigger take rate, the company's margins improve. With increasing scale, costs do not need to increase at the same pace as revenue growth, thanks to its aggressive cost-cutting during the pandemic. This gives Despegar operating leverage and contributes to margin expansion. We see signs of it already starting to happen.

***Q: What is your price target or estimated value?***

A: While Despegar's share price has approximately doubled since we began our position, we feel that the fair value is still materially higher from its current level given the drivers for continued growth, the quality of the business, the strength of its balance sheet, and its business-savvy management team.

***Q: Do you have anything else to add about this stock that's important for investors to know?***

A: It is worth noting that Expedia bought a stake in Despegar in 2015. Expedia currently has a seat on Despegar's board and a 12.5% stake in the company. Aware of the large barriers to entry to compete with Despegar in Latin America, Expedia opted to form a partnership.

# Long Thesis for Zuken

***Q: Please tell us briefly about your stock pick:***

A: Zuken is a Japanese industrial design software company. Specifically, its software is used within the electronic design automation (EDA) space.

The company has four reporting segments: printed circuit board (PCB) design, wire harness design, IT solutions, and maintenance/ services. Engineers use the software to design PCBs and cable wire harnesses. Both components are used extensively in machinery and gadgets across diverse end markets, including auto, aerospace, industrials and medical.

Zuken's IT solutions segment consists of collaboration software tools that enable teams of engineers to access and manage design files from different locations at the same time.

Zuken has a fairly straightforward business model of selling software subscriptions and licenses to corporate customers. When it sells licenses, the company charges an annual maintenance fee, generating ongoing support revenue.

Zuken was founded in 1976 in Yokohama, Japan, and it started with a PCB design tool. It quickly expanded globally by entering the U.S. market in the early '80s. Subsequently, Zuken entered the wire harness design space by acquiring a German firm in 2006. Over the decades, other than a few key strategic acquisitions, it has mostly grown organically. And while the chairman and founder still owns close to 25% of the company, the business has been run by professional CEOs in recent years.

***Q: What initially drew your attention to this stock?***

A: As a reminder, we have four key criteria when picking stocks. We look for a good business with good management and a good balance sheet that trades at a good price. Zuken satisfied all four of our key investment criteria. It's a rare Japanese software company that's globally competitive.

***Q: Please share your thesis on your stock pick in more detail.***

A: I'll walk through our investment criteria one by one for Zuken.

In terms of Zuken's business, it operates in duopolistic or oligopolistic market segments that serve large enterprises. In PCB design, it's the dominant player in Japan and has a 20%–25% share globally, with the other two major players being Siemens/ Mentor and Cadence. In wire harness design, it mostly splits the global market with Siemens/ Mentor. The industry has a global secular growth tailwind as we continue to see electrification and miniaturization. We expect Zuken to organically increase its compound annual growth rate into the mid-to-high single digits with further margin expansion potential.

When it comes to the quality of management, we judge it by two things.

One is operational excellence, and the other iscapital allocation. Regarding the former, management has continuously improved its operating margin from mid-single digits a decade ago to now being close to 13%. We believe Zuken has room to improve its margin even further. Regarding the latter, we're glad it has resorted to M&A sparingly. The German company that Zuken acquired in 2006 to enter the wire harness design space was a notable deal that turned out well. In addition, the company bought back around 5% of its outstanding shares last year at a price that we considered depressed, which was a great capital allocation move.

Zuken also has a net cash balance sheet. We are fine with what others might consider "lazy" balance sheets. Leverage can kill a company in a downturn, and although having a clean balance sheet might not fully optimize our upside potential, it gives us downside protection as a margin of safety.

Finally, we consider Zuken to be very undervalued. It's currently trading at a little over 7x EBIT or around 10–11x P/E ex-cash. We see no r eason why a globally competitive software business with a secular growth tailwind should not trade north of 14x EBIT or 20x P/E ex-cash.

***Q: Why this company over others within the same industry? What sets them apart? And/or are you bullish on their industry as a whole?***

A: We are bullish on the industry as a whole. A scaled business in this industry tends to be a good business.

Zuken stands out among its peers because it's less discovered by the broader market. This is reflected in a much lower valuation multiple compared to larger U.S.-listed peers such as Synopsys and Cadence. Synopsys and Cadence trade at close to 40x EBIT, a valuation that we believe is very rich and more than reflects the companies' growth potential. In contrast, we think Zuken's modest valuation multiple undervalues the quality of the business and its growth potential.

***Q: Have there been any recent updates to Zuken's products and what do they mean for its current and long-term prospects?***

A: Early this year, Zuken was one of the first industry players to unveil a new version of its flagship PCB design software that incorporated AI. The new technology is called AIPR, which stands for AI-powered place-and-route. This update shows that Zuken continues to prioritize innovation and aims to stay ahead of the curve. This attitude bodes well for long-term growth prospects.

***Q: What risks does this company face and why do you think they are less important than the advantages this company enjoys?***

A: The biggest risk we see is competition from Altium, an Australian player selling PCB design software and trying to move from small and midsize enterprises (SMEs) to large enterprises.

Although this risk is certainly worth considering, a couple of mitigating factors make us feel that Zuken's position is relatively secure. One, the large enterprise sales nut is extremely hard to crack, if not impossible, for players like Altium that are used to selling to SMEs. It's a different ball game that requires a different selling motion with a different sales cycle.

Two, selling to large enterprises requires a fundamentally unique product architecture with much more stringent security requirements. What's more, Zuken's current depressed valuation mostly reflects this or any competitive pressure.

***Q: Does Zuken have any key customers? If so, who are they and what does their business mean for Zuken? Are they growing their business with the company?***

A: Its top customers are in Japan's auto or electronics industries. Engineers in these industries use Zuken software to design automobiles or electronic equipment. As far as we know, no single customer accounts for more than 10% of its revenue, helping to remove any concerns surrounding customer concentration risk.

***Q: Does Zuken deserve a growth-stock valuation due to its recent earnings growth? Why or why not? What about revenue growth?***

A: We don't look at investments through a lens of growth versus value. As mentioned above, we see no reason why a globally competitive software player with a secular growth tailwind and double-digit earnings per share growth should not trade at least 20x P/E ex-cash. We also see its model of selling licenses and charging annual maintenance fees as supportive to revenue.

***Q: Do some investors feel Zuken is a high-risk investment and if so, why do they think that and why do you disagree?***

A: If other investors perceive Zuken as a high-risk investment, we don't share that view. First, it is not in a cyclical industry. Some of its customers are in cyclical industries, but they pay for Zuken software out of their R&D budgets, and that type of spending is much more resilient over time. Zuken also has a strong balance sheet with no leverage. And Zuken trades at a modest valuation to its major U.S. peers. Overall, it meets all of our key investment criteria.

***Q: Do you think there are greater opportunities in international vs. U.S. stocks?***

A: We do believe there are greater opportunities to generate alpha in non-U.S. small-cap companies, although we admit that we're biased. The S&P 500 Index sits at the opposite end of the spectrum in terms of asset type. U.S. companies, especially large caps, are very well-researched, and hence, the S&P 500 Index's valuation multiple is relatively high. On the other hand, our investable universe attracts very little sell-side coverage, creating a better chance for stock pickers like us to uncover hidden gems like Zuken.

***Q: Do you have anything else to add about this stock that's important for investors to know?***

A: Nothing is perfect. If there's one thing we would improve about Zuken, it would be a higher dividend. We believe that Zuken could materially increase its payout ratio to north of 50% without endangering its growth potential. We are in continual dialogue with the company to nudge them in that direction.

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| Investment Results as of 9/30/24 (%) Artisan International Explorer Fund | QTD | YTD | 1 year | Inception | Expense Ratio |
|---|---|---|---|---|---|
| Advisor Class: ARDBX | 2.61 | 9.67 | 22.75 | 11.19 | 1.78%/1.43% [1] |
| MSCI AC World ex USA Small Cap Index | 8.90 | 11.93 | 23.25 | 10.08 | |

*Source: Artisan Partners/MSCI. Class inception: Advisor (16 May 2022). [1] (%Gross/Net). Prospectus dated 30 Sep 2023. Net expenses reflect a contractual expense limitation agreement in effect through 31 Jan 2025. See prospectus for further details.*

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Beini Zhou and Anand Vasagiri are the co-portfolio managers for Artisan International Explorer Fund. This article represents the views of Hedge Fund Alpha and Beini Zhou and Anand Vasagiri as of 14 October 2024 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 Hedge Fund Alpha.

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**Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is an indicator of a company's financial performance which is calculated by looking at earnings before the deduction of interest expenses, taxes, depreciation and amortization. **Price-to-Earnings (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. **Operating Profit Margin** is a ratio used to measure a company's pricing strategy and is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as wages, raw materials, etc.

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