THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Looking for Inefficiently Priced Stocks in the Midcap Space

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SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Washkowiak: Yes. Our firm was founded in 2011, yet our track record for the midcap strategy goes back to 1999. As we speak, we have $4 billion in assets under management, and the vast majority of that is in our midcap core equity strategy. The second strategy that the firm manages is an ESG strategy, which we launched at the beginning of this year, and that really was a byproduct of our current strategy, which had fairly high ESG ratings in and of itself. There are different reasons for that: one of which is the type of companies we invest in, the fact that we pay a lot of attention to corporate governance, and we've been voting our own proxies for over 10 years.

TWST: And do you work on any specific fund at the firm?

Mr. Washkowiak: I do. I'm a Portfolio Manager and Analyst on our midcap core strategy.

TWST: And could you tell me a little bit about that strategy?

Mr. Washkowiak: It's fairly concentrated. The portfolio holds 45 to 50 stocks. We are fundamental bottom-up investors. We seek to invest in companies that are inefficiently priced relative to their long-term outlook over the next three to five years. We tend to look for companies that have a strong business model and typically are leaders in their space.

Effective management is important to us. We do a lot of management interaction, and we try to get to know our management teams. We have pretty good access to management because of the size of our fund, and we're long-term investors.

Financial strength of our companies is also very important. Our portfolio tends to have a stronger debt profile than the indices, and we like that because we think it enables our companies to invest in their business, grow their market share, in both good economic cycles and bad. And then lastly — valuation. When we are adding to existing positions or initiating a new position, we look at valuation relative to a company's own history and peers, and the company will typically be trading below their historical averages.

TWST: And why might that make sense for an individual investor or an institutional investor to have a midcap core strategy like that one as part of their portfolio?

Mr. Washkowiak: That's a good question. We actually find that the midcap space is an overlooked space in the market, believe it or not. What we find is that managers or investors like to pick a large-cap manager or a small-cap manager, and what we find is that a lot of large-cap managers cheat down into our space, and a lot of small-cap managers cheat up into our space. We define the midcap space as market caps between $2 billion and $29 billion, and our weighted average market cap currently is at about $7 billion, which trends above the S&P 400, which is about $6 billion, but is much lower than the Russell Midcap Index, which is almost $15 billion.

Here at Fairpointe, we are 100% employee-owned and majority female-owned. And we think there are some differentiators on our team. Thyra Zerhusen is the original architect of the strategy. She created the midcap strategy in 1999, and then, myself, Mary Pierson, Marie Lorden, all are part of that investment team, and we have an average of 28 years of industry experience.

TWST: And did you want to highlight a stock that you find interesting right now?

Mr. Washkowiak: Well, there are a couple, but one in particular. We have a position in a company called **LKQ** (NASDAQ:LKQ). **LKQ** stands for like, kind, quality. In this market environment, a lot of the auto parts companies, which **LKQ** is one, have really sold off on concerns about OEM auto demand. What **LKQ** does is a little bit different. It's really more of an aftermarket provider. What they provide are alternative parts to the repair and replacement model or market.

So if a car gets into an accident and it is off that initial three-year manufacturer warranty, and it gets taken into a shop, chances are that repair shop is using **LKQ** parts. It is cheaper for the insurance company, and it is cheaper for the end consumer. So we believe that the stock has been oversold in the current environment. Demand for these products should continue to grow, and they have a very strong market position.

TWST: And is there anything on the horizon for the company that investors might find interesting. Is it more of the same, or do you think there might be some new initiatives or changes?

Mr. Washkowiak: It's really more of the same. They initially built their footprint in the U.S. They have a very strong footprint here with leading market share. The last five years, **LKQ** has gone into international markets, primarily Europe, and has made some acquisitions there. They are building up their business in Europe, which we think is a long-term opportunity.

In North America, they buy salvaged vehicles and strip the car that's been deemed a total loss by the insurance industry. They keep the usable parts and repair some parts. Those are the parts that get sold back out into the repair marketplace, and we think they have a leading footprint in that area.

So where the stock stands today, it is trading at about 11 times earnings, which is at the low end of its five-year range. We expect the company to continue to grow both top and bottom line in the coming years.

TWST: And do you want to mention another company?

Mr. Washkowiak: Yes, another company I'd like to talk about is **Hormel** (NYSE:HRL). **Hormel** is a company we own in the strategy. **Hormel** is a very strong operator as well. They own some very well-known brands including, of course, **Hormel**. They also own Spam, Jennie-O Turkey Store, Skippy peanut butter. And what we think is interesting about **Hormel** is a couple of things: The management team has an excellent track record of growing both revenues and earnings. They have a very strong focus on protein — actually in all of their products.

But what we think is interesting is today it's primarily a domestic company. They generate about 93% of the revenue domestically, but in the last several years, they've taken aim at the international markets, primarily in China. We believe that products like Spam and Skippy have very strong growth potential in Asia, in those international markets that are underappreciated by the market today.

TWST: And what do you think it is about them that makes them so popular? Is it just the brand, or is it the variety of products that they're selling and the health benefits?

Mr. Washkowiak: It's primarily the brands. Like I said, a lot of it is protein; some of it is healthy, Jennie-O Turkey. They do a good job of branding themselves as a healthy alternative to red meat. But they've also done a good job of making some small acquisitions. They own a brand called Muscle Milk. As I said, they own Skippy. They own Applegate Farms. So we think that in the long run, protein-based products are going to continue to be in demand, especially in international markets.

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TWST: And it could go even beyond China?

Mr. Washkowiak: Well, China I think is the big opportunity. **Hormel** recently completed a plant there. Although they have some other markets, China is their big opportunity for growth in the next few years.

TWST: Did you want to mention a third company?

Mr. Washkowiak: We think **Cooper Tire** (NYSE:CTB) is interesting today. **Cooper Tire** is a leading manufacturer primarily of replacement tires. There's a couple of reasons we think it's interesting. Due to the recent rise in raw material costs, primarily oil, we believe the company is underearning its long-term potential. There are a couple of things that the company is doing and has been in the process of doing for the last couple of years. They are also shifting some of their production mix toward more higher-margin, higher-value-added tires. So think about larger rim sizes, lower-profile tires, higher-speed-rated tires, those are all higher-margin products, and the company has an increasing presence in those products.

The other thing that's going on is — I said previously that they are primarily a replacement tire company — is that we expect them to have an announcement sometime in the near future of winning a piece of business with an OEM. We think it will be a luxury OEM and believe that will also provide some brand equity to the company here in the States and actually around the world.

Lastly, the tire market is a consolidating industry. We don't buy specifically just for takeouts; we must have a thesis as I just laid out. But we buy midcap stocks that generally have strong balance sheets, and **Cooper** fits that category. We think there's a chance that someday **Cooper** could get taken over.

Highlights

Brian Washkowiak discusses Fairpointe Capital, LLC's midcap strategy. The portfolio is fairly concentrated, holding 45 to 50 stocks. Mr. Washkowiak is a fundamental bottom-up investor. He looks for companies that are inefficiently priced relative to their long-term outlook. Mr. Washkowiak likes companies that have strong business models, that are leaders in their space and that have effective management teams. He notes that financial strength is also important. The expectation is that the companies held in the strategy will generate as good or even better earnings growth than the benchmarks.

Companies discussed: LKQ Corporation (NASDAQ:LKQ); Hormel Foods Corp. (NYSE:HRL) and Cooper Tire & Rubber Co. (NYSE:CTB).

TWST: And I would think that a lot of people are driving their cars a lot longer than they used to, so there is a demand for replacement tires, and that's benefited them long term.

Mr. Washkowiak: That's correct. It's kind of perplexing. In the near term, replacement tire demand has been a little bit weaker than expected, but in the long run, just as miles driven increased and, as you said, as people drive their cars longer, replacement tire demand should continue to grow.

1-Year Daily Chart of LKQ Corporation

Chart provided by www.BigCharts.com

There are a couple things that I would highlight. The portfolio, as it always does, has a stronger balance sheet profile than our benchmarks. So portfolio long-term debt to capital stands today at about 38% — that compares favorably to both the S&P 400 and the Russell midcap benchmarks, which are both above 45%.

What we also find interesting is that we continue to find what we think are attractive long-term companies. We expect our companies to generate as good or even better earnings growth than the benchmarks. Today, the expected earnings growth of the long-term earnings growth of the holdings in the portfolio is 12%, which is actually above both S&P 400, which is 11.4%, and the Russell midcap, which is 11.6%. Despite those metrics I just told you, the portfolio is trading at about 13.5 times this year's price to earnings multiple, which is a very good discount to both the S&P midcap, which is trading at 15.8 times, and the Russell midcap at 15.9 times.

We feel the portfolio is well-positioned. We have a very good long-term track record. This year has been somewhat frustrating, although in the current selloff that has happened, particularly this month, what we've noticed is that growth stocks are down versus value. So we believe we're well-positioned fundamentally for the portfolio to rebound when fundamentals really matter and more value-oriented stocks are recognized.

TWST: And as we talk in October, when you talk with your clients about their concerns for the rest of this year and into next year, what are some of those concerns that you care to mention?

Mr. Washkowiak: When we speak to our company management teams, there is a lot of uncertainty regarding global trade policy. That would be the number-one concern we have and a lot of our company managements have. Now, there has been progress on that front, although China is a big concern, and that is really what has been disruptive this year.

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1-Year Daily Chart of Hormel Foods Corp.

Chart provided by www.BigCharts.com

Some people are concerned about higher interest rates — that's definitely impacting the market indexes and our portfolio this month. Although we would argue that, in the long run, having a stronger balance sheet profile like we have should serve us well in a rising interest rate environment. In the bull market — since the end of the financial crisis through recently — it's actually been the more heavily indebted companies that have done better than the higher-quality companies like we own, so that might be another factor that's about to change in our favor.

TWST: And when it comes to trade, is the concern generated more by just the uncertainty and wanting to see something in place as opposed to maybe the specifics of it, or is it more about the specifics of the eventual deal that might be worked out?

Mr. Washkowiak: When we talk to our management teams, it really is the uncertainty. Once they know what the ultimate deal will be, there may be some short-term adjustments that have to be made, but companies will generally make those adjustments. If there are tariffs, eventually that will generally get passed on in the form of higher prices to the end customers. But it's sort of these lists being put out one week and then maybe things changing and just the uncertainty of not being able to plan, we think, is the biggest issue.

TWST: And did you want to talk about the portfolio a little bit more?

Mr. Washkowiak: Yes. So from a portfolio perspective, we're actually at a really interesting time. We are core managers. However, we consider ourselves to be a bit contrarian, and as I said, valuation is important to us. Given the length of the bull market and how growth stocks in particular have outperformed value stocks, especially over the last year and a half to two years, our portfolio is trading at a very attractive value.

TWST: And is there also concern overall about the volatility of the market?

Mr. Washkowiak: We strive to have a portfolio that would minimize volatility, but volatility is a reality that we all have to deal with. As midcap managers, we probably experience more volatility than large-cap stocks but less than small-cap stocks. What we do in periods like this that we've had here in October is really look at the portfolio and look at the ideas that are out there that we've been watching, and we try to take advantage of that volatility to position the portfolio for long-term performance. We are in the market every day, adding to positions that we think are attractive.

TWST: Is there anything we didn't talk about that you care to bring up, either about the firm or about some trends out there?

Mr. Washkowiak: I would just reiterate we have a team-oriented approach at Fairpointe. We are all very experienced. There are 15 employees and seven investment professionals who are long-tenured. We have a process that's been in place since 1999. It has served us well, and we are going to keep executing that process and believe it will continue to serve us well in the future and serve our clients well also.

TWST: Thank you. (ES)

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