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MONEY MANAGER INTERVIEW

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Delivering a Margin of Safety and Superior Long-Term Results

ESWAR MENON, HARPER CAPITAL MANAGEMENT LLC

ESWAR MENON heads Harper Capital Management LLC. He is also a Trustee and Chairman of the Investment Committee for the San Jose Police & Fire Retirement Fund, and an Advisor to India-based Sameeksha Capital, a wealth and equity portfolio management group. Mr. Menon manages portfolio investments in three equity strategies — Global Equity, International Value and Emerging Markets. Before starting Harper Capital Management, he had more than 25 years of asset management success in prominent Wall Street firms such as Nicholas Applegate Capital Management, Loomis Sayles & Co., Denahi Global Investments, WHV Investment Management, and Geneva Advisors. He holds an undergraduate degree in electrical engineering from the Indian Institute of Technology Madras, a graduate degree in electrical and computer engineering from the University of California, Santa Barbara, and an MBA from the University of Chicago.

SECTOR — GENERAL INVESTING

Highlights

Eswar Menon discusses the investment philosophy behind Harper Capital Management's three strategies: international value, emerging markets, and global equity. He says they look for durable businesses that will survive in the long term and generate cash flow and strong returns on capital. They also try to buy these companies at an attractive discount to intrinsic value. They believe these factors provide a margin of safety and deliver superior long-term returns. Mr. Menon says they seek to exploit the inefficiencies caused by short-term negative news that creates mispricing or by the markets underestimating potential runways for growth. He says that having patience provides them with a competitive edge helps them deliver and add value for investors. Mr. Menon discusses three companies he views favorably: Unilever, ICICI Bank and Lockheed Martin.

Companies discussed: ICICI Bank Ltd. (NYSE:IBN); Lockheed Martin Corporation (NYSE:LMT); Unilever plc (NYSE:UL) and Nestle ADR (OTCMKTS:NSRGY).

(AHU544) TWST: To start, would you please provide us with an introduction to Harper Capital Management?

Mr. Menon: Harper Capital Management set up about six years ago. We have three strategies: international value, emerging markets, and global equity. The international value and emerging markets have over six years of track record, the global has over two years of track record. We are a GIPS compliant firm. And really, our goal is to grow the business through institutional clients, and we are in the stage where we have a long enough track record that we're starting to market and talk to institutional clients.

TWST: Tell us more about your overall investment philosophy, and how you would define your approach to portfolio construction and risk management?

Mr. Menon: I'll walk through the different steps. In terms of investment philosophy, we look to own high-quality businesses which have durable business models, and by that what we mean is that we have a high conviction that these businesses are around in the long term, and that for us is over 10 years. And we say that because we think a key part of delivering strong investment returns is just the fact that your company survives and does well. And we look for businesses which have long-term sustainable growth, so durability and long-term sustainable growth, and we try to invest in these companies when they trade at what we find is an attractive discount to intrinsic value. So, going through and finding what that valuation is where they're attractive is an important part of our process.

And I think when we combine the three — the durability of the business, long-term growth potential and the valuation discount when we buy them — it gives our investors what we would say is a margin of safety, which is an important component of superior long-term investment returns.

The markets are efficient in a lot of different ways. There's a lot of information flow. The one thing that we know is, we know what we're not good at. We don't think we have an information edge; we think most people don't have an information edge, so we don't operate trying to get any kind of information edge.

"We're very careful in terms of what we hold in technology, for example, just given that the pace of innovation is fast, and companies can disappear within five to 10 years. You can have a great company, but innovation can disrupt the business model, so we try to stay away from those kinds of situations."

But we think there are inefficiencies in the market, and to us, the inefficiencies that we see in terms of the markets are — one is that with durable businesses, sometimes there is short-term negative news flow, and this creates a mispricing, because people don't want to hold these companies because of short-term concerns. And so, we try to capitalize on that. The second is that with these durable businesses the markets underestimate potential runways for growth, i.e., these companies can grow far longer at that long-term growth rate than the market estimates. So we think these are the inefficiencies that we try to capitalize on.

Then in terms of what we do, if you look at why we are unique, this long-term outlook — which I would say is a generational outlook — we're trying to take a seven- to 10-year view in terms of these companies having durable business models. They're going to survive, and therefore they're going to compound returns at a superior rate. Second, for us, risk is the permanent loss of capital and it's not the short-term volatility. In fact, we think the short-term volatility presents an opportunity for us as long-term investors, because you get these great businesses which are trading at a discount because there are a lot of investors that care about the short term, and we try to capitalize on that.

And then we try to align our interests with investors. We're willing to be competitive in terms of fee structure for investors who commit long-term capital.

Then in terms of our investment process, there are many different parts of the investment process. How do you generate ideas, how do the ideas get in the portfolio, how do you construct the portfolios, and how do you manage risk? In terms of idea generation for us, we have proprietary methods in which we screen. We screen for companies and use that as a potential source of ideas. We read a lot, most of this is primary research, which is reading companies' annual reports, 10-Ks, 20-Fs, things of that sort. We talk to our peer group to some extent, share ideas, we go to conferences, and often there are themes in terms of what's going on.

We like India, for example, and a company there that we can talk about later is **ICICI Bank** (NYSE:IBN). We've owned it for six years. We'll talk about the growth in India, the underbanked, etc. — these themes can be an opportunity. **Lockheed Martin** (NYSE:LMT) is another idea, where, as the global strategic environment gets less secure, if you will, companies like **Lockheed Martin**, we think, are going to have a step up in terms of the defense spending, not just in the U.S. but in Europe, etc. So we look at these themes as a source of ideas.

Starting with these ideas, we come to a narrower universe where we have to analyze the companies, and the analysis for us has three parts to it. One is a qualitative analysis, where we do roughly a Porter Five Forces kind of analysis. The second part of it is looking at financial metrics to justify that qualitative assessment. And, finally, valuation.

The Five Forces analysis is really looking at the industry the company is in, how do firms compete, what are the barriers to entry, how is the firm's position in the industry relative to their suppliers, their customers, who has the strength in those relationships?

And finally, you're looking for disruptive forces.

We try to hold these companies for the long term, so we really avoid industries where we think that there's a high risk of disruption and stay away from those kinds of situations.

So that is a qualitative analysis, which is a very important component of what we do. If we don't like the positioning of the company or the industry, chances are that we won't be there. We're very careful in terms of what we hold in technology, for example, just given that the pace of innovation is fast, and companies can disappear within five to 10 years. You can have a great company, but innovation can disrupt the business model, so we try to stay away from those kinds of situations.

1-Year Daily Chart of ICICI Bank Ltd.

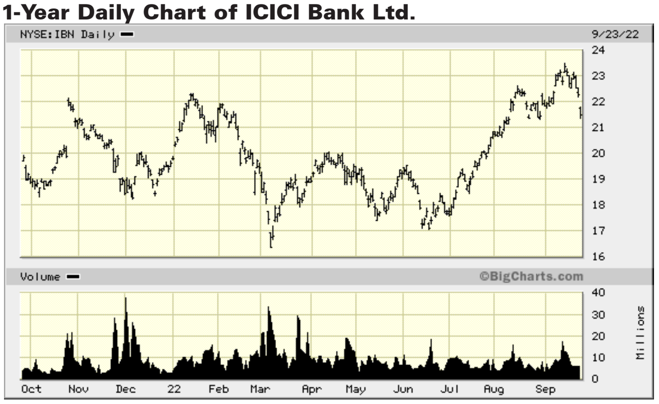

Chart provided by www.BigCharts.com

And then the financial metrics, we look at a lot of different financial metrics to justify our qualitative assessment of the company, and that's a combination of looking at cash flow that the company generates, the sustainability of margins that the company has, and the return on investor capital and return on equity. We look at a lot of these different metrics, and we look at it on a historical basis. We go back about 15 years if the data is available, and look at how that has been trending, how the company is positioned relative to its own history and relative to the peer group.

And finally, valuation. We like to say that we try to triangulate the valuation, where we look at traditional metrics like price-to-earnings, price-to-book, maybe EV-to-EBITDA, but we also look at discounted cash flow. So we model every single company that we invest in, and we try to combine these to get a sense of what the valuation is.

> ***"Often, we think investors struggle because they don't have a sense of what really drives the company, and when you get what we would characterize as shorter-term noise they may misjudge for a fundamental signal, they don't react properly and often they cut positions or eliminate positions that they should not, or sometimes hold on to positions they should not."***

The valuation for us is as much an art as a science — so the elements of science, where you build out these models and look at these metrics, but it's also an art in trying to say what is driving the valuation. For example, are these reasonable assumptions that you're making as you build your model? We think it's a combination of both art and science in terms of how you look at valuation.

The next step after you do this analysis is, how do you construct a portfolio? The key parts of that are how many names do you have — we have fairly concentrated portfolios, typically 15 to 25 names — and how do you size the positions? We do tend to own, in all these portfolios, larger-cap companies that are very liquid. We recently did an analysis on the international portfolio, and I would say if you hypothetically managed a much larger size of fund of about $5 billion, there are very few names where we hold more than three days of trading, even assuming that you just trade about one third of the daily trading volume in each company. So it's fairly liquid in terms of the names that we hold.

And the conviction that we have in the names. How much upside do you expect on the company? Those are the things that determine what the position sizing is, and I think that's a key component of how the portfolio does. So, not only finding the right name, but it's also sizing it in terms of the performance that you think it will generate, and that's a key component of the portfolio performance.

In terms of risk management, we talked about our differentiated view, which is the permanent loss of capital, and that goes with the fact that, as I said before, long-term returns are going to be enhanced if you avoid permanent loss of capital. The permanent loss of capital typically comes because you didn't do your due diligence, where you didn't identify all the risk factors, and often an investor may not fully understand the company.

Often, we think investors struggle because they don't have a sense of what really drives the company, and when you get what we would characterize as shorter-term noise they may misjudge for a fundamental signal, they don't react properly and often they cut positions or eliminate positions that they should not, or sometimes hold on to positions they should not. You can make mistakes in both directions. I think that initial due diligence and really understanding what drives the company is a key part of the risk assessment.

We typically have 15 to 25 companies in each portfolio to ensure it is well-diversified, but having said that, we can have pretty large chunky positions in individual companies. Then we identify what we think are potential risk factors. We limit individual countries and individual sectors. Individual sectors, we typically have less than 40%. Individual countries are typically less than 40%, except for the Global Portfolio — in that case because the U.S. is a large component of any global index, we do not impose this limit.

I think the most important component of risk, having managed money for over 27 years, is really being aware of what drives the portfolio and being able to look at the performance in any time period and looking at outperformance or underperformance and being able to key in on why that is the case.

It doesn't mean you need to do anything. Our portfolio turnover is very low — it ranges from about 10% to 20% annualized, and that includes all elements of turnover, including trimming and adding to positions. So, very low turnover, and the holding period is between five to 10 years. But at the same time, being aware of what is driving the portfolio and being comfortable that you understand why your portfolio may be underperforming in a period or outperforming in a period — it doesn't mean you need to do anything, but you need to be aware of what's driving the portfolio.

1-Year Daily Chart of Lockheed Martin Corporation

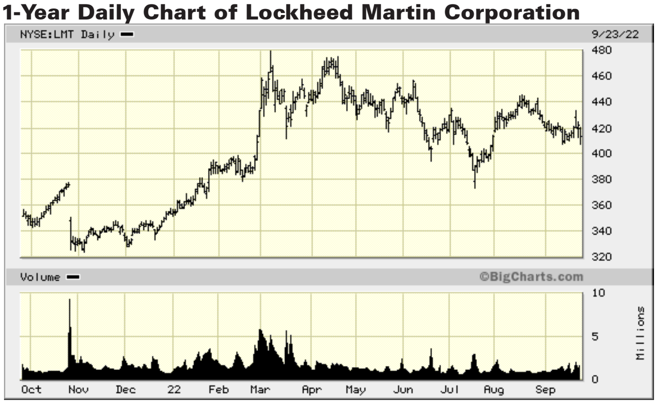

Chart provided by www.BigCharts.com

I think those are the key elements of what we do, which is a very long-term outlook, in-depth due diligence at inception, continuing to monitor the portfolio but being very patient. In our July investment letter, we talked about it being more difficult sometimes to have the patience and not doing anything, and overcoming the feeling that you need to do something and act on what we would characterize as noise for a long-term investor. I think that patience, which reduces our portfolio turnover, is a competitive edge for us, and that has helped us to really deliver and add value to investors. All our three strategies have done extremely well in the long term, significantly outperforming their respective benchmarks and peer groups.

TWST: With all of that as context, are there any particular industries or sectors or countries that you're finding especially attractive right now? And would you give us a couple of specific examples of favorite stock picks/top holdings?

Mr. Menon: We're very what we call bottom-up, which is, we're driven by the fundamental research in companies. So a lot of our decisions are not based on identifying a country or a sector. Though we do rule things out if we think, for example, the rule of law is not well established in the case of countries, or in the case of sectors or industries, if we think that we don't really understand the regulatory framework and that could be an added risk in terms of the companies. Again, it goes back to really investing in what we know, and if we think there are things we don't know, we stay away from it. That, we think, is a big mitigator of risk.

"The valuation to us, from our discounted cash flow model, suggests there is at least a 25% upside to the company. The ADR trades about $48. I think on a very conservative basis, the stock can trade at least at $60. We think this is a company which will survive and compound returns."

So let me walk you through a few companies that we own. The first is **Unilever** (NYSE:UL). It's a global consumer company. It has a market cap of about $124 billion. This company has a dividend yield of about 3.8%, a free cash flow yield of about 6%. The free cash flow is important to us. The dividends are important. It could be either dividends or share buyback — it's important for us that excess capital that's being generated by the company is returned to shareholders, either through dividends or through share buybacks. We think **Unilever** meets those criteria.

This company has 14 of the 50 top global brands. They have 13 brands which have sales of over a billion euros. They sell in 190 countries, they're all over the world, and they sell in 25 million retail outlets, so it's a combination of two things that we really like, which is strong distribution and strong brand strength. They have both of those. They operate in three broad segments: beauty, which is about 42% of the business; what's called home care, it's about 21%; and then food and refreshments is about 38% of the business.

If you look at how they've done, they've consistently had the ability to grow both volumes and pricing. Not big numbers, but there's a certain consistency to it. But we also think that they've been a bit undermanaged over the last five to seven years, and maybe they've been a bit slower than some of the competitors, like **Nestle** (OTCMKTS:NSRGY), in trying to focus on the faster growing areas of the consumer staple segment. But I think management realizes it.

They've also been caught up in unnecessary controversies. There was a controversy where one of their brands, Ben & Jerry's — they have some kind of unique arrangement when they acquired Ben & Jerry's, that the Ben & Jerry's board can make independent decisions, and Ben & Jerry's talked about not selling in parts of the West Bank — and certain public funds wanted to divest from the company because of that. So I think management has lost a bit of focus.

But what's good is that there's an activist investor, the hedge fund Trian run by Nelson Peltz. They've taken a stake in it, and I believe they have a board seat now. Our belief is that the company is going to get refocused in terms of what they do.

The valuation to us, from our discounted cash flow model, suggests there is at least a 25% upside to the company. The ADR trades about $48. I think on a very conservative basis, the stock can trade at least at $60. We think this is a company which will survive and compound returns. We talked about durability, we talked about the long-term growth, we talked about valuation. We think this company can turn around some of the areas that have been underperforming, and there's potentially a lot of upside to it.

Second is a bank in India called **ICICI Bank** with a market capitalization of $73 billion, and this we've held since we started Harper Capital Management six years ago. When we first bought it, this bank had many problems which we believed were short-term in nature and fixable. The quality of management was not as good. They had a legacy problem because they had certain corporate loans which had become non-performing. They had a really good consumer banking segment, which is a very strong brand, strong positioning in India, but some legacy issues, which meant that the bank was not priced by the market as we thought it should.

We analyzed it. They had certain subsidiaries in the insurance area and in asset management and securities business, and if we stripped those publicly listed entities out, we thought that the core banking was trading about one times price-to-book. We felt that over the next three to five years the bank could, through its own profits, address all of the non-performing assets, and we thought when that happened, that the bank would get re-rated. And that's exactly what played out, because over the last five years they have restructured or written off the non-performing loans without damaging book value.

1-Year Daily Chart of Unilever plc

Chart provided by www.BigCharts.com

Net NPLs are now less than 1%; it was a much higher number before. And the core, the jewel of the business, the consumer banking, if you look at the latest quarter that they reported, that retail segment was growing at about a 24% year-on-year kind of rate. So the execution has improved.

And during this process, actually, there was a little controversy with the old CEO who was caught up in some issues about her husband being involved in some business that **ICICI Bank** also was involved in, so she ended up stepping down. And so, if you combine that governance issue which has gone away, the NPL issue which has gone away — now the market is focusing on the consumer banking segment, strong brand recognition, strong growth in India, which we think continues to be under-banked, and that consumer segment is growing about 24%, and so the bank has really gotten re-rated.

"Is this company going to be around in 10 years? Absolutely. Does it have strong cash flow? Yes. What about the return on capital? In this case, the ROIC is about 40%. We think the margins are stable to improving. So everything in terms of what we look for is there in terms of Lockheed Martin."

When we initially entered it, we thought there was at least a 30% upside. I would say the stock is up about 250% since we bought it. And we still see, at least by our current estimates — the ADR trades about $21 — we see at least 28% upside to $27 on the ADR.

A third example, I mentioned this name before, is **Lockheed Martin**. **Lockheed Martin's** market cap is $114 billion. It has a dividend yield of about 3%, free cash flow yield of about 6.8%. It trades at about $430. We think there's about a 29% upside to it; based on a discounted cash flow, it can trade up to $555.

If you look at the defense industry, over the previous five years it's grown about 2% a year. We think that it's going to be double that over the next five years, because of all the geopolitical issues that are going on: Russia, Ukraine, China, what's happening in the Indo-Pacific area, and we think both U.S. spending and, more importantly, European spending — they've been laggard in terms of what they contribute to NATO — I think they're going to step up. And there are other parts of the world, in the Middle East and Asia, where defense spending is also increasing.

Lockheed Martin, if you look at the U.S. defense industry, they have about 22% market share. And we think they're going to participate in the different segment growth. Their different segments: They have the aeronautics and missile segment, and what they call the rotary segment. The aeronautics is the F-35 and various missile systems. The rotary is the helicopter segment and also some defensive systems that go into it. And then they have a space system, which is satellites, etc. And the breakdown between those, I think the space system is about 18%, the rotary system is about 25%, and the aeronautics is about 40%. So, three different segments, multiple business lines.

We think they can participate at that 4% kind of a growth rate, and the valuation in terms of cash flow is very compelling, and we see a lot of upside to it based on where it is trading right now. It's a really high-quality company. Is this company going to be around in 10 years? Absolutely. Does it have strong cash flow? Yes. What about the return on capital? In this case, the ROIC is about 40%. We think the margins are stable to improving. So everything in terms of what we look for is there in terms of **Lockheed Martin**.

And if I may go back to **ICICI**, the ROE is about 15.4%, and we think that can probably improve over the next few years, improve 1% to 1.5%. **Unilever**, we think the ROIC is about 20%. So everything that we look for, each of these names is there in terms of the cash flow, the return on capital, the valuation, and really great businesses which are durable for the long term.

TWST: How, if at all, do you incorporate protection from inflation? How do you account for the rising interest rate environment and all of the effects on both the economic and the market environment that we're living in currently?

Mr. Menon: So, two parts: inflation and interest rates. Inflation, our view is, if you own a great company which has that strong business model, durable business model, they're going to have the pricing power, and so that's not an issue. Whether it's **Unilever**, **ICICI**, **Lockheed Martin** — they all have the pricing power. And in terms of interest rates, when we look for quality, an important part is to make sure that the company is not over-levered. We pay close attention to the balance sheet, and it's important for us that the debt metrics and the cash flow metrics and the ability to pay interest on any debt that they have, all are conservative.

We think none of the companies that we own — not just these three, anything in the portfolio — we monitor very carefully, and we don't think any of the companies have a problem. And if you have a company with a durable business model, high-quality franchise, they're going to have the pricing power to overcome inflation, and that's exactly what we've seen as we look at the quarter 2 reporting, where inflation has been high. **Unilever**, for example, has been able to increase its pricing to compensate for inflation. We see that across the board in terms of the companies we own.

1-Year Daily Chart of Nestle ADR

Chart provided by www.BigCharts.com

TWST: You mentioned the topic of companies being over-levered. As you evaluate individual equities, what other red flags do you look for? What else would make you cautious?

Mr. Menon: In terms of what will make us cautious, first, I talked about the rule of law — if we're not convinced that we have a stable legal system. In China, for example, we consider China to be somewhat uninvestable, because we are concerned that the rule of law is not clear. There's a lot of changes, because the government and the Chinese Communist Party — CCP — they make the decisions and they cannot be challenged, for example, what happened to Chinese Internet companies. They can say, you're making too much profit, that the companies have too much power. They interfere. So we're very careful in terms of avoiding those kinds of situations. We stay away from it.

Any kind of corporate governance issues. We talked about **ICICI**, where they did have corporate governance issues, but we were clear that issue was going to go away because the Indian regulator was addressing it. Sometimes, especially when you invest internationally, you can have management that has interest in multiple companies, and so it's not clear that the company that you invest in is the one that the management is focused on. Again, we stay away from those kinds of situations.

We look very carefully at what we call capital allocation decisions. We're looking for companies that generate adequate returns on capital, adequate cash flow, but that cash flow has to be handled well. Either it's reinvested in opportunities that generate great return on capital, or it's returned to shareholders. So the capital allocation decisions are very important.

And lastly, accounting issues. If we think there are any accounting issues where the management is being lax in terms of how they report earnings, i.e., they don't use conservative accounting principles. And we do look at differences between cash flow and earnings, and if we see a big discrepancy, where the cash flow is not strong, but the earnings are strong, we would stay away from that.

So those are the kinds of things we try to avoid, because again it goes back to avoiding permanent loss of capital. We are happy to stay away in certain situations. We see segments, industries, sometimes sectors, and often companies that do extremely well in terms of share price performance, but if we see governance or durability risk factors, we are comfortable staying away.

TWST: Would you like to wrap up with some final thoughts or advice for our readers?

Mr. Menon: We look for situations where we have companies that have durable businesses that will survive in the long term, and we look for the ability of these companies to generate cash flow, to generate strong return on capital and we see an opportunity to buy the company at an attractive discount to our estimate of intrinsic value. We look for excellent governance in terms of capital allocation and return of capital to shareholders, and we avoid situations where we think there is risk in terms of the factors that we look for.

And when we look at all of these, we think we provide a margin of safety in our investments, and that avoids what we call the permanent loss of capital. When we do that — combine avoiding permanent loss of capital and investing at an attractive discount to intrinsic value in these durable business models with long-term growth — we think we can compound returns at a superior rate. That's a key component of why we have delivered strong returns for all of our strategies in the long term.

TWST: Thank you. (MN)

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