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Little engine that can

Palm Valley Capital Fund (PVCMX) closed 2022 with a gain of 3.16%, compared with a loss of 16.1% for the S&P SmallCap 600 Index. The secret to the success of the value-seeking equity managers, who, when they see no value, don't invest? Cash, tenacity and good balance sheets.

Constant readers may recall a profile of Palm Valley and its founders, Eric Cinnamond and Jayme Wiggins, in the issue of *Grant's* dated March 18, 2022. Now as then, the fund is roughly 80% in cash; and now as then, the founders are living lives of voluntary entrepreneurial privation. But whereas, nine months ago, Palm Valley had $115 million under its wing, today it manages $187 million (not counting separately managed accounts, which sum to almost $30 million).

The partners do their investing from the bottom up, no matter their witty and informative writing and blogging on current financial affairs. They do volunteer, however, that 2021 corporate profit margins were the highest they'd ever seen and that they'd take the time to perform de-bubbling adjustments to bring those frequently flattering figures back to Earth. "We believed at the time," says Cinnamond, "that investors were extrapolating that kind of bubble profitability, and I think in 2022 we started seeing some reversion but not nearly as large as what it would take to get back to average. So still very high."

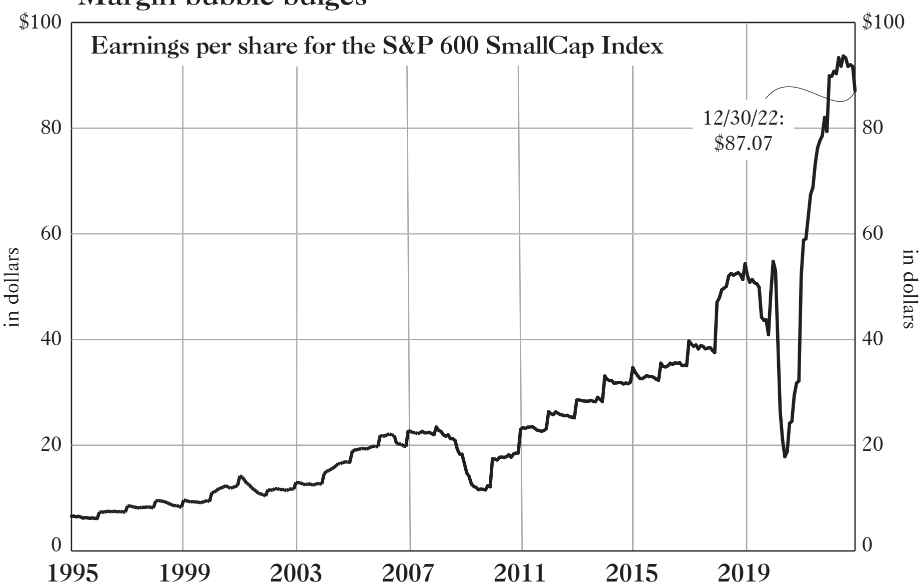
The kind of company for which Palm Valley refuses to overpay is a decades-old, slow-growing, well-financed market leader—Oil-Dri Corp. of America (ODC on the New York Stock Exchange), maker of cat litter and other products derived from sorbent minerals, for example. "The market in cat litter should not be growing at 15%. But people often think, 'Small caps, that's what they do,' " says Cinnamond. "I mean, if Oil-Dri was growing at 15% a year, we'd be overrun by cats."

A $250 million market cap, family-controlled and -managed company, Oil-Dri trades at 14.5 times earnings, at 1.62 times book value and 0.66 times sales. It shows a ratio of enterprise value to Ebitda of 9.75:1, and Ebit covers interest expense by a ratio of 18:1. The dividend yield is 3.2%.

The partners say that their potential buy list numbers 300 or so companies—"the list doesn't change much because there are only so many mature small-cap businesses," says Cinnamond. "Why don't they become mid-caps and large-caps? The industries themselves are not usually $5-$10-$20-$100 billion industries. We just bought the market leader in tow-truck manufacturing [Miller Industries, Inc., MLR on the Big Board]. That will never be a $20 billion industry. These are smaller industries. But you can still have a good market-leader business that generates a lot of cash."

We observed that, while value is desirable, the definition of value is changeable, especially in a time of technological upheaval. Who wants to own a cheap disruptee? A strong balance sheet is the best armor against permanent loss, Wiggins says. "Focusing on the good balance sheets has enabled us

Margin bubble bulges



source: The Bloomberg

to avoid having too many major losses over the history of the strategy."

"One thing we never do," Cinnamond continues, "is combine operating and financial risk. If we have, for example, an energy-service company that has operating risk with all of its cash flows, we will never buy that with debt, and if we have a company with debt, e.g., a Constellation Brands [the beer, wine and spirits vendor—STZ on the Big Board], that is fine as long as it is in a stable business. Over time, avoiding financial risk and operating risk together can save you from major losses. Keep in mind, we are an absolute return strategy. We can't have the type of losses you can't recover from. We can't have permanent losses to capital."

To which Cinnamond adds: "We have a 3–5 times debt-to-free-cash-flow hard rule on how much leverage we'll take on. The reason we use 3–5 times is, usually that's the maturity wall for most small-cap businesses. They are not like Disney, which can borrow for 50 years."

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