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Ori Eyal

Founder and Managing Partner
Emerging Value Capital Management

{ INTERVIEW BY KHAI NGUYEN }

Ori Eyal is the Founder and Managing Partner of Emerging Value Capital Management (EVCM) with over 14 years of experience in global value investing. EVCM manages global, long-short, value hedge funds which invest based on Mr. Eyal's global investing framework.

Born in Israel and raised both in Israel and the US, Ori has a strong understanding of how to invest in both developed and emerging markets. Previously, Ori performed global investment analysis at Deutsche Bank Asset Management, Deephaven Capital Management and at Aquamarine Fund.

Ori won first place in the LCG investment challenge (National Value Investing Competition) and third place in the VCIC (National Venture Capital Investing Competition). He presented at several prestigious conferences including the Value Investing Congress (California), The Value Investing Seminar (Italy), the Best Ideas Conference (Online), and ValueX (Zurich).

Ori earned an MBA from the University of Chicago Booth School of Business, an MSc in Computer Science from the Open University of Israel and a BSc from the University of Maryland. In addition to investing, economics and emerging markets, his interests include logic games & puzzles, artificial intelligence, strategy, science/physics/astronomy, and the upcoming technological singularity.

Khai Nguyen: I'm here with Ori Eyal, Founder and Managing Partner of Emerging Value Capital Management. Ori, welcome and thank you for joining us.

Ori Eyal: Khai, good to see you and thanks for having me.

KN: Your career, since 2001, has been focused specifically on value investing. What about value investing makes it so compelling to you?

OE: While I started out as a Computer Scientist, I was always interested in finance and economics. Around the year 2000, I read "The Essays of Warren Buffett" and became a value investing addict. Studying the writings of top value investors including Warren Buffett, Charlie Munger, Joel Greenblatt, Seth Klarman, David Einhorn and Bill Ackman has helped lay the foundations for my investment framework. The basic tenets of value investing make intuitive sense to me: buying something for less than its worth, investing within your circle of competence, demanding a large margin of safety, investing for the long term, being contrarian, and the power of compounding over time.

Ever since, I have been on a journey to learn from the masters of value investing and to develop my global value investing framework. I earned my MBA at the University of Chicago - Booth School of Business in 2006. I worked for Deutsche Bank Asset Management as an analyst at one of their global investing funds. I also interned for several hedge funds, including Deephaven and for Guy Spier at Aquamarine.

KN: What were some of the investing lessons you took from Guy Spier and incorporated into your investing process?

Around the year 2000, I read "The Essays of Warren Buffett" and became a value investing addict.

OE: I was very fortunate to work for Guy Spier at Aquamarine Fund while studying for my MBA at the University of Chicago. Guy Spier is an extremely talented and thoughtful investor who looks at the world as one global integrated market. Using his deep insights into how the world operates and his latticework of mental models, Guy has been able to successfully identify and invest in some of the world's greatest businesses.

At one point, Guy and I traveled to Israel together and we went to visit and research about 15 undiscovered companies in Israel. In some cases I think we were the first international investors that had ever visited them. Watching Guy interact with the management teams of these companies was a key learning event for me. He has the ability to quickly develop rapport with everyone in the room and get to the main business issues that each company faces. By the time the meeting is over, Guy has a better understanding of the business than the company management team does. On top of that guy intuitively understands the people running the company, their motives, and their likely future behavior.

Working for Guy helped me develop my global value investing framework. He taught me how to analyze great businesses and how to approach and interact with company management teams. He has been a great mentor, role model, and friend over the years. When I launched EVCM Fund, Guy Spier was my biggest supporter and my first investor.

KN: Who are some of the other investors that made an impact on your investment philosophy and way of thinking?

OE: Studying the investment history and writings of top value investors including Warren Buffett, Charlie Munger, Joel Greenblatt, Seth Klarman, David Einhorn and Bill Ackman has helped lay the foundations for my investment framework.

Zeke Ashton of Centaur Capital has also been a great mentor, teacher and friend. After I launched Emerging Value Capital, Zeke was kind enough to invite me to his office and has helped me further develop and refine my investment approach. Closely studying the fantastic investing framework that Zeke has developed as well as many of his specific investments, has been a tremendous learning experience for me. I have also learned a lot and continue to learn from my interactions with great value investors including Monish Pabrai, Guy Spier, Whitney Tilson, Glenn Tongue, Ken Shubin Stein and Rick Reiss.

KN: You founded, Emerging Value Capital Management, a focused global value hedge fund in 2008. How was that experience and what were the difficulties in launching your own fund?

OE: As the financial crisis of 2008 was unfolding, I saw that tremendous bargains were being offered by the markets. Stock were being sold indiscriminately as panic selling and forced liquidations became common. While I did not know the exact timing, it was clear to me that anyone with the courage and conviction to invest capital into carefully selected stocks would end up earning a fantastic return once the crisis had passed.

I therefore felt it was the right time to launch my global value fund after years of developing and practicing my global value investing framework. I resigned from Deutsche Bank and set up Emerging Value Capital Management and its first fund (EVCM Fund) in October 2008. EVCM is a long-biased global value fund. At EVCM, I strive to integrate my global value investing framework with the best practices and ideas from the value investors I have studied. In hindsight I was a bit early as the markets kept declining until March 2009. Still, my early investor's courage and conviction was rewarded with excellent returns.

As you can imagine, finding investors for a new hedge fund in 2008 and early 2009 was very difficult. Many investors were more interested in buying canned goods and were worried about how to protect themselves if the entire banking system collapsed. Convincing them to invest in a new hedge fund was not an easy task. At one point in late 2008, I attended an investing conference where the overall mood was very gloomy. When I introduced myself I said: "Hi, I'm Ori and I manage a small hedge fund". To which a few people jokingly replied: "All hedge funds are small now".

Despite the difficulties, I was able to find a handful of smart, contrarian long term investors. They earned a great return investing in EVCM Fund in 2008 and have continued investing with me ever since. A big chunk of my life savings are invested in EVCM fund so I "eat my own cooking".

Having learned much from launching and managing EVCM Global Fund in the last 6 years, I am now launching our second fund—The Emerging Value Israel Fund (EVCM Israel Fund). While US markets look expensive to me, I am finding cheap bargain stocks in Israel and believe there is, once again, an opportunity to earn outsized returns for investors willing to take a contrarian long term approach.

KN: You grew up in Israel and received your Master's degree in Computer Science from the Open University of Israel. Being so deeply rooted into the culture, what was it like growing up in Israel and how did it shape your investment philosophy? In what ways does this help or hurt you when investing in Israel?

OE: I was born in Israel but also lived for many years in the US. Watching Israel grow economically and graduate from a developing to a developed country has had a deep impact on my thinking about economics and investment. Having an international background, I became convinced that value investing can and should be applied to global markets.

By comparing certain developed industries and companies in the US to their less developed counterparts in Israel, I was able to project the growth path of these Israeli companies. For example, one of my first investments in 2001 was in an Israeli company called Hilan Tech (HLAN). HLAN is the leading payroll processor in Israel. Their main business is processing mid and large company payrolls and issuing monthly paystubs to employees. It's the kind of repetitive, non-core and tedious process that most companies choose to outsource. This makes HLAN's customer base very stable and the company a high quality cash-cow. By comparing HLAN in its early stages to ADP and Paychex in the US I was able to accurately predict the growth path and profitability of HLAN. Over the years my investors have earned an excellent return investing in HLAN and we still own it today.

Israel is well known for its technology focus and very entrepreneurial workforce. Unofficially it has been called the "start-up nation" since it has more start-ups per capita than any other country in the world. Most of these start-ups are technology oriented. To some extent this has resulted in less focus on non-technology companies in Israel. Non-tech companies are often overlooked by investors in Israel which creates an opportunity for us. As a value investor, I love investing in stable, boring companies that generate lots of cash. Israeli banks, insurance companies, REITs, and old fashioned industrials may not be as exciting as the hot new technology start-ups, but they can often generate great returns for investors with much lower risks. Taking advantage of this opportunity is one of the reasons I decided to launch the Emerging Value Israel Fund.

KN: Why did you decide to launch a fund focused specifically on investing in Israel and Israel related companies?

OE: Earn a great return while supporting Israel. That is my vision for setting up the Emerging Value Israel Fund. We are launching the new Israel Value Fund in May 2015 because we think there is an attractive opportunity to invest in cheap, underfollowed Israeli value stocks.

After 14 years of global value investing, I am convinced that some countries are simply better places to invest than others. It is of critical importance that we invest in stable countries with regimes that respect foreign investors and the rule of law. I also prefer to invest in countries that have embraced capitalism and have free markets.

> Working for Guy Spier helped me develop my global value investing framework. He has been a great mentor, role model, and friend over the years.

In many respects, Israel is the perfect example of the kind of country that global investors should seek to invest in. Israel is a stable, capitalist, pro-business, pro-investors, free-market democracy. Investors in Israel benefit from its strong property rights, investor protections and respect for the rule of law. In addition, serious corporate fraud is rare in Israel due to a zero tolerance policy by regulators and courts. Having grown up in Israel I can attest that most Israeli's view foreign investors as desirable, long term business partners that should be treated fairly and respectfully. Partners, not patsies.

There are also multiple tail-winds that should drive the Israeli economy forward over the next decade and beyond. First, Israel is a world leader in technological innovation which is the driving force of economic growth in the world. Second, an incredible amount of natural gas has been discovered offshore near Israel and it is coming online in the next few years. It will allow Israel to become energy independent and will accelerate the entire Israeli economy. Third, Israel has a pro-business government that is constantly working to break up monopolies and increase competition in the markets.

If you looked at a chart of the S&P 500 versus the Tel Aviv 100 (TA-100 Index) starting in 1997, you would see that despite greater volatility and recent underperformance, the Israeli stock market dramatically outperformed the S&P500. Accounting for currency deprecations does not alter this picture by much. If we are correct in our analysis, the Israeli stock market should continue to outperform over the long term.

KN: What is your view on the Geopolitical situation in Israel?

OE: While the newspaper headlines often look scary, I have a somewhat contrarian view of Israel's current macro and geopolitical position. Many of the recent developments in the region have actually improved Israel's security situation. Egypt is fighting terrorist attacks from both Hamas and Isis and as a result has become a closer ally of Israel. The implosion of Syria and the elimination of its chemical weapons stockpile has removed a major military threat to Israel. Hezbollah, while still trying to project strength, is mired in internal problems in Lebanon and is losing its battle with Isis. Iran is, hopefully, slowing down its nuclear weapons program as negotiations with the US continue. So overall we see that many major threats to Israel have been neutralized, or at least temporarily removed.

Tel-Aviv 100 Index (blue) vs. S&P500 (red) – 1997 to 2014

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In addition, the sharp drop in the price of oil is a huge benefit to Israel. It reduces the funds available to the countries and terrorist organizations that wish to harm Israel. It is also helping transform the world economy where the driving force is now technological innovation instead of access to oil and scarce resources. Israel, a world leader in technical innovation, is well positioned to prosper in this new world economy. In contrast, many of the countries and terrorist organizations that wish to harm Israel are completely dependent on selling oil for high prices and may even collapse if oil prices stay low. Given all of the above, I would argue that Israel is actually in one of the best security and geopolitical positions it has ever been in its history. When investors realize this, Israeli stocks should go up.

KN: Can you explain your fund strategy and investment process for investing in Israel?

OE: The new Israel Value Fund will invest mostly in Israeli and Israel related companies. There are about 600 publicly traded companies listed on the Tel-Aviv stock exchange in Israel. There are another 120 Israeli companies listed on foreign exchanges. Of all these, about half are investable in terms of minimum market-cap and trading liquidity. So my task is to thoroughly research and analyze the investable universe of about 360 Israeli stocks and to own the most attractive 10 to 20 stocks at any given time.

I initially search for potential ideas by talking to other investors and fund managers, reading Israeli newspapers, attending conferences, reviewing my stock watch lists, and screening for cheap stocks. Once I find an investment idea that looks potentially interesting I do independent in depth research and analysis. First, I read and analyze all available financial filings of both the company and its main competitors. Second, I often try to speak directly with management to assess their competence, future plans, capital allocation skills, and respect for shareholders. Third, I study the industry and the where the company is heading. I then combine all of these into an assessment of what the company might look like and be worth under various future economic scenarios.

Every investment idea should pass four tests or filters before it can be added to the portfolio. Is it within my circle of competence? Is it a good business with permanent competitive advantages? Is management capable, honest, and shareholder friendly? And is it cheap?

For Circle of Competence we look at: Do I understand the business and industry? Can we reasonably predict the company’s future prospects and cash flows?

For Quality of Business we try to answer: What are the businesses competitive advantages? What is its expected long term ROE and ROA? Can the business grow profitably without requiring too much capital? Is the balance sheet strong? What are the industry dynamics? What is the long term outlook for the industry and the business? Is the business recession resistant?

For Management we ask: Are they competent, shareholder friendly, and good capital allocators? Have they created shareholder value in the past? Can they articulate a clear plan for increasing shareholder value?

For Price we determine: How cheap is the business? Is there a large margin of safety? How much can we lose? Is it a favorable risk/reward?

Finally, I use my extensive network and connections in Israel to verify my investment thesis and to seek out different opinions about the company and its management team.

KN: What are two interesting companies you see in Israel right now from a value investing perspective?

OE: We are finding a lot of interesting value companies in Israel so it’s difficult to pick just two, but I will discuss a few.

The first is Israel Discount Bank. Israel Discount Bank (IDB) is the third largest bank in Israel. Incorporated in 1938, it has since grown its equity to over 12 billion ILS and its branch network to over 230 locations, inclusive of the 100% owned mercantile bank locations. Its major business lines include retail banking, corporate banking, financial management, capital markets and private banking. IDB also has key overseas operations in the US, Switzerland, and the UK.

Operationally, IDB is the least efficient major bank in Israel. Its employees belong to a fairly militant union so they make cost cutting and operational improvements an always difficult undertaking. As a result IDB suffers from a bloated cost structure and earns sub-par returns on equity, with sustainable ROE currently around 7%. The market is well aware of these issues and therefore values IDB at a low price to book ratio of only 0.5.

IDB recently got a new CEO, Ms. Lilach Topilsky. Previously, Topilsky led the operational turnaround in Bank Hapoalim, Israel's largest and most efficient bank. We think Topilsky will, in time, be able to cut IDB's cost structure and improve its sustainable ROE to around 9%, which would warrant a 0.9 price to book multiple. That's a potential 80% upside from current prices.

IDB also has hidden assets which provide strong valuation support. We value IDB New-York at about 2.8 billion ILS, which is less than book value. We value 72% owned Visa Cal at 1 billion ILS or 10X normalized net income. Excluding these two assets, we find "Core-IDB" trading for just one third of book value. A price that is too cheap and should increase as assets are sold and/or ROE improves.

Another compelling value idea is Golf & Co ("Golf"). It is a leading group of retail chain stores located in Israel, all under the umbrella brand "Golf". The stores fall into two main retail categories: fashion clothing and home accessories. Golf has 281 stores today across all its sub-brands. Sub-brands include Golf Kids & Baby (kids clothing), Intima (lady undergarments), Polgat (men's suits), Max Moretti (lady shoes, purses and accessories), Blue Bird (surf wear), Golf & Co (home accessories), and others.

As the largest retail chain in Israel, Golf enjoys multiple competitive advantages including a strong and well recognized brand, excellent mall based locations and economies of scale in distribution, operations, advertising and purchasing. The Golf brand is generally associated with good value for money, but is not necessarily the most fashionable or cutting edge.

Golf is a slow-growth, conservatively managed cash generating business. It has recently started implementing its strategic plan to increase shareholder value. The company will refocus and revamp its core brands and leverage its economies of scale to make bolt on acquisitions. In addition to acquisitions, the company plans to open around 40 new stores in the next three years which implies about 4% organic growth per year in the store count.

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Golf experienced a weak 2014 due to the war in the Gaza Strip. People don't usually go shopping when missiles are flying. 2015 should be back to normal and Golf could earn operating profits of 65 million ILS. The company also has a strong balance sheet with plenty of cash and no debt.

At Golf's current stock price we are paying just 5.5X EV / EBIT. While this price is already cheap, we note that one of their sub-brands, Blue Bird, is currently losing about 10 million ILS a year. We expect that over the next few years Golf will either return this store chain to profitability or else shut it down. Excluding Blue Bird, Golf trades for under 5X EV / EBIT, an unreasonably cheap price. The company currently pays a 10% annual dividend yield although the dividend fluctuates from year to year.

KN: How do investors generally get exposure to Israeli equities?

OE: While many people and organizations around the world want to invest in Israel in order to earn good returns and also to support the Israeli economy, it's actually not simple to do. Because of strict US regulations, it's difficult for US investors to invest in the Israeli stock market. For example, most Israeli banks and Israeli brokers will flat out refuse to open a new account for a US investor simply due to regulatory restrictions. This limitation has drastically reduced the number of Israeli funds that are offered to US investors.

As a result, most foreign investors choose to invest mostly in Israeli start-ups via the many venture capital (VC) firms in Israel. We think VC and start-up investing are great, but want to encourage investors to also consider other investment options including value investing in more mature publicly traded Israeli companies.

One way around this restriction is for US investors to open accounts with large global investment banks such as JPMorgan or UBS and have them purchase Israeli stocks for their account. The problem with this approach, in addition to the large minimum account size, is that most global investment banks don't have a physical trading desk in Israel. They often trade from London or some other remote trading desk and therefore are removed from the Israeli market and are unable to offer real-time market insight or best execution.

At the Emerging Value Israel Fund we have found an excellent structure that circumvents these issues. We custody with

JPMorgan which is widely regarded as safe and reputable. We then use our local connections to execute most trades with local trading desks in Israel. This gives our investors the best of both worlds. Excellent local execution and market access combined with the safety and peace of mind of having their capital under custody at JPMorgan.

KN: Who would be the ideal investors for your New Israel Value Fund?

> Israel is well known for its technology focus and very entrepreneurial workforce. Unofficially it has been called the "start-up nation" since it has more startups per capita than any other country in the world.

OE: Earn a great return while supporting Israel. That is our vision for setting up the Emerging Value Israel Fund. Interested accredited investors and institutional investors should have a value oriented mindset and should invest for the long term, with a time horizon of at least a few years. Obviously we are looking for investors that also support Israel, are impressed by how far it's advanced, and are excited about its future potential.

There is also an opportunity for one or more seed investors to invest early and get equity in the management company. We think this is a great deal for the right investor since their capital is invested in a conservative value fund, yet the management company equity potentially offers a big upside.

KN: You have a computer science background and have talked in the past about how technology is shaping our future in non-linear ways. How do you view the long term future for Israel? Is it well positioned in this regard?

OE: Technology is becoming a bigger and bigger part of our economy and our lives. We tend to view technological progress as moving at a linear pace but in reality many technologies progress at an exponential pace. For example, we all know about Moore's law and how the costs of computing power, data storage, and communication decline at an exponential pace. But did you also know that the number of genes we can sequence per dollar cost, the installed solar power generation capacity in the world, and the resolution of brain imaging technologies are also all growing at an exponent pace?

Because of this exponential technological progression, more and more industries are getting disrupted. Land line phones, long distance communication, brick and mortar retailing, travel agents, and physical libraries are good examples of industries that have already been disrupted by technology. And this is just the beginning. New fracking technologies have disrupted oil and gas exploration which is why we are seeing the large price declines in these commodities. Uber is disrupting the world wide taxi industry. Self-driving cars and 3D printing are poised to disrupt multiple industries. In short, we have entered the age of technological innovation and disruption.

Israel is incredibly well positioned to succeed and even flourish in this new age of technological innovation. It is a world leader in start-ups, innovation, entrepreneurship, R&D, and advanced technologies. Many of the world's leading corporations know that when they need top-notch, state of the art, ground breaking R&D, Israel is the place to do it. It is not a coincidence that companies like Google and Intel have extensive R&D in Israel.

Value investing in Israel is a smart way to participate in these future trends and our new Israel Value Fund is positioned to benefit from Israel's future success.

KN: You mentioned something about a free book?

OE: Yes. I am a founding member of Entrepreneur Organization's (EO) Israel branch. We just published a great new book about Israeli Entrepreneurship and a select group of Israeli Entrepreneurs. It's titled: "Israeli Entrepreneurs Handbook". I'll happily mail a free copy of the book to the first 50 readers that send me their mailing address to: ori@emergingvaluefund.com.