Chip Rewey Asset Management Interview for Capital Employed Newsletter

Hi Chip, thanks so much for taking the time out to do this interview.

Can you please tell readers about your background, and how you got involved in investing?

Thank you for the opportunity to discuss my investing philosophy and process and how I implement this strategy at Rewey Asset Management.

I grew up just outside Detroit, Michigan in an automotive family. Undoubtedly, the severe boom and bust periods of the auto industry throughout my childhood shaped my views on investing – that is an investment must a have strong financial profile and a long-term growth view that can weather shorter term bumps.

I am old enough to remember the severe inflation of the early 1970's and the detrimental impact this inflation had on the economy and the purchasing power of an individual. Even in the third grade, I can vividly remember the price of a pack of gum rising from 15-cents to 25-cents over a six-month period.

The experience of coming of age during the severe double-dip recession of the late 1970's shaped and defined my strong belief that the ultimate goal of investing is to increase one's purchasing power, specifically to increase their wealth at a faster rate than inflation can erode one's buying power.

The stock market was a natural draw to me. I was an inquisitive child that took apart the new walkie talkies to see how they work. The late 1970's and 1980's also saw the rise of first guru investors I followed, such as Warren Buffett and Peter Lynch. The draw to stocks was to learn about what companies did. To assess which ones could be good investments has always been one of my favorite activities.

Over the course of my investing career, I have had the fortune to work with, and be mentored by, three legendary value investing gurus, Laura Sloate, Jerry Cramer and Marty Whitman. I have curated my investment approach by pulling what I believe are the best pieces of these investors' philosophies into my own Rewey Asset Management philosophy. Laura Sloate instilled the need for vision when analyzing a company. Laura, who was blind, focused on not only what assets and opportunities a company has today, but what was the multi-year vision, or strategies of these companies could be over the future, and if management had the tools and resources to execute on this strategy. I call this, "The Ability to Grow". Jerry Cramer taught me the importance of behavioral investing. The market can offer true value in situations that are neglected or misunderstood by most investors. Any active investor needs to believe the market is inefficient. If one is willing to do their own work and think for themselves, they can potentially identify neglected and misunderstood situations that are incredibly undervalued. Finally, Marty Whitman emphasized the importance of a strong financial profile, i.e. start with the balance sheet. The markets are unpredictable, and any enterprise that can grow and thrive over time must be able to survive short periods of market or economic stress.

I summarize this philosophy into 1) Financial Strength, 2) The Ability to Grow and 3) Valuation.

What type of businesses, situations, or even industries do you like to invest in?

I am relatively agnostic as to which industries I invest in. I search for investment situations that follow the outline of my philosophy.

About half-of my ideas come from proprietary quantitative stock screening tools and half come from more qualitative areas, which includes everything from my prior knowledge of the company to articles in industry specific trade magazines that may discuss new and innovative offerings form certain companies.

Importantly, it is the combination of neglect and the ability to grow that define the opportunities in which I invest. While I focus on superior operating statistics, the focus is 1) can the factors that lead to these statistics continue or improve for the company, 2) if recently the statistics have eroded, is there a credible path to regaining or exceeding those statistics in the future and 3) is the general investment community incorrectly viewing potential of these companies, i.e. is there neglect as well as undervaluation. Jerry Cramer believed that it is as important to buy bad statistics and sell good statistics as it is to buy low and sell high valuation levels.

It is also very important to note that despite my proclivity to traditional value stocks, growth is a critical and necessary component of my investment philosophy. Growth is not the opposite of value. Decline is the opposite of growth. Overvalued is the opposite of value. I will not invest in a company where I do not see the ability to grow over time.

Once you find a company that interests you, what does your research process look like?

When I start reviewing a company, I start with the balance sheet. If I cannot confirm that a company has a strong financial profile, I will move on. I will quickly exclude companies with high financial leverage including debt and other liabilities, such as legal or environmental obligations, which can drain cash from the enterprise. The management teams of highly leveraged companies, in my experience, are focused on managing their leverage and surviving the near-term, versus planning and executing a long-term plan that includes capital deployment opportunities.

Second, I then try to assess the ability to grow. This is where most of my time will be spent. Some of the metrics I use here are Return on Invested Capital, Free Cash Flow and Free Cash

Flow Yield. Simply, does a company have the ability to invest capital at rates that generate superior returns, and does the company have the ability to generate capital for that investment?

I will not only look at the quantitative measures discussed above, but qualitative factors as well. If the company has sold off recently, I will investigate where the weakness stems from, and then assess whether it could be temporary or something more damaging and long-lasting.

I will evaluate the company's position and strategy along the lines of the Porter 5-forces model to determine what are the company's competitive advantages, how durable are these advantages, and are there emerging competitive or macro threats that could erode the company's ability to grow?

I will evaluate management and their plan to build the company and deploy capital. I typically begin with a review of the CEO letter in the annual report. I will listen to conference calls, investor presentations and other interviews where management discusses the company's strategies. I will speak with the company to answer any questions I have.

One major differentiator of my process comes after I have arrived at an initial positive investment thesis on a company. At this point, I switch gears and start attacking my thesis and see if I can prove myself wrong. I attack the financials and stress test the balance sheet to see if the company has the liquidity to survive in periods of stress. I will consider the strategies of the company's competitors and interview their management teams, to see if I can find a reason why they will be more successful than, perhaps at the expense of, the company I am evaluating. As a side note, this is often how I find new ideas, by looking at competitors, customers and vendors, and connecting to dots to see if there is a more attractive investment opportunity.

In my view, the more I am unable to prove my initial thesis wrong, the higher conviction I build in the investment case. If I can identify and assess the risks an investment faces and decide if it is adequately discounted in the price of the investment, I gain the ability invest through market neglect. I believe this method is a critical and differentiating component of my investment process.

You like to buy when you believe the stock is trading 30% under its intrinsic value. What valuation methodologies do you employ to arrive at your estimate of intrinsic value?

Valuation is the third pillar of my investment philosophy and I believe valuation always matters. One must invest for return on capital and not invest on other irrelevant metrics, such as market share, clicks, eyebrows, momentum, how it looks on a chart, etc.

As a general rule, I like to invest when I see at least a 30% minimum annual compound return potential to my estimate of Assessed Fair Value (AFV). I arrive at this estimate of AFV through the intersection of several valuation methods. I look at free cash flow and free cash flow yield. I look at price to book value and the compound growth of book value over time. I look at gross margins and operating margins, current price-to-earnings and EV to Ebitda ratios, but as these are income statement driven metrics, I look at them more for the ability for a company to improve on these ratios over time.

I will look at sum-of-the-parts or break-up value, but only if the company has stated they may sell a division, or the whole company, or they have implemented a strategic review to study these measures. Otherwise, I will not incorporate the upside of a take-out or break-up valuation into my AFV measure, as these are events that a company likely cannot control.

I search for the confluence of financial strength, conviction in a long-term growth path, investor neglect and undervaluation. I view time as my investing ally over the long-term, in sharp contrast to many currently popular investing strategies, like algorithmic trading and hedge funds, where an extremely short-term focus can position time as an investing adversary.

Can you talk about two specific companies in your portfolio you're bullish on? What was the thesis for investing?

Richardson Electric Company (RELL)

Richardson Electric Company (RELL) is in my view a company that offers a strong balance sheet, compelling upside potential with multiple avenues to grow, a solid financial profile with net cash on the balance sheet and significant investor neglect.

Richardson's products include electron tubes and microwave generators, old technologies that are finding new life in the semiconductor manufacturing industry and in multiple green energy applications.

RELL has a strong financial profile. RELL has over $22 million net cash on its balance sheet and no debt. RELL has $116 million in inventory – a level rivaling its current market cap of $122 million – with roughly 90% in finished goods inventories. Importantly, these inventories are supported by long-term orders, such as supplying GE windmill battery replacement units. RELL forecasts returning to a positive free cash flow position in its FY25 (May) year, as sales recover, and inventory is delivered. Further, although we do not ascribe any value to this in our valuation, RELL's headquarters and main facility in La Fox, IL sits on 125 acres, much of it unused. We estimate that RELL could monetize roughly 100 acres if desired. RELL's management team has been a good steward of capital and has further indicated that it will sell or shut its smaller health care unit if it does not begin to show profitability as it exits this fiscal year.

RELL, in my view, is suffering from significant investor neglect currently, due to the downcycle in the semi-conductor capital equipment cycle. RELL's largest customer is Lam Research (LRCX), but RELL sells to most of the major suppliers in the industry including Applied Materials, MKS

Instruments and Tokyo Electric. Due to limited sell-side coverage, we think investors are misunderstanding the decline in RELL's earnings from semi-equipment suppliers in 2024 due to the cycle, and have ascribed no value, or vision, to the ability of RELL's sales and earnings to recover with the eventual cycle recovery. We see palpable neglect in the fact that RELL's customers, e.g. LRCX, are trading at near all-time highs as RELL trades near multi-year lows. We see the CHIPS Act, the Inflation Reduction Act, artificial intelligence, a PC refresh cycle, 5G, EV's and autonomous driving and the internet of things all as drivers to the semi-cycle over time. RELL's products are essential and proprietary and should continue to capture significant orders. Further, LRCX believes the pending up cycle will be stronger than any past peak and is offering financial support to suppliers (RELL does not need this support) to keep their capacity in place.

We see RELL's emerging Green Energy Solutions, or GES unit, as another source of strong earnings upside for RELL, that is significantly neglected by investors. RELL has developed engineered solutions for multiple uses in the replacement of lead acid batteries in green energy offerings like windmills and locomotives. RELL's battery replacement modules are approved for GE wind turbines and are an aftermarket solution offered on the GE marketplace site. There are up to 18 modules in each GE windmill, and RELL's units last up to 10-years, vs. 2-years for lead acid batteries. These units are plug-and-play replacements for lead acid batteries. As it is incredibly expensive to service these windmills, up to 300 feet off the ground, RELL's units are not only more efficient, but also a better cost of service for the operators. There is an in-place market of roughly 35,000 GE windmills worldwide. RELL is also working with Suzlon Energy in India on a similar pitch energy module, where battery life for windmills can be as short as 6-months due to humidity. RELL has also designed back-up battery replacements for generators in the base stations of Siemens and GE windmills.

RELL is also working with both Progress Rail (CAT) and Wabtec (with a GE joint venture) to replace lead acid batteries in the starter unit of diesel trains. Additionally, RELL has completed battery module shipments for its first delivery of an all-electric train, used on-site in a mining operation, and longer-term could benefit from the increase in electric train utilization, likely first for subway and commuter rails.

RELL also is a leading supplier of magnetrons used to grow synthetic diamonds, very high-quality real diamonds that are increasingly preferred by consumers due to the i) lower cost ii) clean ESG profile due to no mining and iii) conflict free nature versus natural diamonds.

Our AFV driven price target is up over 100% of current trading levels under $9 per share. We base this target only on a recovery to FY2023 revenue and earnings levels. We view this near term AFV target as extremely conservative, as it is under RELL's 2023 $24.97 share price in February 2023. This AFV target is supported by its current balance sheet, its earnings recovery power and its growth potential. However, we do see a significant multi-year growth opportunity for RELL and think management can achieve its long-term goal of $500 million in revenue in a few years, vs. the FY23 reported $246 million.

Mayville Engineering Company (MEC)

MEC is a $268 million market cap company that specializes in metal fabrication for prototyping and manufacturing. We believe MEC is moving past several issues that pressured revenues and earnings over the last two years, including supply chain challenges, unabsorbed overhead from a new facility (and related contract dispute), and the fear of weaker end markets in some of its key verticals. We see MEC as suffering from extreme investor neglect as the market overlooks its numerous positives including i) significant new business wins from new and existing customers, ii) significantly improved free cash flow as MEC has finished building its large new plant in Hazel Park Michigan, iii) and significant margin improvement opportunities as its new CEO is aggressively introducing Kaizen (or lean) manufacturing initiatives.

We believe MEC has a very strong Financial Profile. Although on quantitative screens, MEC's net debt to ebitda might screen high at 2.1x, we believe this debt level has already peaked and is on its way down. In 2023 MEC finished constructing its new Hazel Park Facility and acquired MSA aluminum for $96 million in cash. Debt peaked in 2Q23 at $198 million, but due to strong 2H23 cash flow of $36 million, MEC paid off $38.8 million in debt in 2H23. MEC is forecasting only $15-$20 million in CAPX in 2024, with free cash flow targeted at $35-$45 million (a 15% free cash flow yield at the mid-point), and long-term growth in free cash flow to $65-$75 million a year in 2026. As MEC has indicated most of its free cash flow will be used for debt reduction, we believe MEC will exit 2024 with leverage at the low end of its 1.5x-2.0x forecast range. Moreover, although we don't build an upside into our AFV price target from the lawsuit, we think MEC is very well positioned to win its breach of contract lawsuit versus Peloton, with potential proceeds of up to $107 million or more, a substantial amount versus MEC's market cap of $268 million.

We see several avenues of revenue growth for MEC. First, MEC is ramping up its new Hazel Park facility, which should reach a full $100 million revenue run rate in 4Q24. The profit impact should be substantial throughout 2024, as startup up costs that were $6.2 million in 2023 fall throughout 2024, with the plant showing a profit in 4Q24. The revenues at Hazel Park are a mix of new business from new and existing customers, and businesses relocated from MEC's other maxed out facilities, which will in turn allow these facilities to grow their revenues as well. Second, MEC's new business wins are helping MEC guide to increased revenue for 2024, despite potential end market weakness in its commercial vehicle and agriculture markets. We think these new business wins, in part driven by reshoring, are masked in 2024 due to MEC's conservative guidance of potential end market weakness but should show through strongly in 2025 and 2026. Third, MEC has already been able to cross-sell its new aluminum extrusion offering from its MSA acquisition, and MEC sees accelerating cross sell opportunities for MSA.

In addition to revenue leverage and the decline in Hazel Park start-up costs, we see additional margin upside drivers for MEC as well. MEC has over 125 separate Kaizan productivity initiatives underway, and this activity should accelerate in 2024. MEC sees these initiatives adding $2-$4 million EBITDA in 2024 alone. MEC's pricing initiative, initiated in 2023, is expected to add $1-$2 million net over inflation in 2024 as well.

Although MEC shares rose on the strength of a well-received 4Q23 earnings report, we think there is substantial upside for the shares. Our 2024 AFV price target of $21.35 is approximately 63% higher than current trading levels, but still slightly under its 2021 high. We see this level as extremely conservative and believe there is substantial upside beyond this 2024 target as MEC delivers on its 2026 revenue target of $750 to $850 million, vs. 2024 targeted revenues of $620 to $640 million.

What tools do you use to organize your investing - is there any software you use to organize all your ideas, research, and also keep track of company updates?

For every investment, I document my investment cash along the lines of Financial Strength, Ability to Grow and Valuation, i.e. AFV price target. This document serves as a living guideline as to why I own a stock. As time goes by, I measure quarterly and annual results against my thesis to see if the thesis remains on track. I will hold a stock for many years if the thesis remains strong. If at any point, I think the thesis breaks, I will sell the position.

As I run concentrated strategies, between 20-30 positions, it is relatively easy to track these holdings. I do have detailed spreadsheets where I track financial performance and upside to price targets.

I also have propriety tools that I use to help construct the portfolio and measure risk. For portfolio construction, I grade every investment on qualitative factors such as cyclicality, leverage, competitive environment, strength of management, etc. I plot these grades vs. upside potential to arrive at targeted portfolio holding weights. This approach does lead me to trim positions as they approach price target levels. I also keep a "bullpen" of watch list of companies that are close to meeting my investment hurdles, or do meet my hurdles but correlate closely with a superior investment position I already own.

From a risk perspective, one of my favorite tools is what I call risk buckets, i.e. I aggregate the common strengths and risks of my portfolio companies along risk factors that have nothing to do with normal industry classifications. For example, an airplane manufacturer, a car rental company, a travel booking company and a perfume supplier that sells in duty free stores will all face high travel risk, but will be classified as industrial company, a consumer company, a technology company and a materials company.

In this way, I seek to construct a concentrated portfolio with uncorrelated ideas that all offer strong potential upside over a 3–5-year investment horizon.

Thanks Chip.

Notes:

The Richardson Electric (RELL) and Mayville Engineering (MEC) commentary are sourced from company earnings releases, Annual Reports, 10Q, 10-K, Proxy filings, company press releases, company public conference calls and webcasts, company slide presentations, Bloomberg, company webpages and Rewey Asset Management proprietary financial analysis and Rewey Asset Management industry due diligence. Historical share price information sourced from Bloomberg.

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