Emerging Manager Monthly

The Trusted Source for Emerging Managers October 2018

Small-Cap Shop Uncovers Value In Turnaround Opportunities

Daren Heitman

Azarias Capital Management's focus on uncovering value in turnaround opportunities in the domestic small-cap equity space has led to some eye-catching returns as the firm's long-only strategy approaches its three-year track record.

The firm's concentrated value strategy has targeted companies expecting an earnings turnaround building off the varying experiences of Managing Partner and CIO Daren Heitman.

Heitman "cut his teeth" on deep value turnaround opportunities in his time at Schneider Capital, but the firm took more risks with balance sheets and business quality. Meanwhile the focus at Cooke & Bieler, his most recent stop before founding Azarias in 2014, was on business quality and balance sheet strength and less so in turnaround opportunities.

"Here at Azarias I'm combining the best of both opportunities," he said, noting his concern is with finding and concentrating on the best 15 to 20 opportunities, allowing for a 20% weight in any industry and 30% in any sector.

"What we're looking for in industries is the opportunity for there to be a recovery, an industry turnaround, a cyclical recovery," Heitman said. "Everything we do is a turnaround and there are two types: company specific and industry, cyclical upturn, and we do both. We are constantly on the lookout for industries that are near cyclical troughs and when we identify those we will find a company that meets our criteria and that will participate in that industry specific recovery."

The returns have borne out for the Berwyn, Pa.-based shop, which has returned 27.24% against 14.46% for the Russell 2000 Value Index for the period ending Sept. 30 since the strategy's November 2015 inception.

What makes Azarias' approach unique is that the investment team looks for ideas from a market-cap perspective rather than a certain sector or regional perspective, according to Partner Joe Knecht, who joined the firm in July to lead its investor relations efforts.

"That is going to be something that definitely differentiates us from the majority of small-cap managers out there," he said of the firm's perspective. "Our names come from the bottom half of the Russell 2000. Our average market cap is significantly lower than the average small-cap manager."

The Azarias approach relies on a set of four criteria—the "four C's" as the firm calls them—to which all investable companies must adhere: Change, Cheap, Competitively Stable and Conservatively Financed.

The firm will only establish positions in companies that it anticipates experiencing significant, positive fundamental changes within three years, or more specifically, the company's earnings will be materially and sustainably higher than the current level. The company's stock value must be significantly undervalued relative to the firm's estimation of intrinsic value.

In addition, the firm requires companies to have stable or growing shares of predictable and essential markets and have access to capital that comfortably exceeds their capital requirements, and usually by a wide margin.

The firm also maintains a rigid discipline in the sale of companies, Heitman said, noting "when the fundamentals and the turnaround play out as we expect it typically takes one to three years. That's the winning scenario."

"When you find a good company do you buy it and hold it forever? The answer to that is an emphatic 'No,'" Heitman continued, adding that the firm only holds companies until they

Continued On Next Page

AZARIAS CAPITAL

Azarias Capital Management
1055 Westlakes Drive, Suite 300
Berwyn, PA 19312
Joe Knecht
jknecht@azariascapital.com
(215) 494-3360
www.azariascapital.com

AZARIAS: Small-Cap Shop Uncovers Value In Turnaround Opportunities

Continued From Previous Page

achieve the turnaround or hit their price target.

The Azarias investment team is led by Heitman and rounded out by Partners and Portfolio Managers Christopher Caton and Christopher Gillespie.

"The discussions are very collaborative and I'd say fairly academic...very fundamentally long-term oriented discussions about the company's long-term essence and economics," Heitman said, noting that while he is reliant on his colleagues' insight, as cio he makes the final call. "We talk until we've got to the economic truth of those companies we're discussing."

At roughly $80 million in assets under management, $75 million in the small-cap value fund and another $5 million in the firm's long-short strategy, and the three-year track record fast approaching, Heitman and the Azarias team felt it was a good time to ramp up the marketing efforts toward institutions more concertedly.

"Even though we've had early success with single family office clients and that's an important market segment, we're migrating to the institutional marketplace and the traditional consultant or gatekeeper," Heitman said, noting that the team is comprised of institutional backgrounds and mindsets.

The firm's migration to an institutional client base is reflected in one particular investor, a private family office, which Heitman and the team are proud to count among its partners and highlights the firm's institutional quality.

"We're proud we've met their criteria because they really did their due diligence on us," Heitman said. "We think that's an indication that when other sophisticated investors look at us we'll be able to meet institutional-level scrutiny."

Weathering the institutional due diligence process and keeping up its strong performance are chief among Heitman and the Azarias team's efforts, in addition to keeping the fund at a manageable size to maintain that outperformance, Knecht emphasized.

"We've been very public about our pledge to not raise more than $500 million in this strategy," Knecht said. "We anticipate a soft close well in advance of that depending on the types of relationships we've established."

Past performance cannot guarantee future results. Investing involves risk, including the possible loss of principal and fluctuation of value. The return reported in the article is the average annual return of the Azarias Small Cap Value Composite, Net of fees for the period from Inception date of the composite (November 1, 2015) through September 30, 2018. Net of returns are presented after management fees, any accrued performance-based fee and all trading expenses. Fees vary between accounts in the composite. The firm's standard annual fee schedule is 1% of assets under management and 20% of outperformance of the Russell 2000 Index. See Part 2 of Azarias' Form ADV for additional disclosures. Returns are expressed in U.S. dollars. Composite returns are net of transaction costs and gross of non-reclaimable withholding taxes, if any, and reflect the reinvestment of dividends and other earnings.

The Russell 2000® Index is a small-cap stock index of the bottom 2000 in the Russell 3000 Index stocks based on market-capitalization. The returns of the index include the investment of dividends but do not account for transaction costs and operating expenses, which an investor might incur in attempting to obtain such returns. If an index had expenses, its performance would be lower. You cannot invest directly in this index.

AZARIAS CAPITAL

Azarias Capital Management
1055 Westlakes Drive, Suite 300
Berwyn, PA 19312
Joe Knecht
jknecht@azariascapital.com
(215) 494-3360
www.azariascapital.com