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MONEY MANAGER INTERVIEW

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Value Investing with an Event-Driven Special Situations Approach

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SECTOR — GENERAL INVESTING

(AGU511) **TWST:** Could you please identify yourself?

Mr. Foster: Yes, Mark Foster.

TWST: And could you tell me what's your title in the company you work for?

Mr. Foster: Chief Investment Officer and Portfolio Manager at KIRR, Marbach & Company.

TWST: And could you tell me a little bit about the firm?

Mr. Foster: Sure. KIRR, Marbach & Company was started back in 1975. We are one of the few firms that has a 40-plus year track record. We're 100% employee owned; we currently manage about \$600 million in total assets with two main strategies, an all-cap equity and a small-cap equity. I function as a Portfolio Manager for both of these.

TWST: And does the firm have any unique philosophies?

Mr. Foster: Yes. Our philosophy is a value approach but with a twist, and that twist is an event-driven special situations approach. So what does that mean for us? We focus on special situations like spinoffs, post-reorg equities, management changes, restructurings and activist filings. That really drives the process, and the common theme there is change. There's some sort of change going on within that organization. Change at times can create confusion and a dislocation of value, and so we're going to spend the majority of our time focusing on names in those areas.

TWST: Why does that approach make sense for investors in this type of investment climate?

Mr. Foster: Well, I think what we're trying to find are some inefficiencies, some things that haven't been recognized by

the market and have fallen between the cracks. In a market that's hitting all-time highs, certainly most names don't look cheap. They're average-priced, and companies where the fundamentals are doing well are clearly recognized by the market.

So spending time focused in some of these less-efficient areas, we think in most cycles, but particularly today, can provide some advantages. And again, as I mentioned earlier, there are two strategies that we run: an all-cap strategy and a small-cap, and clearly the inefficiencies that are out there are even more prevalent in the small-cap space. So it's good place to be looking today.

TWST: And maybe you can explain what are some of the benefits of the small-cap strategy given both the inefficiencies and the more macro trends that are out there, especially with President Trump getting elected?

Mr. Foster: Well, obviously small cap has had a pretty good move since then, but I think that's signaling people are expecting several positives. Better economic growth will certainly help the small-cap group. Tax rates coming down would be of benefit, and to the extent that the dollar has moved higher, that probably has more of a negative impact on the bigger multinationals than it does on some of the small-cap names. So it makes sense to me that there are a number of things driving that.

People are feeling a little better about the economy, as we've seen with consumer confidence and business

confidence moving higher, and those tend to provide a pretty good backdrop for small cap as well. And I guess that's a good point to make. So even within our all-cap portfolios, probably about a third

Highlights

Mark Foster says his firm has two main strategies, an all-cap equity and a small-cap equity. The firm's philosophy is a value approach with also an event-driven special situations approach. Mr. Foster says the common theme is change. He tries to find inefficiencies in the market, as spending time in less-efficient areas can provide some advantages. He says the inefficiencies today are more prevalent in the small-cap space, so it's a good place to be looking. Companies discussed: Extended Stay America (NYSE:STAY); AMC Entertainment Holdings (NYSE:AMC); Colliers International Group (NASDAQ:CIGI); FirstService Corp (NASDAQ:FSV); NewStar Financial (NASDAQ:NEWS) and Zimmer Biomet Holdings (NYSE:ZBH).

of the portfolio would be large cap, and then the other two-thirds would be small and midcap. So our all-cap strategy as well has a pretty good exposure to the small and midcap markets.

“Not only do you not have the currency risk, but there are some positives being put in place with this administration. That’s a balancing act that they have to do, but it certainly should help small-cap names.”

TWST: And my understanding is that with many small-cap stocks, sometimes they have less exposure to overseas business. So if there is a priority in the Trump administration to encourage domestic production, and maybe even some protectionism, they could benefit from that?

Mr. Foster: Yes, I think that makes perfect sense as well. So not only do you not have the currency risk, but there are some positives being put in place with this administration. That’s a balancing act that they have to do, but it certainly should help small-cap names.

TWST: Did you want to mention a company that you find interesting right now?

Mr. Foster: There are a couple of things that we currently own that we think are reasonably attractive today. We own a company called **Extended Stay America** (NYSE:STAY). This is the market leader in extended-stay accommodations, really by a large factor. The stock has a 5% dividend yield, a 10%-plus free cash flow yield and is trading at about 10 times enterprise value to EBITDA.

The key is for us though — and again, this goes back to the strategy and the special situations — they have a new CEO with a proven track record. He came from **AMC Theatres** (NYSE:AMC), and he’s driving some significant change at the company. He’s putting in some new systems, new revenue management systems, centralized pricing and changing the model a little bit. They’ve primarily been owners of their hotels, and now he is instituting a franchise model that will make them more asset light and in the process of doing that be selling some hotels along the way.

So there will be some excess cash from that, likely to be returned to shareholders and used to pay down debt, both of which should generate additional shareholder value. So again, we like to find stories where we’ve got a change in place. Historically, we’ve found those to be pretty good catalysts to not only improve the business but generate significant shareholder value, so all of those aspects are pretty prevalent in **Extended Stay**.

TWST: And I would think that in a field like hospitality, especially extended-stay hotels, that a lot of their business comes from business travelers and people who have assignments at different locations for their corporations, so that if the economy improves that would definitely help that type of industry?

Mr. Foster: Absolutely. Yes, I think their average stay is like 30 days, and you’ve hit the nail on the head — it can be a construction guy working at a site, and so yes, a better economy

would certainly help the business aspect of that, because a good percentage of their stays are business-oriented as opposed to leisure. There are some leisure stays, but they are mostly business-oriented.

TWST: And did you want to mention another company?

Mr. Foster: Well, another name that we own is a company called **Colliers International** (NASDAQ:CIGI). This was a spinoff from **FirstService Corp**, essentially split in half, and **Colliers** traded as a separate entity, and **FirstService** (NASDAQ:FSV) traded as a separate entity. **Colliers** is in the commercial real estate business; roughly a third of the business is sales brokerage, a third is lease brokerage, and then the other third is what they call outsourcing and advisory. That’s managing real estate portfolios and projects. It’s more recurring business.

And so, if you look at this historically, you’ve had a company here that’s been able to grow revenues 20% a year for 20 years, high insider ownership at roughly 20% and a very fragmented industry. The top five companies within the industry represent less than 20% of the industry. So one of the keys that **Colliers** has been able to do over the course of the years is grow the business organically 5% to 10%, but then add another 10% or 12% through acquisitions. So the fact that the industry is still pretty fragmented, we think, gives them a pretty long runway.

The stock is down as people are concerned about interest rates moving up and the impact that might have on the brokerage side of that business. But these guys have been very consistent growers. And now that they’re a separate company, separated from the **FirstService** side, we think that they’ll be able to continue or perhaps even enhance that long-term track record. So we’re excited about **Colliers** as well.

TWST: If it’s office and maybe retail, those types of settings, if the economy picks up, they could stand to improve?

Mr. Foster: Yes, for sure. And it’s the smallest of the big three real estate firms. So potentially some M&A activities really going either way, them growing through acquisitions or potentially somebody taking a look at them as well.

1-Year Daily Chart of Extended Stay America, Inc.



Chart provided by www.BigCharts.com

TWST: And do you get a sense that of the opportunities that are out there for companies like that, is it existing properties or is it the building of new properties?

Mr. Foster: Well, the vast majority of their business is in sales brokerage and the lease brokerage business, so they're taking existing facilities and either selling those or potentially a new build that somebody has built, and then they will come in as the agent and look to fill that office space as they go forward. So again, I think commercial real estate obviously took a major hit in 2008/2009, and it took a couple of years for it to get back on its feet, simply because these are long-term projects and financing pretty much dried up. So we would think that cycle still has some legs to it, and somebody like a **Colliers** should benefit.

“Usually when interest rates go up, financial stocks don't do well. But this cycle, because interest rates have been so low for so long, you're finally getting interest rates to move up — all the financials have rallied because you finally get some elevation to the yield curve and some additional slope to it that should help them.”

TWST: And did you want to mention another company?

Mr. Foster: Well, another one that we bought just at the end of last year is a small-cap name called **NewStar Financial** (NASDAQ:NEWS). It's about a \$400 million market cap, so clearly a small cap. Really two businesses within that: They are a commercial finance company specializing in the middle markets, and then the second piece of that is an investment management subsidiary called **NewStar Capital LLC**, and they provide asset management services, mostly private credit funds and things like that that are tied into their commercial finance business.

In this case, there's a fairly significant restructuring going on. They have aggressively reduced their headcount and sold off some businesses, maybe some more traditional lending businesses that they felt were too competitive, primarily because of the banks — things like equipment lending and commercial real estate lending — and instead are focusing on these middle-market private-debt-leveraged lending. And so they've laid out a plan to reduce operating expense by roughly 30%, and they've initiated some share buybacks.

The stock's trading at 0.6 times book. Most financial names have had a pretty good run in the last few months, and this one has barely budged at all. Part of that's probably a function of the market cap and just not very well-known, but I don't see a whole lot of things trading at 0.6 times book these days.

TWST: And I guess that with a company like that you'd also be watching what happens with interest rates and how they increase?

Mr. Foster: Yes, although what I found interesting this cycle, for somebody that's been around the markets for 30-plus years — usually when interest rates go up, financial stocks don't do well. But this cycle, because interest rates have been so low for so long, you're finally getting interest rates to move up — all the financials have rallied because you finally get some elevation to the yield curve and some additional slope to it that should help them. But yes, from a lending standpoint, as interest rates move up that might create some

sort of a negative, but certainly a better economy helps as well.

TWST: And did you want to mention another company?

Mr. Foster: The last name I had was a large-cap name that we own in our all-cap portfolios; that's a company called **Zimmer Biomet** (NYSE:ZBH). The restructuring or the event-driven aspect was the fact that you put these two companies together in a merger. They've had some issues initially with integrating the sales force, figuring out who you're going to keep, who you're not, and getting those guys focused and working through the overlap issues. And then more recently they've had an issue with tool kits that they provide physicians who use their product. There's been a shortage of those, and that's impacted their near-term growth rate.

So as they work through the integration and some of the issues that come along with that, we think this will be a pretty good company coming out the other side. There's certainly no reason they can't grow at an industry growth rate which historically has been around 4%. There are some costs that they can take out as well. The stock is trading at 12 times 2017 earnings, should generate in 2017 close to \$1.5 billion in free cash flow, so you've got almost a 7% free cash flow yield, and there's some big-picture demographics that come along with it.

Most of us are getting older, and unfortunately we're probably going to need some of these products as we go forward. Some of the tax changes such as eliminating that medical device tax would be a plus for them as well. So several catalysts lining up for the **Zimmer Biomet** story.

TWST: And a lot of their products are those that can be covered by insurance? Or are they more the ones that people buy on their own?

Mr. Foster: No, mostly covered by insurance and many covered by Medicare, because most of that's going to be through older patients using those products.

TWST: Any changes to Medicare might impact a company like this?

Mr. Foster: Could have, yes. We'll just have to see what that looks like. That elderly voting base is pretty powerful though, so most people have learned over the years not to mess with them.

1-Year Daily Chart of NewStar Financial, Inc.



Chart provided by www.BigCharts.com

TWST: I understand that your firm also deals with

institutional clients. Could you talk a little bit about what some of their concerns are in this coming year?

Mr. Foster: If you look at our portfolios or our assets as a whole, probably half of those would be high-net-worth individuals, and the other half would be institutional clients. And I think some of the issues that institutional clients are dealing with are really more macro trends. The last couple of years have been a little more difficult for active management. So if you look at fund flows, we have seen a lot of money coming out of active management and a lot of money going into passive investments such as index funds and ETFs and things like that. These trends go in cycles, and from a valuation standpoint, I think some of the main drivers of a lot of those index funds are getting to the extreme.

So the way the index fund works, if more money comes in, you're buying more and more of those same issues, and they're cap-weighted, so it has a total disregard for value. And we think that's changing. We think certainly in the second half of last year active management began to reassert itself, and we think that will continue as we move through 2017 as well. So I think that's one of the issues that people have been struggling with and certainly we see it on our end. The industry numbers in terms of dollars coming out of active managers have been pretty significant over the course of the last couple of years, so to the extent that changes, that's a plus for us.

TWST: When we talk about the high-net-worth individuals, do they have any concerns as the year continues?

Mr. Foster: Well, I think everybody is focused on the economy and focused on tax rates, and to the extent that those come down that is obviously a plus for people. If you look at sentiment numbers, as we've mentioned earlier, those have turned positive since

the election, and people are anticipating some things that should be beneficial to their bottom lines. Campaign trail talk and actually managing are obviously different, and we'll see how that plays out. But the setup is good in the sense that the things that have been proposed should be positive for businesses and earnings growth.

I think the other thing is that with the high-net-worth side of our business, people are probably a little more absolute-oriented than they are relative-oriented. The fact that you've had five or six quarters of flattish earnings growth in the market that has led to five or six quarters of flattish stock prices in the market has been frustrating. So being a little more absolute-oriented, a generally rising market makes everybody a lot happier.

TWST: And when you use the term absolute oriented, maybe you can explain that a little bit?

Mr. Foster: So an institutional investor might be more concerned about their performance relative to an index. If the index is down and their performance is down less, they're likely happy with that. Absolute-oriented investors are more concerned with their actual return. They desire to see their assets grow on a consistent basis regardless of the index return.

TWST: Thank you. (ES)

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