

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Investing Where There is Growth in the World



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### SECTOR — GENERAL INVESTING

**TWST:** Can you tell me a little bit about the firm and its philosophy?

**Mr. King:** Our firm is an investment management firm that was founded in 1979. And we focus principally on long-only, although we have some other strategies that do incorporate some long/short — although it's a small portion of the business. We have a lot of our assets in client portfolios and separate managed accounts, but we also have a family of mutual funds and some limited partnerships as well as both aggregated pools.

Our firm philosophy is that we really view investing as investing in a company as opposed to buying stock for short-term trading operations and trying to capture short-term value. We really keep an eye toward a long holding period in very well-positioned businesses that can compound value for our shareholders and clients. Normally, this also benefits many of our clients, as about 60% of our total assets are taxable, and so we really want to capture that tax-efficient gain for those clients, and really, that has shaped our investment philosophy as it relates to how we approach our due diligence and analysis of any companies that may be a part of our portfolio.

So along those lines, we prefer high-quality companies as measured on any absolute measure, and so not just against a small, narrow industry comp group but also how those return profiles match up against what our expected returns would be for any investment that we might have. We measure that against an ROE, return on equity, or return on tangible common equity or return on invested capital, which is just your typical analysis. And so we also break it down into the components, and we want them to be able to reinvest this free cash flow at those high rates. So we also want to see high free cash flow generation and attractive incremental margins.

We like to see them accomplish this with modest leverage so that we have balance sheet strength in order to be the staying power that are balanced for turbulent times. We look for those opportunities where those companies may be positioned to do well due to cyclical, secular or idiosyncratic factors that can drive earnings growth and improve returns going forward. So we also want not only absolute returns but really the trend as well.

**TWST:** So it sounds like some of the holdings that you're looking at — if the stock market were to go through a correction — there'd be independent reasons why those might be able to weather that correction and do halfway decently.

**Mr. King:** That's absolutely right. We really try to focus on high-quality names with those types of balance sheets that are solid and return metrics and really margins. Margin can be either the price or the marginal cost of production, and you want to make sure that those are better than their peers and better than the broader market. Certainly, you want your margins higher and your marginal cost of production lower, and go weather the storm and typically take share and come out on the other side — if we own them through it and don't tactically trade around it. Then, they'll come out on the other side much better, typically taking share and just adding to the value that the shareholder will ultimately receive.

**TWST:** Did you want to highlight a stock that you find interesting right now?

**Mr. King:** There's a couple. One that quickly comes to mind in the small-cap space is **Banc of California** (NYSE:BANC), and it's a little bit of a special situation. There's a lot going on there that can really cloud the story. It started off years ago as a thrift conversion. That started really getting pushed through when a new management came in again quite a few years ago, about five years ago or so, and that new management

really made some acquisitions, started increasing their branch footprint. Those acquisitions were commercial banking branches, started bringing in a lot of new employees, but they still had this big mortgage operation that created some earnings volatility.

They were doing some things on their securities book that was also adding some lack of visibility, and they were bringing in a lot of capital. They had some private placements that added to the capital capacity that they had, but they had poor transparency. They had volatility or uncertainty around their earnings, and they had questionable board oversight, and there were some shorts that came in and highlighted and actually made some false accusations, which was really too bad because they were ill-founded, but they highlighted some of the concerns around the transparency and the oversight.

So there was a management change. The stock had sold off dramatically, and it actually accelerated their move into becoming a commercial bank, and now they have a new management. It's a long-tenured banker who's created value prior in his career. He comes with wanting to normalize the earnings based on commercial banking operations, so they've already sold off their mortgage operations. They're rationalizing their securities book, and you're going to have really a reset on the earnings, and those earnings should grow going forward approximately 10% to 12% — that's kind of our estimation — off of their base. And they're trading currently at a discount on a price to

particular strategies are on the J curve, and they're relatively early, and they're expecting a lot of those platforms, such as Treasury, to really start to accelerate. As that happens, typically what happens is you also end up getting better profitability, and that drops down, so your incremental margins and thereby your incremental returns really start to go up. I would say that's the best opportunity.

### Highlights

*Mason D. King discusses Luther King Capital Management. The firm focuses on long-only investments and views it as investing in a company as opposed to buying a stock. Mr. King looks for well-positioned businesses that can compound value for shareholders. He wants to invest in high-quality companies, and he doesn't measure that based on industry comp groups. Mr. King compares how a company's return profile matches up against the expected returns of any investment he might have. Overall, the characteristics that Mr. King looks for include high free cash flow generation, incremental margins and balance sheet strength. He also likes for companies to be able to drive earnings growth and improve returns.*

*Companies discussed: [Banc of California \(NYSE:BANC\)](#); [Royal Bank of Canada \(NYSE:RY\)](#); [RealPage \(NASDAQ:RP\)](#) and [Julius Baer Gruppe AG \(VTX:BAER\)](#).*

Southern California, also, you've got a little bit of a challenge in the down-cap, if you will, regional banking space. **City National** was taken out by **Royal Bank of Canada** (NYSE:RY) a few years ago, and they are still allowed to function with some autonomy. But typically, when you see that happen, then you start creating opportunities for those small and medium-sized enterprises that really enjoy the benefits of a regional or community bank. So I think that **Banc of California** is really going to have some good opportunities in further developing relationships, and they're still growing their loan book at about 10%, which is a solid growth rate.

**TWST: Do you want to mention the second company?**

**Mr. King:** Another one is **RealPage** (NASDAQ:RP), and this is one that we know. It is in our backyard so to speak. They are a company that provides software for property management of multifamily properties, and they're a leader in their industry with increasing penetration and secular tailwinds. They've also been taking more share against their competitors through bundled solutions.

***“They have about a 95% recurring revenue stream, so they have a very high retention of existing customers that provides a lot of visibility on sustainability of existing revenues as well as our excitement around the opportunities for growth of future revenues. They have also a large library of data that they've been collecting through the years.”***

tangible book value, and I expect that that will narrow over the next year to two as you start to earn some credibility back and start to grow on the new commercial platform.

**TWST: Anything on the horizon that's particularly promising for them, either something that's going to happen in the sector or something they might be following up on? Obviously, a lot more people are getting work and might need different banking services and things like that.**

**Mr. King:** They have been working on some of their Treasury management, and they've been working on some of their commercial lending platforms and the product suites associated with that. The last meeting that I had with them — I've actually had a couple meetings with them this year — they talked about where those

They have about a 95% recurring revenue stream, so they have a very high retention of existing customers that provides a lot of visibility on sustainability of existing revenues as well as our excitement around the opportunities for growth of future revenues. They have also a large library of data that they've been collecting through the years. Although they've been doing this, they're re-emphasizing the focus on leveraging this data for better value and analytics for their customers.

They also have a great track record of strategic acquisitions that they're able to integrate into their platform, and they've done this historically in a highly accretive manner. They also have really nice free cash flow characteristics, and this is beneficial in their acquisition strategy because they can make these acquisitions employ leverage in doing so but quickly get their leverage back down to very attractive

levels for us. Most recently, they've come out with a very clearly articulated 2020 plan. It's focused on growth of earnings per share and growth of revenue and also increasing their margins.

#### 1-Year Daily Chart of Banc of California



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

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#### 1-Year Daily Chart of RealPage



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

So it's not one of the cheaper stocks that we have on our buy list, but when you look at it relative to the expectations that we have for their growth, and you factor in that, and the price to earnings growth is just over 1.5 times on our three-year growth expectations relative to their price to earnings on their 2018 numbers or really future 12-month numbers. So we think that that should provide a great runway and good opportunities for value creation going forward.

**TWST: You mentioned the data analysis. I would think commercial real estate is a pretty competitive field, and to compete in that sector, those companies do need a sophisticated data analysis to see where they can improve operations and find new sources of revenue. Is that something this company is providing given that it's pretty important for the sector?**

**Mr. King:** It really is, and in fact, there are some specific examples provided where they were discussing somebody who is going to go in and put in a multifamily and believe that they could move the lease prices a certain amount, but they had a data library of a lot of the different locations around, and they could collaborate with that particular developer and either agree with or review the assumption of what they might be able to accomplish on a lease, a lot of that due to what they are able to gather through their penetration into all these multifamily units. So the data is very powerful, and historically, it's been a pretty fragmented industry. There's a couple of large players, but there's a lot of small players in the multifamily as well, and they are arming them with some of the data and the analysis to be able to better utilize their existing properties or for better decisions as it relates to development or redevelopment of existing properties.

**TWST: Did you want to mention a third company?**

**Mr. King:** I did. I'll mention one on the international side, and this one is **Julius Baer** (VTX:BAER), and it's a Swiss private bank, and this is one that we've owned a couple of years. I have

perhaps a bias toward it because I've done a lot of work on it, but it is a high-quality private bank that really is targeting your high net worth individual. They oftentimes are actually lumped into the asset management or wealth management peer group. So they have some of those characteristics within their model, even though they also provide quite a bit in terms of loan origination and are also regulated as a bank according to the oversight.

They've been investing over the past few years very aggressively into Asia. They made some acquisitions in 2015 buying out some of the **Merrill Lynch** offices out there. They've made other smaller acquisitions. They've also brought on quite a bit of professional staff in order to address that market, and these have burdened some of their cost structure over the past 18 months. They're just about to that point where you should start to see those investments in personnel and in locations start to drop down.

Typically, in the banking world and in finance, you look to about 12 to 18 months before you really start to see those types of investments internally really start to drop down, and my expectation is you'll start to see their earnings growth resume over the next few years. I would expect it to be kind of 12% earnings growth over a three-year period. Their return profile should continue to be supported by that.

Currently, they are earning about 12% return on equity and about 24% return on tangible common equity. I expect this to continue to rise. Currently, they're trading low-teens multiples. So you're looking at something with a growth expectation that would put that at a close to one time PEG, and with those types of returns, I find that as an attractive investment.

They also have done very well managing their credit, and so during the last credit cycle, their total nonperforming loans over total loans didn't break 1%, which is enviable relative to many European banks, and they also are managing these returns with a mid-50s loan-to-deposit ratio. So they have quite a bit in terms of deposits relative to their loans, so they're not having to push their balance sheet or any other leverage in order to try to make the returns that they're able to accomplish. So that I view as a high-quality solid-return bank trading at a reasonable price to earnings in that European market.

**TWST: So most of their focus is on Europe and Asia right now?**

**Mr. King:** Most of their focus currently is on those two markets, but they do serve other markets as well. It's just a smaller component of their total.

**TWST: Have they done anything with the United States or not that much?**

**Mr. King:** Not that much at this point in time. They're really focused on Asia. For perspective, their operating income from the Americas is about 3% of their total.

**TWST: I understand, while we're talking about international, that you work on international portfolios. So maybe you could talk a little bit about that?**

**Mr. King:** This is something that is relatively new for the firm, so it's incubated currently. I came from domestic equity research and actually serve as a manager for core equity portfolios. But over the years, there were questions about looking in international, and I felt that we had an opportunity, and the opportunity is predominantly developed international.

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There are a lot of similar companies out there that we can leverage our knowledge base in research, and then, we can also better serve our existing clients because many of those companies compete against our domestic companies, and so we shouldn't have too narrow a focus and look just at one domicile when we need to think about it as a global economy and lots of different trade partners that exist across the world. Likewise, we went with the developed because they have better rule of law and better transparency into their accounting, and so we were able to have many of the same risk factors that we have in the U.S., whereas you introduce a lot of other risk factors once you start going into emerging.

We're applying the exact same philosophy, and so we typically take a long-term view on the companies. We look for high-quality companies. I have a characteristic tilt screen that I look at all the time almost obsessively that measures the return on equity relative to the benchmark and how many standard deviations it may be above in this case. I look at the price to earnings growth ratio, the price to earnings ratio. I'm OK with paying a little more on the price to earnings ratio as long as my return is higher and my growth is significantly higher, and then, I look at it on a leverage basis as well.

Then, I look at the volatility, and all of those should come out to where the aggregate portfolio is that high-quality, lower-volatility, high-return, better-growth-type book, and we're looking currently at about 40 to 50 names, really probably on the lower end of that. So it's a relatively concentrated book of high-quality names. We introduced this strategy in 2014 actually just internally. So currently, we have internal partners with one exception, and we've been incubating it, and we believe the performance has been very solid to date with the equities outperforming significantly and quite a bit of alpha generation on the 5% to 6% side.

**TWST: When you advise your clients about investing, do some of them have a little reluctance about bringing something like an international portfolio into their holdings, or do you think that they understand that it helps diversify what they have?**

**Mr. King:** It's a good question. For disclosure, at this point, there's no outside investors in the international strategy with one exception, and all of them are internal. But in the dialogue that we've had with clients, this actually came as a response to many clients who were asking if they could have some of that diversification. Many of our core equity companies and our core strategies still have a lot of international exposure.

So I think that's one that oftentimes is lost is that as it goes, the S&P 500 has 40% of the revenues coming from non-U.S. countries, and so you still get a lot of international exposure in the domestic, but what we are seeing, you still want to perhaps own a little bit outside of that. You have geopolitical reasons. You have currency reasons. You may have cyclical reasons as it relates to economic cycle. There are a lot of reasons where you might want to have some ownership outside, and this provides an avenue and a source to do that.

Again, it's very consistent with our philosophy. So we're trying to buy really high-quality companies that exist in countries where you have very clear and defined rule of law, you have no issues as it relates to foreign direct investments and really investments in their exchanges, but really also the movement of currency back and forth, and so we've found actually positive response so far.

**TWST: Looking at the bigger picture, when you talk with your clients and they look at the rest of this year and into next year, what are one or two things that they're perhaps a little bit concerned about?**

**Mr. King:** I think the big question is going to be what's going to happen with tax reform. That's probably one of the most common questions that comes up and how much of that's priced in. I think that the reason why people are the most concerned about tax reform and really movement of any sort of legislation through Congress is that we're historically on the far end of what would be a normal economic cycle. So as we start moving forward with monetary stimulus being a little less evident — in fact, going the other direction — then how are we going to balance that with fiscal stimulus in order to push the economic cycle out further so that, as opposed to realizing an economic recession in 2019,

which may be even normal time according to when they started their rate movement in terms of the normal lag between the economic impact and when the first rate movement is, it may be 2020 or 2021 if you end up having a fiscal stimulus come in place that might be able to push that economic cycle out further.

So that seems to be a pretty common question: What's going to happen with taxes and tax reform going forward? I think that we're optimistic that something may get done. We're hoping that it's more along the reform route than a tax cut. Reform typically has a much longer life to it and broader economic impact than a simple tax cut.

**TWST: Thank you. (ES)**

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