March 16, 2012

Dear clients and colleagues,

It has been a busy few weeks for our team at Global Alpha, last week, the team attended 3 conferences in the US and 1 conference in Japan.

One of the conferences we attended was Raymond James 33rd Annual Institutional Investors Conference with over 1,700 attendees and 300 presenting companies. It is the largest small cap conference in the US. For the last 12 years at least, it has taken place in Orlando during the first week of March, we know, because this is our 12th year in a row that we attend.

One of the benefits of attending this conference each year is that it gives us a good feel of how the economy has progressed in the space of one year, using the same reference point.

A few observations:

For the first time in at least 4 years, we saw new construction. A lot of it! We stayed on International Drive near Central Florida parkway, across the street from our hotel; an apartment complex is being built. Beside it is a Sheraton condo resort, and they are building a new phase, the first time since 2007. Just beside, 2 new retail strips are being built.

We then travelled to Kissimmee, South West of Disneyworld. We went to visit 2 new homes development by Lennar and D.R. Horton. Activity was brisk with a lot of demand from foreign investors. Houses are built only if they are sold, not on spec. Lennar has already increased prices twice since New Year. However, prices still remain very attractive. A brand new detached home, with 5 bedroom, 4 bathrooms, a garage and a splash swimming pool, with the back on a small pond and access to resort facilities such as pool, tennis and cinema was selling for $230 000.

Restaurants were busy and hotels were fully occupied. There were a lot of “help wanted” signs.

A caveat, we paid $3.89 per gallon for gasoline and there is a lot of anxiety about high gas prices. A survey done revealed that 25% of people have already changed their spending habits in the last few months and another 40% of the people will change if price reach the psychological $4 a gallon. Economic data still does not reflect the latest rise in gasoline prices.

Overall sentiment: companies and investors are very positive that the recovery is gaining speed.
We sensed this unanimous view across all industries. All companies expressed confidence in the accelerating economic recovery and are back in growth mode.

Many companies have plans to build or bring back capacity in the US. Rising costs in China are seen as an issue, although most companies mentioned that China will remain their most important sourcing partner.

Balance sheets are very strong and capital is returned to shareholders via dividends and share buybacks. In Q3 and Q4 of 2011, almost 40% of US small cap companies repurchased their shares spending over $15.5 billion. ***We believe that if stock prices were to decline repurchase activity will accelerate.***

The most optimistic companies were the homebuilders and the technology firms.

Key challenge: Margin expansion will be difficult.
With corporate profits and margins back to peak level, further margin expansion seems unlikely in the near term. Rising energy and commodity prices add even more pressure. US companies believe they can offset the cost-hike by higher utilization rates, better sourcing, higher-margin product mix, and gradual pass-through to customers. In reality, it might not be that easy.

Key opportunity: the US and Emerging markets.
In term of growth strategy, the US seems to be the best region for growth. For other areas, Latin America, especially Brazil took the top spot this year. China, South East Asia, Eastern Europe also remain areas of focus.

Existing holdings: positive feedback.
We met many companies held in the portfolio.

Zebra Technologies (ZBRA US), a leading asset tracking and management solution company. The company's strategy to grow sales and earnings by 10%+ compounded in next 5 years is twofold, product innovation and international expansion.

Mid-American Apartment (MAA US), a residential owner of more than 50 000 apartments continues to see solid fundamentals in the apartment sector. Vacancies are expected to remain low and rent to increase over 5% this year. The company will continue to grow via acquisitions and new developments.

Manhattan Associates (MANH US), a supply-chain software company sees strong demand for its best-of-breed solution. Improving corporate profitability will bring more investments in IT projects with good return on investment. In addition, recurring revenues are now over 50% of the company's revenues providing a strong cash flow for growth and value creation.

Raymond James Financial (RJF US), our host, but also a holding in the portfolio, just acquired Morgan Keegan and will focus on integration.

Waste Connection (WCN US), the 4th largest waste management company in the US sees volume increase in 2012 after more than 5 years of contraction. Coupled with strong pricing, high commodity prices for recycled materials and potential acquisitions, we should see earning grow at more than 15%.

Comstock Resources (CRK US), our largest holding and our biggest loser in the past 24 months, demonstrated the value of its holdings, worth more than 4x the current stock price.

NIC Inc. (EGOV US), the most important operator of state government website in the US, explained the impact of its recent wins in Texas, New Jersey, Maryland, Mississippi, Oregon and Delaware. 2012 should see muted EPS growth due to the costs associated with bringing these states online. However 2013 should see 20%+ profit growth.

Chico's (CHS US), a leading women retailer explained the growth potential of its White House/Black Market, Soma Intimate and Boston Proper Brands which they think can double the size of the company in the next 5-6 years.

Finally, Merit Medical (MMSI US), one of our latest addition, see our November 9 weekly, presented its most important new product line up in the company's history, as well as its initiatives to go to a direct sales model in markets such as Russia and Brazil. This week, Zoll Medical, a comparable, with slower sales growth and lower margin got acquired by Asahi Kasei of Japan for 3.6x sales and 24x Ebitda, compared to Merit which currently sells for 1.4x sales and 9x ebitda.

Of the more than 30 companies we met, our existing holdings are clearly our preferred names. They share common attributes as follows: a big and growing target market, revenue growth faster than industry, clear growth strategy, strong competitive edge, high operating margin, and low/no debt.

What do we think today?

We are very optimistic for equity markets for the next few years. The US economic recovery is gaining momentum. Europe is addressing its structural problems. Emerging markets are still growing fast and are showing increasing good governance. Some risks remain in the shorter term. The Iranian nuclear situation. The uncertainty brought by elections in France, Germany and the US, rising oil prices. Extreme currency volatility.

The stock market is on its way to one of its best start ever in Q1, we would not rush to invest now, but for long term investors, this is one of the best periods to invest in equities, especially with bond yields so low.

Have a good week.

The Global Alpha team