Interview #81 : Roger Fan (RF Capital Management)

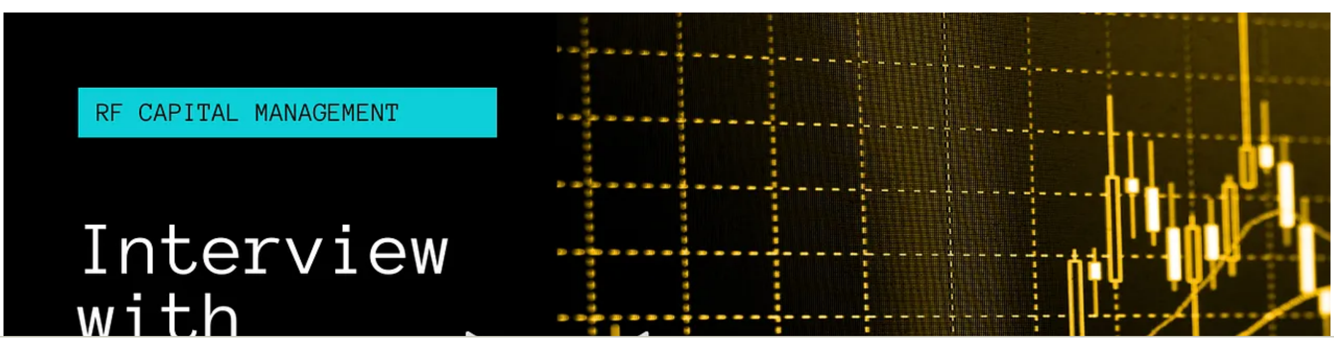
Searching for obscure, quality, and undervalued companies from across the world.

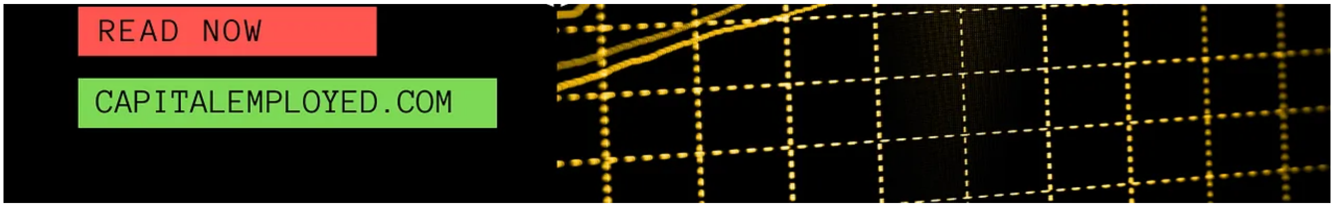
CAPITAL EMPLOYED
DEC 8, 2023 · PAID

For this issue we have the pleasure of interviewing Roger Fan, Founder and Chief Investment Officer of RF Capital Management.

⚡ *Consider becoming a Premium Subscriber to read these interviews in full, and gain access to the growing archive, for just $15 monthly or $150 annual subscription.*

Read the last two editions with Tom Bachrach (PFH Capital) and Jordan Lampos (Midway Partners) ➡️





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

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

Before we dive in, thank you for the opportunity to do this interview with you. I’m familiar with your work, and I think it’s a fantastic resource for students, private investors, and investment professionals.

So I've always been interested in business. My parents came to the U.S. from Taiwan in the early 80's. They've always been business owners - primarily fast food restaurants and convenience stores.

I remember shopping for inventory at wholesale clubs, stocking the shelves, working the cash register, and counting the money after closing in the summers and after school starting at age 5 all the way up until I left for college. In fact, I’ve heard my parents tell stories of when they used to bring me along with them to work when I was a baby, so it was even earlier than that!

So I learned what work ethic and grit looked like from an early age. Liquor stores, fast food restaurants, and food courts are not easy businesses to run by any stretch.

However, your options are limited when you immigrate to a new country and you don't speak the language. Both my parents also didn't have college degrees. That's probably why they emphasized education so much and steered me towards medicine.

In college, I took the full pre-med course load, volunteered in hospitals, completed summer internships, conducted research in labs, and secured professor recommendations. I was also scoring well on my practice MCATs.

However, I decided to become a hedge fund manager in my senior year, so I never ended up sitting for the exam.

In hindsight, it may have been the wrong decision because I didn't have the resume or experience to land a prestigious investment banking job straight out of undergrad. However, I have my dream job now as CIO of RF Capital, so it all worked out!

Ironically, I discovered value investing while I was working in hospitals and clinics during my freshman year. That led me to Warren Buffett, Charlie Munger, Ben Graham, etc. I read all the books that I could on investing.

I also remember going to Borders and reading all of the books in the investing section. Eventually, I thought I knew enough about investing and starting investing my parent's money and my own in May 2008.

I've always said it was the perfect start to my career because I learned how to invest real money during a preceding bull market and the Great Financial Crisis that followed. Making at least 2x to 3x on every investment certainly gave me confidence.

I only had one breakeven investment and one losing investment where we lost less than 1% of assets. I enjoyed investing so much that I was conducting investment research and managing the portfolio before classes, after classes, and on the weekends.

I even took the full economics course load to get a better understanding of economics and how finance worked. I was just a language requirement short of getting a double major.

After graduating, I worked for three years before going to law school. I decided on law school because I felt like it was a better option than getting an MBA.

The skillset that you gain from law school is directly transferable and much more valuable for investing than what you would get out of an MBA program. So I went to law school and focused on corporate law classes in my second and third years. After graduating, I launched RF Capital and here we are today. That's how I got into investing.

What does your ideal investment look like?

My ideal investment would be a company with a sub-$100M market cap. The business would have high revenue, earnings, and free cash flow growth.

On the balance sheet side, the company would be net cash with no debt and would trade at a discount to net current asset value. EV/EBIT, EV/EBITDA, P/E, and P/FCF multiples would all be low single-digits, P/Tangible Book and P/NCAV would be less than 1, and ROIC above 20%.

With that being said, very few companies fit that financial profile and you often times have to compromise. But the idea is to find egregious mispricing's in the markets.

Beyond the numbers, the company would also be a niche business with a dominant market position. Margins and return on invested capital would be steady historically and growing.

Additionally, I would be able to project normalized earnings with a high degree of confidence over the next 2 to 3 years.

Additionally, the business would be obscure with little to no institutional ownership. There would be minimal to no coverage by buy-side analysts or even retail investors.

However, there would be high insider ownership with recent insider purchases. The management team would be shareholder-oriented with great capital allocation skills. Board members would also own significant stakes in the company and bring a diverse set of experiences that compliments the management team.

Finally, I'd be able to figure out why the opportunity exists. When a company fits all of the criteria, there's usually something wrong with the industry or the business itself.

High-quality businesses tend to be expensive. They wouldn't trade at single-digit multiples or provide high IRR's unless there was something wrong with it.

Similarly, I would be able to determine what event(s) would move the stock price. "Value traps" tend to occur because there's no catalysts and the short thesis wasn't properly considered.

Although that is the ideal investment, I'm perfectly fine with other types of investments as long as they meet our hurdle rate.

Stable, free cash flow-generative businesses, net-nets, turnarounds, cyclicals, high-yield bonds, special situations, etc. are all fine.

I just prefer the high quality business at deep value prices because you can take large positions and hold for many years without making many other investment decisions, which would reduce your error rate.

Once you find a company that interests you, what are the next steps you take?

I always start with the most recent annual report. Then I supplement that with the most recent investor presentation if it's available, 10-Q, and proxy.

Assuming I'm still interested, I'll start building an Excel model with historical financials as far back as I can go. That way I get comfortable with the numbers and can get a sense of all the important KPI's and ratios. This

process typically takes up the first few hours of research depending on how fast I read and how quickly the numbers get entered into Excel.

There's many ways to skin a cat, but what's your favorite methodology for valuing a business?

I like to keep it simple. I want to figure out what normalized earnings will look like in 2 to 3 years and put a multiple on it. Compare that price to the current price and you can figure out the IRR.

However, more precision is needed, so I use all the applicable methodologies to give me a range of valuations. DCF, relative value, private market value, and liquidation value are all used when applicable.

When the target trades at a discount to the entire range, that's how you know you have an undervalued company on your hands.

At the end of the day, you can't go wrong buying companies at single-digit earnings multiples and/or at a discount to tangible book and NCAV.

Valuation really doesn't have to get any more complicated than that. You just have to get everything else right and execute.

I enjoy technical analysis, so I was glad to hear you also use technical analysis to provide signals for when to buy, sell, add, and trim. Have you found this has improved your returns?

It's hard to say from such a small sample size. I've only started implementing technical analysis over the past few years. We'll see how it plays out over the long term.

However, I would say it has improved my returns so far. From when I started employing technical analysis up until now, it seems to have coincided with better returns.

However, I'm always cognizant of the fact that I may be leaving money on the table. If you own a company that is going to be a 100-bagger, you wouldn't want to sell a single share.

You would want to capture the entire upside! That's easier said than done though. In the end, you have to learn to give up some upside in exchange for downside protection because the inverse can also be true.

If a stock appreciates but subsequently drops in a big way, you wish you would have sold some.

Trading around positions isn't easy. It may not even be ideal over multi-decade periods. However, I just want to maximize the short and medium-term upside while managing risk as best I can.

The framework and process itself just gives me an added layer of confidence and conviction that RF Capital will outperform over the long term.

Where are you finding good ideas at the moment? Is there any specific industry or country where you're currently finding good value?

I'm finding good ideas in the nano and microcap space. RF Capital isn't a microcap fund, but we always look there first. Often times, microcaps are the only place to find investments that meet all of our criteria.

However, that isn't always the case. Sometimes small, mid, and large caps may be more attractive. That's why we aren't constrained by market cap.

There's also no specific industry at the moment. We just conduct a broad search and are willing to invest in any industry. However, the target must fit our criteria. That's also how we view countries as well.

There seems to be good value in multiple countries. For example, we own companies in countries like the U.S., Canada, Singapore, Japan, and Hong Kong.

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

Sure, my top two holdings are Zengame and Sprouts. As a disclaimer, Zengame is currently actionable, but Sprouts is not.

At current prices, we would not necessarily buy shares of Sprouts. However, Zengame is still undervalued despite trading around an all-time high.

💡Zengame Technology (2660.HK)

Zengame is a mobile game developer in China. The company develops and operates board, card, and casual games for mobile devices. Zengame uses the free-to-play model. The games are free for users to play, and income is generated from sales of virtual items and advertisements.

Currently, revenue by business segment is 94.7% from in-game virtual items and 5.3% from the in-game information service. By category, it breaks down as 98.2% for card and board games and 1.8% for casual games.

Fingertip Sichuan Mahjong is the company's flagship game. The game ranks second on the board and card games iOS bestseller list in China. Fingertip Sichuan Mahjong also consistently ranks in the top five in that category.

Having a game that's always highly ranked at the top of iOS bestseller list is an impressive feat. Zengame has consistently been able to do this. Previously, it was their flagship game Fight the Landlord that did extremely well on the charts.

The management team also owns a lot of shares. Ye Sheng, Chairman of the Board and CEO, currently owns 22.49% of the shares outstanding, and Yang Min, Vice Chairman and CTO, owns 19.18%.

A combined insider ownership of 41.67% between the two of them is quite high and is one of the reasons why we think the company will continue to do well going forward. We love founders and owner-operators who own significant stakes in their own companies.

The H1 2023 numbers and financials were excellent as well. For the first half of the year, the company reported YoY increases in revenue, gross profit, profit, and EPS of 64.2%, 59.1%, 70.6%, and 70.8%, respectively.

While huge 60%-plus growth rates don't happen every half-year period, Zengame has consistently been able to consistently grow double-digits across the board ever since the company went public. Additionally, the company continues to maintain a robust balance sheet.

There is minimal short-term debt and zero long-term debt. Also, 42.6% of its current market cap is in cash and short term investments.

Traditional valuation metrics continue to be compelling as well despite the company trading around its all-time high. The TTM EV/EBITDA, EV/EBIT, P/E, and P/FCF are 2.49x, 2.50x, 4.62x, and 4.56x, respectively.

Additionally, ROC and ROE are 44.8% and 49.1%, respectively. Combined with high double-digit growth rates, Zengame's valuation remains attractive no matter what type of investor you are.

Although the company is cheap on every metric, there are investment risks to consider. First, Zengame may not be actionable for every investor because all of Zengame's revenue is generated in China.

The risks of investing in China are widely known, so it's up to investors to determine if Chinese companies make sense within the context of their portfolios.

Second, the company may not be able to continue its high growth rate trajectory going forward. Historically, the company has fluctuated between modest, high, and hyper growth rates in the past.

Third, Zengame is admittedly somewhere between average and above average in terms of business quality. The company relies on its flagship game – whatever it may be at any given moment – to generate earnings. There never seems to be multiple flagship games at any one time.

So it's certainly a business risk to be mindful of – much like concentrated customer risk. Last, MAU, DAU, and MPU of virtual items have declined dramatically.

We're watching these KPI's closely in conjunction with all the numbers/ metrics mentioned above because it certainly is concerning. We would like the company to be firing on all cylinders.

On balance, we continue to hold Zengame shares, and the company remains our top position. Our initial cost basis was HKD$1.16/share, so we've done quite well over time.

Despite trading around all-time highs, there's still plenty of room to run. The company continues to be a high growth company with a robust balance sheet that currently trades at low, single-digit multiples.

We would love to add more, but it's already a huge position in our portfolio.

💡Sprouts Farmers Market (SFM)

Next, we have Sprouts Farmers Market, which is certainly a very different type of investment from Zengame.

Sprouts operates over 400 stores in the US and retails perishable and non-perishable food products. Their markets have an emphasis on fresh, natural, and organic food items.

One of SFM's strengths is their niche and the specific types of consumer that shops at their stores. The typical shopper is an older, higher income consumer who focuses on health and wellness. This is an advantage because having a higher earning consumer base means that the stores will be less susceptible to declines during recessions or inflationary environments.

Higher income earners are more likely to continue shopping at specialty stores as opposed to switching to conventional markets in order to save a few dollars.

Furthermore, they are also more likely to shop at Sprouts and cook at home if they are trying to save money by eating out less at restaurants.

Additionally, it is highly unlikely for consumers that emphasize health and wellness to abandon their dietary habits and lifestyle choices overnight.

Sprouts also has a stickier customer base because they provide a differentiated product offering that focuses on natural, organic, and specific diet food items. 27% or more Sprouts shoppers identify with each one of the following lifestyle choices and characteristics:

- Buying organic
- Dietary lifestyle of vegan, gluten-free, pesca, etc.
- Concerned about the environment

- Review nutrition labels
- Looking for fair trade/socially responsible
- Looking to try new things
- Research recipes online
- Listen to podcasts

To match the typical shopper profile, more than 70% of Sprouts' products are attribute-driven. Attributes include organics, paleo, keto, plant-based, non-GMO, gluten free, vegan, dairy-free, grass fed, and raw.

Furthermore, Sprouts offers private label items that have those attributes. YTD in 2023, Sprouts brand sales penetration is 20%, which is up from 14% in 2019. This is a great trend because private label items are higher margin and more profitable.

SFM's net promotor score also seems to reflect customer satisfaction with SFM's product offering. Among frequent shoppers, SFM's NPS is +57, which is strong and in line with best-in-class peers.

Additionally, Sprouts is a company that can continue to grow despite being a mid-cap company with over 400 stores. Management is targeting 10% unit growth per year starting in 2024.

This is doable going forward given that they have opened a lot of new stores every year. For example, Sprouts is on pace to open 30 new stores by the end of this year.

While that isn't quite 10%, atleast they are already in the ballpark. So the target is realistic.

New stores are one of the key driver for future growth because of the attractive unit economics. Here are management's targets for new stores:

- $13M in Year 1 revenue
- Revenue grows 20%-25% over next the next 4 years
- Breakeven Year 1 EBITDA margins
- Grows to blended ~8% EBITDA margins over the next 4 years
- Cash investment for a new store build is ~$3.8M
- Cash on cash return in the low to mid 30's by Year 5

Additionally, management is guiding for low single-digit comp sales and low double-digit earnings growth going forward.

While the growth profile isn't as exciting as Zengame or microcaps in general, low double-digit earnings growth is still attractive given that it's a mid-cap classified as a consumer defensive stock.

Furthermore, the EPS CAGR over the past three years has been 24.1%. Most growth-oriented investors would be pleased with that result.

Other important metrics that contribute to the bottom line have also been increasing. Ecommerce penetration has grown from 2.5% in 2019 to 12.1% YTD 2023.

Ecommerce is important because it is another way for customers to shop, which translates to a higher share of wallet and more sales. Also, ROIC has also been improving from 9.7% in 2019 to 12.9% in Q3 2023. The adjusted EBIT margin has also held quite steadily between 6.1% and 6.4% ever since Q3 YTD 2020.

More importantly, SFM has reported strong earnings this year. The momentum has lifted Sprouts' stock price to near all-time highs. In Q3 this year, net sales, comps, and EPS grew 8%, 3.9%, and 7%, respectively. Sprouts also opened 10 new stores during this time.

YTD, net sales have increased 6% and 24 new stores have been opened. For FY

2023, management expects total sales growth of 6.5% to 7%, comp sales growth of ~3%, and 30 new stores opened.

Although we still like the business, we probably wouldn't add additional shares at the current price. All of SFM's valuation multiples are outside of our preferred strike range. EV/EBITDA, EV/EBIT, P/E, and P/FCF are currently 11.88x, 15.86x, 19.12x, and 15.72x, respectively.

Additionally, consumer staples retailing is an extremely competitive business. Trader Joe's, Erewhon, and Whole Foods are some markets in LA (where we're based out of) that come to mind and are direct competitors. Not to mention Costco, Sam's Club, and the conventional markets.

In short, shoppers have many options to choose from and SFM's competitive advantages must be monitored going forward. Also, we must also be wary of the earnings power of customers and their dining preferences.

Less spending power can be an issue given the higher costs of eating healthier, higher quality foods. All markets also compete with fast food and full service restaurants as well.

However, we continue to hold Sprouts for the predictable revenue and EPS growth and stable cash flows. As mentioned before, SFM is our second largest position and our initial cost basis was $16.32/share.

We are in no hurry to sell, and the stock may be actionable for investors that like SFM's current financial profile and business. SFM's valuation multiples aren't egregious by any stretch.

Zengame Technology is a 24.79% position in your portfolio. Hong Kong is full of extremely cheap stocks.

Does the geopolitical situation, and Chinese economy worry you, or do you

just focus on business performance and ignore the noise?

I just focus on business performance and ignore the noise. Businesses that meet all of our criteria are hard to find. When you do find such a company, you have to bet big and take a position.

If the geopolitical situation or country as a whole concerns me, then I require a much higher margin of safety and projected IRR.

With that being said, I don't ignore the geopolitical situation and the overall economy. There are important data points that may affect a company's earnings.

My job is to figure out how the macro may impact company-specific earnings. I just do the analysis from the bottom up. Top down analysis works, but it just doesn't fit my style.

You launched the fund in 2017, with more of a focus on deep value but since then have transitioned to a GARP style of investing.

You also went from larger companies to focus on micro and nanocaps. What has led you to change your style over the past 5 years.

To be clear, I wouldn't classify myself as a GARP investor. I still refuse to pay GARP-type multiples for companies. I've simply focused more on high-quality company characteristics.

I still see myself as a value investor. I'm looking for high-quality companies that trade at deep value prices. And as I mentioned before, I still make investments that fall into other categories.

I just don't talk about those companies as much, and they are sized much smaller than high conviction positions like Zengame and Sprouts.

However, the biggest driver for the shift to smaller companies came from a significant change in my search process. I no longer rely on investor letters, idea boards, peer investors, or 13F's for ideas.

I generate investment ideas entirely on my own. After the first two years of launching the firm, I realized that I had enough investing experience to find my own ideas. I didn't need to borrow conviction from others. Much like technical analysis, the shift led to significantly improved returns.

As for market cap size, it was a byproduct of finding ideas on my own. Investors that file 13F's and make their letters and ideas available typically are larger firms that invest in companies that everybody has heard of.

When I stopped looking at those sources of ideas, it freed up research bandwidth. I made it a point to look at companies that I'd never heard of or read about anywhere else.

It's fun hunting for investments off the beaten path. Often times, there's more upside too, so it's a win-win.

Where can readers go to find out more about RF Capital?

Readers can find out more about RF Capital via our website at rfcapitalmanagement.com

We post our letters and research there. If people are interested in staying updated, please feel free to fill out the form submission to get on our distribution list.

I'm also on Twitter/X @rgrfan – though I don't post much and use the app infrequently. I also plan on posting content on Substack and perhaps other platforms in the near future. So definitely get on the distribution list for updates.

Thank you again for this opportunity. It was a pleasure.

Thanks Roger.

Disclaimer

This interview is for informational and educational purposes only, and should not be seen as investment advice. Please do your own research before thinking of investing in any company mentioned.

Comments