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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Small and Medium-Sized Businesses with a Private Equity Approach

MICHAEL COOK is the Founder, Chief Executive Officer, and Chief Investment Officer of SouthernSun Asset Management. In his over 30 years of experience as a research analyst and portfolio manager, Mr. Cook has developed a unique investment philosophy and process, which serves as the core of the firm's U.S. and global equity strategies. Throughout his career, he has been featured and quoted in *The Wall Street Journal*, *Barron's* and *Bloomberg Markets* magazine, and has been a speaker on CNBC, Fox Business News and Bloomberg TV. Mr. Cook attended Covenant College and the OCCA Business Programme, Wycliffe Hall, University of Oxford, and is a member of the CFA Institute.

SECTOR — GENERAL INVESTING

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

Mr. Cook: The firm was started back in 1989. I founded the firm. We began at that point with a small amount of family money and a big vision, and almost 30 years later, we have some 35-plus employees. We have six members on the investment team and a great four-member management team now.

TWST: Does the firm have a unique investment philosophy?

Mr. Cook: We do. We've historically, since the beginning, concentrated our efforts on small to medium-sized businesses with really more of a private equity approach. So we've been many times called a private equity firm that manages public equity. We focus in on value and fundamentals of businesses, what unique niches they may operate in and management teams that have a long-term perspective to creating shareholder value. So that's been done since the beginning and we continue to do so today; even though we do have three strategies per se, they all really focus on that same core of fundamentals that we think is rather unique.

TWST: Did you want to highlight the three strategies that you have?

Mr. Cook: Yes. We have our small-cap strategy, which was our original strategy, which is a U.S. strategy. We also have a U.S. smid-cap strategy, and then, we have a global strategy as well.

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

Mr. Cook: Yes. I would say one of the businesses we find interesting at the moment is a company called **Darling Ingredients** (NYSE:DAR). **Darling** is a Dallas-based company that originally was in the rendering business and has really transformed themselves into a very diverse business across the feed and fuel complex. For folks that don't understand what rendering is — rendering is when you take cattle, pig or chicken carcasses and render them down into usable fats, oils, tallows and bone meal. Rendering is a recycling business that generates valuable byproducts.

TWST: Could you highlight a couple things about the company that you find interesting at the moment?

Mr. Cook: Sure. First, **Darling** is recognized as one of the very few larger pure plays in the rendering business. Most rendering is done on a captive basis by the primary users of the base goods. They're recognized as a market leader in gelatin production globally as well as renewable diesel fuel through their partnership with **Valero** (NYSE:VLO) and **Diamond Green Diesel**.

It's a business that generates solid cash flow, what we call discretionary cash flow, which is really that real cash that management has to use to make capital allocation decisions over time, like acquisitions, share repurchases, paying down long-term debt or expanding plant capacity or distribution, whatever it may be. **Darling's** been able to really grow their business across a number of arenas with their core competency over the last decade. Frankly, we think that their opportunities on a global basis have improved as they've gone and found the best-in-class businesses in certain other areas to bolt-on to their core business.

TWST: I understand that they are across five continents, so they work globally?

Mr. Cook: Yes, they do. Interestingly enough, **Darling's** business, probably one of the less understood pieces of their business, is their gelatin business in China. That particular business has been interesting simply because, in China, there have been rather a number of domestic producers of gelatin. The regulatory environment has become significantly more stringent, and it's allowed **Darling** to continue to grow that particular piece of their business as well as their rendering byproducts, which are fats, oils and bone meals. They have been able to apply those byproducts in increasingly more sophisticated and really more attractively priced end markets, such as pet food, aquaculture feed and organic fertilizer.

So the global nature of the business obviously allows them to not only go to market with a higher value add proposition, but also, we believe that it gives them a longer-term runway in terms of the opportunity set for the business versus people who are pigeonholed in each one of those categories. I think that complexity is probably one of the reasons that the business is somewhat misunderstood. There really are no specific public competitors, and in some of the areas, the barriers of entry are pretty high. So it does seem that their scale would be at least difficult to replicate in a lot of ways.

TWST: Did you want to mention a second company?

Mr. Cook: Sure. I think probably one of the businesses that I would also highlight would be a company called **Timken** (NYSE:TKR). **Timken** is probably one of those areas that is a little bit more in the spotlight simply because of the tariff issues. They're a roller-bearing business that we've actually owned for a number of years, and we really like not only their business model but the opportunity set they bring in that particular business. If we look domestically in particular, they're one of the leading providers of bearings, transmissions, gearboxes and related components, as well as the largest maker of what are called tapered roller bearings in the world.

Highlights

Michael Cook discusses SouthernSun Asset Management. Mr. Cook focuses on small to medium-sized businesses and uses a private equity approach. For this reason, he says that SouthernSun is often called a private equity firm that manages public equity. When evaluating companies, Mr. Cook focuses on a company's value, fundamentals and unique niches. He also looks for a management team with a long-term view toward creating shareholder value. Mr. Cook uses this investment philosophy across his three strategies: a U.S. small cap, a U.S. smid cap and a global strategy. According to Mr. Cook, there are two things that really set the firm apart from large companies. One is that the work matters to the people of the firm and is meaningful to them. The second is that they stick to their long-term view and think of their investments as businesses that they own.

Companies discussed: Darling Ingredients (NYSE:DAR) and Timken Co. (NYSE:TKR).

TWST: From what I understand, over the past few years, they've done some acquisitions. Do you think that they could do some additional acquisitions as time goes on?

Mr. Cook: Yes. I mean, the balance sheet would certainly support that. We think that their focus on, again, the more tuck-in or bolt-on acquisition approach really gives them a pretty good opportunity set as time goes on. There are a couple of competitors out there in the bearing space and particularly in the tapered bearing space, which is more complex. So those are larger competitors, but as you look down through the value-added part of their business, there certainly is plenty of opportunity, and we probably would be surprised if we didn't see them make some acquisitions.

I think, right now, execution is the top priority. The business is generating strong discretionary cash flow, in my view, and again, the balance sheet certainly supports itself or lends itself to the capacity to go out and do the types of acquisitions that they've looked for in the past.

TWST: I would guess that a lot of their customers are other businesses. Is that right?

Mr. Cook: It is.

TWST: Given that the economy seems to be growing, and there's potential for more manufacturing and that kind of thing, so is the outlook for them on the good side?

Mr. Cook: We think so. It's supportive at least — I mean, as we have seen even since the end of last year, and there are a number of disruptors out there in the marketplace. Again, obviously, the component price of steel, which is not the steel, but it's been in the headlines on the tariff front, has not been one that is necessarily significant for **Timken**, but from a customer standpoint, as one might imagine, it is a good environment. Particularly if we look back at the difficult environment across the industrial complex, beginning with the commodity drop back in the fourth quarter of 2014, I think that the businesses that have rightsized themselves have, like **Timken**, really well-defined capital allocation priorities with specific financial hurdles around those. Those businesses are in a really good position as that industrial economy, not just domestically but on a global basis, continues to move reasonably well.

"As a result, it gives them a lot of opportunity to do what we historically have liked, and that is grow through bolt-on and tuck-in acquisitions in particular. You need a solid management team that understands the long-term potential of taking that bolt-on acquisition approach, as opposed to a more popular approach today of large, transformative acquisitions."

As a result, it gives them a lot of opportunity to do what we historically have liked, and that is grow through bolt-on and tuck-in acquisitions in particular. You need a solid management team that understands the long-term potential of taking that bolt-on acquisition approach, as opposed to a more popular approach today of large, transformative acquisitions, which have their upsides but also a lot of downside. We also think that **Timken** has good pricing opportunities going into the next couple of years given that their end markets continue to show pretty good strength.

I think that it's fairly easy to get sidetracked with a little bit of an obsession with sort of peaks and economies and whether or not the economies move too far and too fast or whether we've reached a place where we've maxed out on margins. I think the conversation probably misses a very fundamental point, and that seems to be that they're consistently saying, better demand and expanded sales opportunities. So I do think that the environment seems to be conducive, obviously no guarantee, as I said, because we seem to be figuring out ways to disrupt things pretty easily, but we would certainly think that they would have solid opportunities through the balance of this year and into next.

1-Year Daily Chart of Darling Ingredients

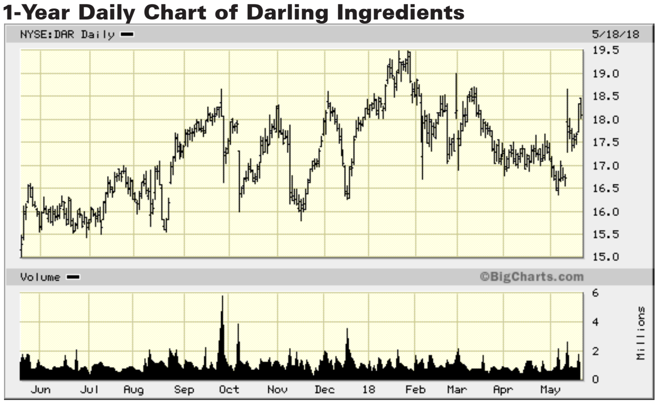

Chart provided by www.BigCharts.com

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1-Year Daily Chart of Timken Co.

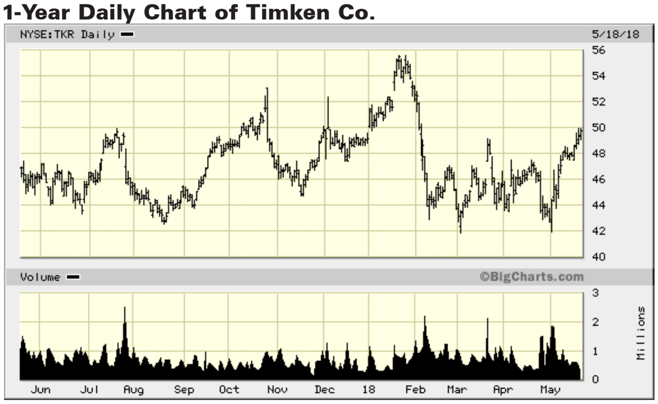

Chart provided by www.BigCharts.com

TWST: When you talk with your customers and clients today, what are some of the concerns that they're bringing forward that you think are on the minds of investors?

Mr. Cook: I think that probably the one that we hear most often is that, because of the money that's flowed into a number of the passive vehicles, are valuations overstretched if you look at them in most historical measures, such as price to earnings or price to book and even, in some cases, price to cash flow? So we clearly are hearing that. I think it's a legitimate thing to be concerned about. It certainly is not unexpected that we would be at this place at some point.

I do think that we've gone through a period where the marketplace has cared less about businesses that are rightsizing themselves and that are preparing themselves and making difficult long-term decisions about how do they go to market, what their value proposition is and how they generate discretionary cash so that, in time, they have an opportunity when we do go into a more general and broad economic downturn, which we think we will enter at some point. I think that segment of businesses has probably been left out simply because the discussion, more often than not, is about revenue growth, about EPS growth, and it's about reaching peak margins. I think that given the run in technology and the components around that and their influence on indexes, it's not an unreasonable thing to be concerned about. I don't think that their concerns are completely misguided.

We would just think of the fact that this is a very reminiscent time for us, certainly nothing ever happens the same way twice, but it is reminiscent of the 1997, 1998, 1999 run-up to the tech-bubble burst. Now, not that we would suggest that that's exactly, and certainly wouldn't suggest that is what happens again, but it is the way that investors' attentions change that is similar. I think, as a result, their concerns follow their attention, and their attention is on technology and just the rapid growth in that arena.

I think there's also a real, almost somewhat misdirected emphasis on this notion of, because I hear the word so often, cadence. I think that there's a sense that because we've seen things sort of kicking along, and even when there's a seemingly significant disruptor added into the equation, it seems to just pick back up and continue to tick along. I think that that can be certainly a siren song, it can be very alluring, and it does trouble us.

So from one perspective, I think what we're hearing from our clients is that the challenge for our approach has clearly been the fact that investing based on businesses that are generating significant amounts of discretionary cash flow, the view is that there's fewer and fewer opportunities to invest that at reasonable prices. Again, I don't know that we would disagree with that across the board. However, most of that is in the arena where technology comes into the purview, as opposed to businesses that frankly are a little ho-hum and mundane, and that's why I think in some sense it is a bit reminiscent of that pre-bubble-burst time when the obsession was with the fact that we really weren't going to need these traditional businesses any longer. Even if we had them, they were going to do business completely different than they'd ever done it before.

Frankly, we would agree with some of that because some of the technologies that are being developed, the biggest opportunities for them are in implementation, by what we would call traditional businesses that produce goods and services across a broad spectrum. I think valuation is a concern, but I don't think valuation is really a concern enough for most investors to change their behavior, if that makes any sense. It always takes something that somewhat slaps the proverbial them, whoever they are, in the face to get back to fundamentals. Fundamentals do matter, irrespective of whether or not some people think that there's a new paradigm for fundamentals, which we would not agree with.

TWST: Do you think the outlook for small cap is pretty decent right now? What's the general feeling?

Mr. Cook: Good question. I do think that it's a little bit of a loaded one, not that you're trying to give me a loaded question because it is one that's being asked. I think the way we would look at it is, clearly, there are a number of small to medium-sized businesses that have gone through a really challenging period since the commodity collapse and industrial recession, if you will, in 2015. That's not just an industrial piece. That's across a broad range where there was easy opportunity to go out and make fairly significant acquisitions, and people were fortunate enough to not pay exorbitant multiples. I think there still remains good opportunity in that small-to-mid space.

We would say on the flip side of that, that while we certainly would not ever suggest that we have any great skill in the high-tech space, it seems that when businesses are trading at 10 times revenues and aren't making money again, that's something that was occurring back in the late 1990s and early 2000s as well. That seems a little challenging, and any valuation would seem steep. So maybe to point specifically to your question, I think there are small to medium-sized businesses that offer what we certainly believe, that we can go out and find 22 to 27 to 30 small to medium-sized businesses that would meet our criteria that frankly are underappreciated and undervalued.

Now, when that is all going to reveal itself, I think people will have to get focused back on core fundamentals in order for that to happen, but usually, that happens way after some period of real execution by those businesses, and so there's kind of a rush. I'm sure as long as you've been covering all this, you realize that in the small to medium-sized space, boy, when there's a rush to sort of transition out of one thing into another, the space gets very, very tight, and so ownership is a real premium at that juncture. It doesn't feel like that sometimes when people are looking the other direction.

TWST: Given some of the trends that we've been talking about, why might investors want to consider working with a boutique type of firm like you have as opposed to maybe one of the really large companies when they're working on their investments?

Mr. Cook: I have always felt like from the very beginning that one of the biggest values that we're going to bring is that this does matter to us. This is our lives. I mean, I have spent the better part of the last almost 30 years on this, and this is still the most significant source of income and wealth for all of our people on our investment team and our management team. So for all of the owners in SouthernSun, it is meaningful. So first, it matters to us every day, so we have to get up every single morning and we have to think about how we can be the very best that we can possibly be. I think that does give us an edge. I think it's given an edge from the beginning.

The second thing I would say is, we are going to have a longer-term view. Even when clients become impatient, when things look as if that what we're doing is passe or when clients are afraid in the marketplace because of valuations, we will still stick to our longer-term approach. I was at a dinner last week, and someone stopped me and said — because I kept using the term, "this particular business that we own" or "the businesses we own" — he said, "Wait a minute, are you in the private equity business or the public equity business?" It is a habit around SouthernSun to talk about our businesses. So we think of them as organic.

As a result, we're highly critical. We see all the capacity to be able to look at them objectively, but I think more than anything else, we're going to spend the time and energy around those businesses and find the few things that really matter as opposed to what I think has become part of the investment pop culture, and that is this notion that more data is better. We can analyze every aspect of everything, and somehow or another that gives us an edge; when in reality, what we know is it actually creates an asymmetry over some time, simply because you're valuing third-party information to sort of build that from the ground up. So our focus is on what are the core drivers and risks of the business that we can follow, we can understand, and as a result, we think we have a better handle on potentially valuing that business over time.

I would say the second thing is that long-term view point. While it would have been equally frustrating for someone that would have been a client back in 1998, 1999, when you get past 1997, 1998, 1999, you recognize that the opportunity set is one that's substantive and fundamentally strong when you have a long-term perspective. And you would have been glad you stuck around through those difficult years with us given what then followed.

TWST: Thank you. (ES)

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