# Manager thinking

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Laurium Capital
Manager of the Curate Momentum Equity Fund

## Why we constantly review our investments

Once we have made a decision to invest in a company, we don't consider that "job done". We constantly review our investments based on new information and their valuations relative to what else we could be holding.

Sometimes, this might make us like an investment opportunity even more and we will buy more shares. At other times we might think something has changed to make the investment less attractive, and so we will decide to sell some shares or exit an investment completely.

For example, we recently sold out of our entire position in Sappi. We had invested originally because we felt that Sappi's earnings were cyclically low. This is important, because if earnings are low, the share price could be similarly depressed. If the share price does not factor in a recovery and earnings recover off cyclical lows, the share price could recover too.

Sappi is known as a paper company, and its graphic paper division faces a structurally declining market. Uneconomic industry capacity closures led to reduced supply, which resulted in higher prices and margins as demand recovered during the Covid-19 pandemic.

But beyond paper, Sappi is also a significant producer of sustainably certified dissolving wood pulp. This is used to make viscose, which is a more sustainable fabric used in clothing production.

When we looked at Sappi, we also believed that the net debt the company was carrying of around $2 billion was unlikely to go higher. This was based on our view that its future earnings and free cash flow expectations were likely to improve and normalise.

As it turned out, we were fortunate that this is what happened. Sappi's earnings did recover off a low base, and its cash flow improved. By the end of its 2023 financial year, Sappi had reduced its net debt position to about $1 billion. This improvement was reflected in the share price, with the rand value of Sappi stock almost doubling over this period.

In fact, Sappi's recovery was so significant that the $1.27 in earnings per share it reported was more than double our assessment of what we believed normalised earnings should be (using mid-cycle commodity prices and margins). In addition, the largest contribution to this increase in profitability and cash flow was the graphic paper division. Graphic paper prices rose exponentially due to logistics issues caused by Covid lockdowns and cost pressures. The result was that Sappi's profit margins were the highest on record and significantly higher than our assumed mid-cycle scenario.

Sappi's share price recovered to our assessment of "fair value" – in other words, what we saw as a reasonable price, where our view of the probability of earnings and the share price moving higher was relatively low. We therefore decided to reduce our position in favour of other opportunities where we expected relatively better risk-adjusted upside.

Ultimately, we exited our entire position in Sappi as we believed the potential risks to the share price falling outweighed the likely rewards. Our current view is that Sappi's need to convert graphic paper plants to specialised packaging paper plants will require capital expenditure, thereby reducing cash flows and increasing debt levels, which could place additional financial risk on the company.

This is likely to be our investment approach when investing in cyclical companies. Opportunities can emerge where markets price them inappropriately at the bottom of a cycle when earnings are depressed. We invest in companies where we feel that the market has not appropriately priced in our assessment of normalised earnings, especially where we feel that the risk-reward scenarios are skewed to the upside.

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