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MY FIVE MINUTES WITH BILL MILLER

In April 2016 I attended a Chartered Financial Analyst Institute (CFA) event in Chicago where the famous investor Bill Miller was a guest speaker. I enjoyed his talk because in true contrarian fashion he spoke about investing in the airline industry (this was before Warren Buffett made his investments), as well as in Amazon, and he also mentioned that he had also made an investment in the highly controversial pharma company Valeant.

The morning after his talk I was sitting in the restaurant having breakfast when he came and sat down at a table close to mine. He was on his own so I thought that before his food arrived it might be a good opportunity to tell him how much I enjoyed his talk. I went up to him and said hello and then he started asking me where I was from and what I did and when I told him that I had my own investment advisory business in Ireland he took me completely by surprise by asking me about what companies did I find good value in the market at that point in time. The first thing that came in to my mind was the fact that I had fairly recently added to my investment in a small Hong Kong based company called Lung Kee. As soon as that thought arrived in my brain I realised that Bill managed far too much money to be interested in a tiny illiquid company like Lung Kee so I spluttered out that I was able to look at really small companies that were not well known and were not covered by many analysts and therefore might be cheap. I then went on to say that those companies would surely be far too small for him but once again he surprised me by saying that with his own money he was able to invest in less liquid ideas. I therefore started telling him about why I was so keen on Lung Kee. I mentioned the following:

- I can understand the business (making a mould base for plastic injection moulding is not that complicated)
- The accounts are also simple to understand (Lung Kee has grown organically and has not made expensive acquisitions)
- The business is conservatively financed (Lung Kee has net cash on the balance sheet)
- Management appear trustworthy (Lung Kee is a family controlled business that was listed on the Hong Kong exchange in 1993)
- There are some relatively limited barriers to entry / economic moats allowing the business to make decent returns on invested capital (The extent of the barriers to entry in Lung Kee's business is debateable and therefore it has to be acknowledged that this is not a truly great business but I would argue that it is still a good business)
- The price is cheap enough to allow a margin of safety (Lung Kee was at the time selling on a Price to tangible book value of less than 1 and a Price to Earnings of less than 10)

By the time I had gone through my short outline of Lung Kee, Bill's breakfast had arrived. I thought I better not overstay my welcome so I asked him for a photo and wished him all the best. That was the end of my five minutes with Bill!

If I had had a few more minutes with him I would have loved to go into more detail on my investment in Lung Kee because I think it highlights one of the most interesting aspects of Value Investing- the importance of patience.

I first came across Lung Kee back in 2012. I was looking at a list of investments held by the Royce Funds International Micro-Cap Fund. There was a number of companies on the list that I had never heard of so I had a quick look to see what each one did. One of them was Lung Kee and the reason why they attracted my attention was because they were in an industry I knew something about.

An uncle of mine used to own an extrusion moulding business. His main product was plastic packaging for the electronics industry. Each product was made in an extrusion moulding machine and each product had its own metal mould. I went with him one day to one of his suppliers to collect a new mould and he explained that being able to quickly design and get his own moulds was critically important to his business.

When I read that Lung Kee made mould bases for the plastics industry I therefore had a basic understanding of what the product was, what it was used for and why it was an important product for their customers.

Once I realised that this was a company in an industry I knew something about I turned my attention to their annual reports. At that time the most up to date one was 2011. From this I discovered the following:

- It was a family run business where the family still owned a controlling interest.
- They were the market leader in China. Competitors were mainly small local companies.
- They were not dependant on a small number of customers.
- The accounts were relatively easy to understand and I particularly liked that their cash balances far exceeded their borrowings allowing them to pay a generous dividend.
- It was cheap based on historic numbers. A P/E of 6x 2011 earnings.

I also discovered however that in the short term earnings would probably be under pressure. First of all they had just opened a new workshop at their main factory and productivity had been impacted. Here is the section from the annual report highlighting this issue:

the Group has successfully merged the production line and facility of factory in Guangzhou, Guangdong Province, China into the newly established high precision mould base production workshop located in the Heyuan factory, Guangdong Province, China. The new workshop concentrated on producing high precision mould base for exporting to overseas countries including Europe, the United States and Japan. ***During the merging period, the production efficiency of high precision mould base had been temporarily affected, but it is expected that the production will be gradually regain its impetus and become more efficient.***

Secondly they were facing rising wage costs because skilled labour was in short supply

Despite the skilled labour shortage prevails in China, the Group tends to suffer less on such aspect. ***Nevertheless, its labour cost will be unavoidably increased****.*

Thirdly they were building a totally new factory in Eastern China (and new factories rarely go to plan!)

To pursue its long-term development goal, the Group has set up a new plant in Hangzhou city, Zhejiang Province, China. Once the construction of the new plant is completed, and the production line begins to run, the Group will gain new impetus to further exploit the business potential in the Eastern and Northern region of China.

Having read the 2011 annual report I had a quick look at their older annual reports. Nothing in the older reports gave me cause for concern. I also looked at their competitors and I also tried to find out about the Siu family by doing a simple Google search.

By this stage I had reached the conclusion that Lung Kee would make a good long term investment and that its short term problems might give me an opportunity to buy at a decent price. The only problem was that I did not know how long those problems would last. I therefore made a small investment on November 23rd 2012 at HK$2.49 per share with the intention of buying more if the price fell.

In the second half of 2013 the new factory in Hangzhou started to operate but as is pretty normal in a situation like this, the start-up did not go smoothly. The following was what was said in the 2013 annual report:
Since it took time for coordinating the manpower, machineries and equipment, the Group's performance was impeded notably during this period.

By the time of the 2014 annual report the new factory was still not where they wanted it:
The time required for training new staff together with an ever-rising wage level limited the production output. Consequently, this plant was still in an imbalance of revenues and expenditures.

By this stage the share price had fallen below my purchase price (see chart appendix 1). These problems had hurt profitability and had resulted in share price weakness but at least I was able to read that productivity was improving at the main factory:
The result of these measures is encouraging. The production skills became more mature in the high precision mould base production workshop of the Heyuan factory.

I think it was around this time that I noticed the Royce Funds International Micro-Cap fund no longer held Lung Kee. Naturally enough I wondered why they had sold. Had they found a better idea? Had they given up due to the fall in profits with no certainty as to when things would improve? Had they discovered something completely different? To this day I still do not know why they sold but I felt that all I had to do was be patient and ultimately they would sort out the new factory.

I was still thinking about buying more but it wasn't until I read the 2015 interim report that I finally acted and bought at HK$2.07 on September 1st. Here is what I read:
the improved operation of the plant in Hangzhou city, Zhejiang Province, China, the Group's performance and profit recorded a slight increase when compared with that of the same period in 2014.
I felt that this was confirmation they were finally turning the corner and this was therefore a good opportunity to buy. Little did I think that a few months later I would be talking to Bill Miller about this purchase!

I'm not sure if Bill would have enjoyed listening to the full background to my Lung Kee purchase but at least he would have realised that this was a company I had owned for over three years. He would also have realised that I had some basic knowledge of the industry.

I doubt that Bill ever looked at Lung Kee and at this stage he might struggle to even remember that 5 minute conversation but I haven't forgotten and I still have that picture up on my Facebook page!
I also said to myself that I would write about this event if my patience worked out and the Lung Kee share price doubled from the time I met Bill and went through HK$4. As can be seen from Chart 1 in Appendix 1, this finally happened after the 2017 interim results when they announced a substantial special dividend and were able to state the following:
In spite of the spiral increase of wage cost, the Group succeeded in further uplifting its productivity per capita and production efficiency. At the same time, the depreciation cost of machinery reduced as compared with the same period in last year, thus, the rising pace of production cost was alleviated.
On top of the capital appreciation I have also received HK$1.29 in dividends since the original investment in 2012. (Over half my original purchase price).

CONCLUSION

Value investors often talk about the need to be long term and patient. My almost five year journey with Lung Kee has been an interesting example for me of just how rewarding that journey can be. (I'm just not sure if Bill Miller joined me on that Journey!)

APPENDIX 1 LUNG KEE SHARE PRICE (HK$)

The Big Short! (Bill Miller is the Big one on the left and I'm the Short one on the right)