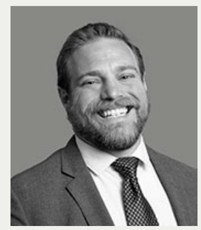
Opportunities Across the Cap Spectrum

DIAMOND HILL CAPITAL MANAGEMENT

We recently asked portfolio managers Chris Welch and Aaron Monroe about their thoughts on the current market environment and where they are finding investment opportunities.

Chris Welch, CFA
Portfolio Manager



Aaron Monroe, CFA
Portfolio Manager

With rising markets pushing valuations higher, where are you finding opportunities?

Chris Welch: Higher valuations have made it more challenging to find ideas that are trading at attractive levels, but we have found pockets of the market that are relatively compelling. Financials is one area. Financials have spent the decade-plus following the Global Financial Crisis cleaning up balance sheets, meeting higher regulatory capital levels and engaging in more prudent underwriting. What we are more interested in, though, are banks that have carved out a specialized niche and/or have a strong geographic footprint giving them a powerful competitive moat even compared to larger players. We are looking for proven, conservative underwriters that have demonstrated their ability to compound returns and grow intrinsic value.

For example, First Interstate Bank, based in Billings, MT, has a unique footprint in the northern Rocky Mountains and Pacific Northwest. It is a community bank with locations across Idaho, Montana, Oregon, South Dakota, Washington and Wyoming. First Interstate has a long, proven history within the region and boasts significant market share in several of its markets. The company has also demonstrated a strong ability to acquire and integrate complementary banks. We also like that it is still owned in part (approximately 33%) by the founding family, which aligns with our patient, long-term value creation philosophy.

Other examples include Sterling Bancorp and Bank OZK. Sterling is a well-run commercial bank based in the Hudson River Valley and Long Island with a focus on small and mid-sized enterprises. The company has proven to be an astute acquirer, executing three larger acquisitions since 2013, contributing to the double-digit growth in its tangible book value. Most recently, the company has announced its pending merger with Connecticut-based Webster Financial, which we believe will be accretive over the long run. Of particular interest is Webster's HSA platform which is a nice source of low-cost deposits that can be utilized by Sterling's stronger commercial loan engine. We think the combined franchise will be well positioned to continue to compound intrinsic value over time. Bank OZK has grown to be a respected partner in commercial real estate development. Its Real Estate Specialties Group tackles highly complex real estate transactions and is a conservative underwriter, as shown by its minimal credit losses over many years of experience.

Given increased concerns of COVID-19 variants, how is the travel and leisure industry faring?

Aaron Monroe: The growing prevalence of the Delta and other variants is raising concerns about a return to heightened travel restrictions. That doesn't change the fact that pent-up travel demand remains—and any reversion to travel restrictions will add to that suspended demand. Given the unpredictability in the near-term of how various virus strains play out and the trajectory of vaccination rates globally, we do as we always do—look to long-term cash generation potential and the company's resilience to reach the long term.

For example, air travel has been particularly hard hit, and the future of business travel remains a question, but we believe that, eventually, people will return to more normal vacationing patterns. For those reasons, we think airlines like Allegiant are particularly well positioned. Allegiant is 100% focused on leisure travel, which has been recovering first, and it benefits from having a more flexible route structure than peers.

Another name we think is particularly well positioned for the long term is casino operator Red Rock Resorts. Red Rock controls over half the Las Vegas locals market, where government legislation restricting greenfield development has effectively created a duopoly. The company should also benefit from favorable conditions for economic expansion in Las Vegas, including an attractive tax environment driving in-migration.

The timing of shutdowns was initially challenging for Red Rock—it recently finished a remodel of the Palms resort, which increased leverage. But management was particularly effective in the downturn—managing costs well and using cash generated to pay down debt. In addition, management has done an outstanding job selectively adding back ancillary services, which has helped the company continue to deliver record margins. Red Rock recently announced the sale of the Palms, which will further improve its balance sheet.

In our view, a greater challenge to the travel & leisure industry than rising variant cases is finding qualified employees, which could increase wage pressure and impact the client experience—which would be detrimental to the return of future customers. However, Red Rock is well positioned here—it retained most of its employees throughout the pandemic, giving the company a competitive advantage going forward.

How is the potential for higher inflation impacting investment opportunities?

Chris Welch: With interest rates on the decline a bit, the near-term concerns about higher inflation seem to be cooling off. However, the odds of higher inflation ahead are higher than they were a few years ago—you can read more about our thoughts on inflation in a recent blog we posted. We know that some businesses can fare better in an inflationary environment, and we are also looking at which businesses can more successfully pass on higher prices and how quickly.

We have been cautious about getting too aggressive with energy stocks—an area that does tend to benefit from heightened inflation expectations—given the potential long-term demand threat as consumer behaviors shift. We like our focused exposure to companies in a strong competitive position with productive assets and good long-term cash generating capability—even if there's a shortfall in long-term demand due to climate change and other factors.

We also own other stocks that might benefit in a higher inflation environment. For example, we like timber REIT, Rayonier—a commodity-based business which stands to benefit from rising log prices over the long term. Shell-egg producer Cal-Maine should also be positioned well for rising commodity prices. It invested significantly in cage-free egg facilities in recent years—in effect, spending yesterday's dollars—putting it ahead of competitors as California's law requiring all eggs sold in the state be cage-free goes into effect in 2022. Archer-Daniels-Midland should be a beneficiary of rising commodity prices with its agriculture processing businesses. And some of our industrial stocks, like Colfax Corporation with its welding equipment division, would stand to benefit from increased economic activity, including a potential infrastructure bill.

As of June 30, 2021, Diamond Hill owned shares of First Interstate BancSystem Inc., Sterling Bancorp, Bank OZK, Allegiant Travel Company, Red Rock Resorts, Inc., Rayonier, Inc., Cal-Maine Foods, Inc., Archer-Daniels-Midland Co. and Colfax Corp.