Several times a week, Seeking Alpha’s Jason Aycock asks money managers about their single highest-conviction position - what they would own (or short) if they could choose just one stock or ETF.

James Vanasek is co-founder of the VN Capital Fund, a $47 million fund focused on six to 12 small-cap stocks and a low-turnover, conservative value investing philosophy. Since its 2002 founding the fund has returned 13.5% annually net of fees and expenses. Previously, he worked for JPMorgan Chase.

First, you've talked with us about high conviction holdings before, so welcome back.

Thanks, it's great to be back. If it had not taken us so long to amass our position in this stock (500,492 shares as publicly disclosed in our recent 13D filing), it would have been much sooner.

It's been just short of a year since we talked about your conviction holding of Big Rock Brewery (BRBMF.PK) - the “Sam Adams of Alberta” - and it's up 6.2% in that span, though it swung more than 10% in either direction at times. How did the trade work out for you?

So far, Big Rock has done very well for us as we still hold our position in the company. We originally purchased shares for our fund in October 2006 at $12-13 per share and increased our holdings when the stock dipped to $6-7 per share during the market crash in late 2008/early 2009, so our overall cost basis is a little below that amount. Although there were some price swings, we'll gladly take a 35% price appreciation plus $4.92 per share of dividends during a time period where the S&P 500 was flat.

Even though the share price fluctuates a bit due to the lack of liquidity, the company keeps doing the most important
thing, which is sell more and more of its great-tasting beer and generate more profits for its shareholders.

**Today, if you could only hold one U.S.-traded stock position in your portfolio (long or short), what would it be?**

**Breeze-Eastern Corp. (BZC),** a small New Jersey-based manufacturer of helicopter rescue hoists, cargo hook and weapons handling systems, with around $60 million of annual sales.

Tell us a bit more about this sector. How much is this an "industry pick" as opposed to a pure bottom-up pick?

The helicopter rescue hoist market is a tiny, stagnant sliver of the overall defense/aerospace industry. The company, however, is expanding into new areas like cargo winches for the Airbus (EADSY.PK) A400M aircraft, to the point where they expect $10-20 million in additional sales per year over the next 10 years from new contracts that they have just completed development work on.

While on the margin higher defense spending does flow through to their programs, ultimately a surge in defense spending doesn’t affect their programs too much. In addition, around one-third of Breeze’s sales are from non-U.S. government contract work.

Tell us about Breeze-Eastern’s competitive environment. How is it positioned with regard to competitors?

Breeze-Eastern has a dominant market position in helicopter rescue hoists with around 60% global market share. Yes, 60%! Their only competition consists of a small division of Goodrich (GR) which accounts for the vast majority of all of the remaining worldwide sales. There are also a tiny number of Russian manufactured rescue hoists out there, but for all practical purposes, their threat (as well as that from any possible low-cost new Asian-manufactured hoist) is nonexistent, since I don’t know of anyone who would want their life depending on a knock-off piece of equipment while they dangle from a helicopter.

Breeze has been able to sustain this level of dominance because there are very high barriers of entry into this market. It takes years of intimate work with the large manufacturers (AgustaWestland, Bell, Sikorsky, etc.) to incorporate the rescue hoist with all of the other systems in a helicopter. Thus, once awarded the development contract, Breeze will produce rescue hoists for the program’s duration - which could last up to 20 years or longer.

Given that level of effort, it is almost impossible for another manufacturer to come along after helicopter production has started to get their competing hoist certified for use. In addition, once its products are installed on a helicopter, Breeze has a monopoly position in providing the servicing, repair and maintenance for those systems - an amount that accounts for around 25% of the company’s overall revenue.

Sounds like a solid position.

Unfortunately, even though Breeze is the dominant worldwide player, old management felt the need to bid very aggressively to win contracts - going so far as bearing the cost of all the design and development work up front, in order to make it up on spare parts and maintenance throughout the long production run. This exposed Breeze to all sorts of financial risk if projects were delayed or changed - which of course occurred, costing the company millions
of dollars over the past few years.

Much of that could have been avoided if Breeze had (a) been more aware of its market position and not bid against itself for certain contracts, or (b) simply allowed Goodrich to “win” some of that money-losing work.

Given its market leadership, Breeze has the ability to set the ground rules for how both it and Goodrich should compete against one another, and I doubt that either company would be foolish enough to go down the path of not forcing the helicopter maker to at least pay for their development work.

**Aside from competing in hoists with Goodrich, with BZC expanding into new aircraft-supply areas, does that expose them to new competitors (and, like Goodrich, bigger competitors) in that segment - such as AAR (AIR)?**

That interesting thing is that for cargo winches, Goodrich really is the only other player out there as both Hoover and Edwards have gone out of business. I suppose some other companies like Cobham Plc (CBHMY.PK), ESW or Bendix could try and enter the market, but none of them have the specific technical knowledge and engineering staff to do so. Probably Columbus McKinnon (OMCO) is the one company who could in theory take some of their overhead material handling equipment (hoists, lifts, chains, etc.) used on factory floors and apply them to helicopters and aircraft.

**How does Breeze’s valuation measure up?**

With an enterprise value of $77 million, Breeze-Eastern currently trades around 5.7 times its fiscal year 2010 cash flow and 21.5 times fiscal year 2010 earnings.

It’s important to realize that both of those numbers have been depressed over the last couple of years and will be boosted going forward, for a variety of reasons. First, the company has finally worked through a sizable amount of engineering and development cost surrounding a host of new programs, including millions of dollars in charges related to the A400M cargo plane winches.

Next, Breeze took an $8.1 million environmental charge dating back several years to properties disposed of by Breeze’s former parent, TransTechnology Corp.; took a $3.3 million charge for obsolete inventory; and incurred $0.8 million of expenses in relocating its production facility. Third, the move into the new plant is complete and will allow for efficiency gains. Finally, potential exists for a yearly million-dollar boost to net income by going dark and avoiding public reporting requirements and Sarbanes/Oxley-related costs.

**What is the current sentiment on Breeze?**

Market sentiment is nonexistent as few investors have ever heard of Breeze-Eastern. Average daily volume is very low (around 8,300/shares per day are traded on the AMEX exchange) and it took us over seven months to amass our position. During that same time, one other large holder, ValueAct SmallCap Management, recently purchased their 8.4% stake in the company, leaving seven holders (including us) owning 85% of the company’s outstanding float.

Anyone in the helicopter search and rescue field knows Breeze-Eastern very well, as their lives depend on the company’s product.

**Does the company’s management play a role in your position? If so, how?**

We believe that the company’s management is an important piece to the investment story.

In the 1990s, Breeze-Eastern was the crown jewel division of a company called TransTechnology Corp. At the time, Chairman & CEO Michael Berthelot felt that given the limited amount of rescue hoist sales out there, the company needed new products and markets to grow. While Breeze did grow organically into natural extensions of its core product line, like weapons handling systems and cargo hooks, unfortunately TransTechnology took a lot of Breeze-Eastern’s cash flow and embarked on a 10-year acquisition binge.
Of course, you can probably guess that the company overpaid for way too many poorly performing targets, nearly ruining the company under an avalanche of debt. After spending the early 2000s shedding many of those businesses at a loss, the company was in such poor financial health that in 2006 it needed an $18 million capital injection from Tinicum Partners, which eventually ended up owning 26% of the company. At the same time, another activist investor, Wynnefield Capital Management began building what would become its 21% stake in the company.

While Tinicum and Wynnefield initially worked together to remove Michael Berthelot, the two investors bickered at times with each other about the company's recovery strategy and board membership. Eventually, both parties realized that they wanted the same thing, a smooth running, profitable Breeze-Eastern run by competent management. They laid their squabbles finally to rest by splitting control of the board and appointing Mike Harlan as CEO in August 2009.

Mike’s mandate was simple - clear up the project engineering backlog, move into a new plant, tighten up cost controls and make sure that the company does not enter any new developmental contracts with open-ended financial risk.

**What catalysts do you see that could move the stock?**

As I mentioned, Mike Harlan has spent the last sixteen months fixing problems, and after following Mike’s performance closely, including a couple of company visits, we are pleased with the progress that his is making on all those fronts and his success (or failure) will be the key driver to the company's future performance. As Mike’s turnaround is completed and the company does a better job of entering into related product lines, Breeze should see dramatically improved financial performance.

We also believe that the highly consolidated share ownership is a major plus going forward. First, we believe that the company will be run in a very shareholder-friendly manner, insuring that the company’s owners will see the fruits of these labors. Second, we feel that Breeze is a prime candidate to “go dark” and save up to an additional $1 million per year. Finally, our guess is that once the company thrives, the board will look to either sell the company to a larger defense player or go private, either of which will be done at a premium to the company’s current stock price.

**Can you detail a bit for readers what would be involved with BZC going dark?**

Sure. The main requirement to suspend public reporting obligations is for a company to have fewer than 300 shareholders. Thus, generally the first step to go dark is the board of directors approving a reverse stock split and subsequent odd-lot tender offer to repurchase the fractional shares. Most of the time, the offer is set at a slight premium to the current stock price so as to (a) ensure the offer gets approved, and (b) avoid any lawsuits from stockholders who say they didn’t receive a fair price for their shares.

If shareholders vote in favor of the tender offer, the company conducts the reverse split, purchases shares and then files a Form 15 with the SEC which suspends the company's duty to file public financial reports. Although the company’s stock is then de-listed, most of the time it will still trade on the pink sheets. In addition, many “dark” companies still post financial information on their websites or send their quarterly and annual reports directly to their shareholders.

**What could go wrong with this stock pick?**

Execution risk is clearly the biggest potential pitfall to this investment, or any other turnaround situation. We are pretty confident that the bloc of large shareholders will be holding Mike Harlan’s feet to the fire, and in the event that he fails to fix the operation, then someone else will be brought in quickly. We also gather comfort in that if the franchise survived all the turmoil and mismanagement over the past 15 years, it could shrug off any small mistakes Mike might make going forward.

Besides execution risk, one of the company’s big future projects is dependent upon the Airbus A400M cargo plane. That multinational project has suffered from a series of delays, cost overruns and customer cancellations which have put its completion at risk. While it accounts for a large part of Breeze’s $130 million order backlog, cancellation would not cripple the company given its financial strength.
And thanks again for sharing your thoughts with us.

My pleasure. I look forward to discussing our next idea with you and your readers.

**Disclosure:** Long BZC.

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If you are a fund manager and interested in doing an interview with us on just one stock or ETF position you'd hold, please email us at Just One Stock.

Comments on this article

Add a comment

Marc Gerstein

I'm not sure if this should be directed to Mr. Vanasek, the hedge-fund manager or Mr. Aycok, the Seeking Alpha editor, but here goes:

Why is this stock being featured in this high-profile editorial context? What am I or any other reader supposed to do with the information?

Is there a hope that readers will be interested in learning more about the hedge fund and, possibly, becoming investors assuming they are qualified in the context of hedge funds?

Is there an expectation that readers will find the stock appealing and want to buy it?

In terms of the latter, I have to frankly confess that I didn't really absorb much from the discussion of the company because I couldn't focus; I couldn't get my mind away from the horrible liquidity (Does the fund REALLY have a 35% return; is there any chance such a return could actually be realized absent a private buyout?) and the possibility that the company may go dark.

Even if a buyout can be arranged and a nicely profitable selling opportunity surfaces, there remains the question as to whether it would be worth the risks associated with liquidity and going dark. There are plenty of other fish in the sea, even in the sub-micro segment of the market, that have produced comparable or better returns without these special risks.

I'm completely baffled by the point of this piece.

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Jason Aycock

Hi Marc ... thanks for asking; it gives me a chance to amplify the description at the top.

In terms of what we accomplish, the interviews (you can read more at seekingalpha.com/tag/j... and seekingalpha.com/tag/j...) I think speak for themselves -- for a while now, I've asked money managers what their high-conviction holding is, whether long or short. And then pressed into the fundamental details of why.

It's not too much more or less than that. The expectation is that you might get a perspective on an aspect of a security or asset class you may have overlooked, or a security like this one that's off the beaten path a bit. Our CEO, David Jackson, has explained the value of "buy-side research" -- not a recommendation for or against a stock, but a description of why a manager like James took the position he did.
And then down here we can ask questions and debate the merits, or lack thereof. Your second-to-last paragraph is the key one for me: Is it worth the liquidity risk, etc. Someone else may like or dislike its debt/equity ratio, and so on. It's not a recommendation but one person's explanation of a high-conviction position.

I have yet to meet a security that's for everyone, so -- as always -- your own due diligence needs to inform whether any investment, like BZC or the other stocks and ETFs that get mentioned here, is worth your time and money.

Feel free to message me if there's anything I can help clear up.

Marc Gerstein

Thank you for your response Jason. I may have occasion to further message you privately, but I want to address an important area of concern in this context since Mick Weinstein, when he was still with Seeking Alpha, had already made the issue public and expressed a hope for community input. I'm referring specifically to the article he posted on 12/3/08 entitled "Reconsidering Penny Stocks" (seekingalpha.com/article...).

Note: I'm well aware that the price of the stock presented in this interview is way above $.01, but it is a pink-sheet stock with risks akin to what you find as you move toward down below $1, so I think it's fair game to raise the matter -- I'll get to it later.

What you may not realize is that I was the catalyst for Weinstein's "Reconsidering Penny Stocks" posting. Back in the day, I submitted an article entitled "Taking Penny Stocks Seriously" wherein I discussed the challenges of investing in that area, presented a primarily-fundamental screen aimed at identifying credible ideas in that group, and discussing seven names that struck me as worthy of consideration for a Seeking Alpha audience. The article did not appear in the usual course. After several days, I contacted editorial and was told that there was a blanket policy of rejecting all penny stocks but that the editors were analyzing my submission and re-considering the policy. The Weinstein article is the result of those deliberations. (By the time it came through, my piece had gone stale and I didn't bother to re-write it.)

This particular fund-manager interview, and some others that have caught my eye, suggest to me that the policy may need to be discussed anew.

The focus of the old editorial policy and the Weinstein article involved price levels below $1.00. Actually, though, that may be something a huge distraction. Ironically, most of the stocks I discussed in the original article traded above $1.00; my screen used $3.00 as a top threshold. (My "error" may have been in using the phrase "penny stocks" in the title.) The real concern, as evident from the Weinstein piece, was the potential for sketchy occurrences in that end of the market and as we see, the $1.00 price threshold may not be the best measurement. The concerns were liquidity, tradability, the potential for trading abuse, etc. Weinstein correctly used SIRI among others to demonstrate that there can be situations where these problems are not too threatening even if the price is below $1.00. In my opinion, this interview is an example of a situation where the concerns addressed by Weinstein can be resent even with a stock price way above $1.00.

This Just-One-Stock/ETF interview series looks to be taken very seriously by Seeking Alpha readers. We see one reader in this discussion area saying he's actually trying to buy BZC and another asking the sort of questions consistent with one who is seriously considering doing likewise. Should this be a concern? Even though these interviews aren't Buy recommendations, per se, it's hard to ignore the prospect of readers using the article as a basis for purchase decisions. Mr. Vanasek understands this, having expressed a belief in his reply "that the Seeking Alpha editors feel that people who read the article might be sparked to do some further research on the name, and possibly invest in the company."
So I wonder if the policy set forth in the Weinstein article needs to be refreshed. Forget the $1.00 threshold. The issues are trading risk and legitimacy, regardless of the price threshold.

I’d be happy to discuss this further (I, together with Forbes, publish a low-priced stock newsletter and have accordingly put a lot of thought into this topic), but private messaging may be the appropriate setting for more detail, at least for starters. Or if there's interest, I'd be fine doing it publicly, though I'm not sure it pays to stretch the discussion further as a comment thread for this specific interview.

Thoughts?

Marc Gerstein

On taking another look, I notice that my thoughts were bouncing back and forth between the stock Vanasek wrote about now and the prior one. Both bear exceptional and unusual risks that I believe warrant special consideration in the context of the 12/08 Weinstein article, but they aren't identical between the two stocks. The first one, BRBMF.PK, involves the penny-stock-like liquidity problems. The liquidity problems for BZC, the current selection, are merely horrible but not as much so as BRBMF.PK. Even so, BZC, the $7.00-and-change stock, would still fail the liquidity test I use for my under $3.00 newsletter. There's also the issue of the potential reverse split. That would, in this case, send the stock to the pink sheets and probably decimate what limited liquidity there is today. Also there's the issue of the firm going dark, in which case it may or may not choose to informally inform shareholders of future financials. Vansek suggests it will, but if it doesn't turn out that way . . . that could get incredibly ugly for any shareholder wanting to sell. In other words, the reader who commented here that he put in a limit order may get execution on the Buy, but it may be a one-way ticket; it's not clear he'll be able to do likewise when he wants to sell. Maybe shareholders will be rescued by a buyout. Maybe not. I'm not expressing an opinion one way or another on the probabilities. I'm just raising a flag to the effect that I've seen Seeking Alpha editors express discomfort with liquidity risks of this nature.

So despite the miscues in my prior post about which stocks was being talked about at which point in time, the fact remains that this feature is putting before Seeking Alpha readers a situation like this. And it's not isolated: In addition to Vanasek's year-ago interview, there's also a June 2010 interview with Kerrisdale Partners, another hedge fund, that talked about a stock it owned in an Australia-based payday lender penny-stock wasn't even tradeable on the pink sheets; there, you had to trade on the Toronto Venture Exchange.

I beleive Seeking Alpha readers and contributors need a bit more clarity on current ground rules.

Al in Oregon

I'm taking a shot at BZC - a small shot with a limit order. I like the story - it's believable. I checked out the financials - the debt's a little higher than I'd like, but I've started buying small positions in micro and small caps to tuck away for the long haul. I'm doing this slowly as I run across them. Last week I bought a little CNRD.

Vanasek

Marc,

Perhaps I can address a couple of your points. Seeking Alpha approached me a year ago (as well as a bunch of other managers) looking for what we feel are our best investment ideas. I did a profile of Big Rock Brewing (BRBMF) which was positively received and so the offer was extended to contribute another article whenever
we came across another good idea.

As far as our returns go the 35% return you saw in the article is our return is what we gained from our Big Rock position. If you want, you can go to our vncapital.net website and look at some of our past newsletters which outline when we first purchased our shares.

Yes, Breeze-Eastern is an illiquid stock, but for an individual investor who is looking to purchase a up to a few thousand shares there is enough liquidity to buy and sell a stake in the company. For us, however, we are very long term investors and are happy to own our position in a good, solid company while we Mike Harlan implements his turnaround.

I won’t speak for them, but I believe that the Seeking Alpha editors feel that people who read the article might be sparked to do some further research on the name, and possibly invest in the company.

I also be happy to answer any further questions you have about Breeze-Eastern.

Marc Gerstein

James,

Thank you for your response. As you can see, my thoughts are expressed in a comment above. I don't really have any questions about Breeze-Eastern per se because I don't do pink-sheet stocks and would not consider a stock that is or could go dark. It's not what I do.

Vanasek

No worries although I should point out that BZC trades on the AMEX and not the pink sheets.

JoeD99

Mr. Vanasek, very interesting on BZC. Where do you see the stock trading at in 12-18months? Thanks for your time.

Vanasek

Joe,

The short answer is that I (nor does anyone else for that matter) have any idea what the stock will be trading at since predicting the future is impossible.

What I can say, however, is that I expect the company's earnings to improve due to the turnaround, expected sales growth and the other factors I mentioned in the article.

When I want to buy a stock for my fund I look for minimum of a 30% discount from a very conservatively calculated intrinsic value and widen that to account for a number of risks, including illiquidity.

I do believe that 12-18 months might be too short of a time investment horizion, but I hope that we will see some nice gains in the stock over the long run given the fact that a smoothly running Breeze would be very attractive to any number of potential buyers (management, small private equity firms, other defense companies, etc.).
Why would anyone buy this illiquid stock with a terrible set of statistics that is largely owned by a few interested parties when, for almost the same money, they can own proven winners GSIT, NVMA, that should double over the next 2 years and continue to make new highs.

I am an eclectic investor