COVE STREET CAPITAL

Cocktail Napkins

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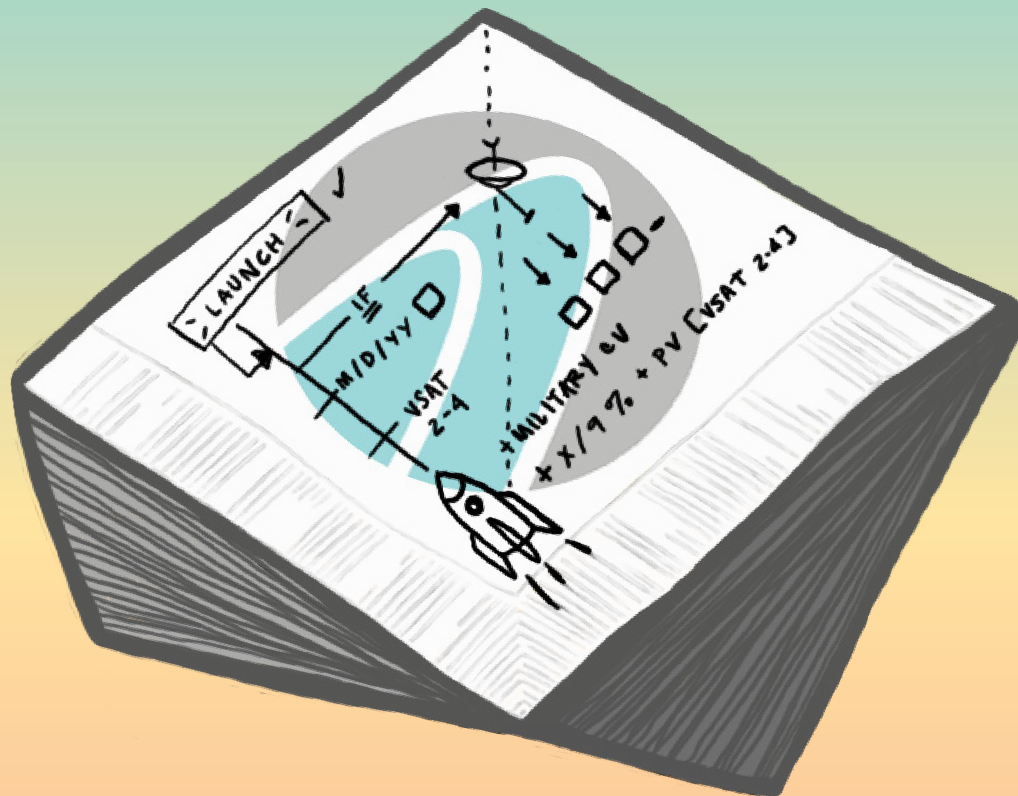

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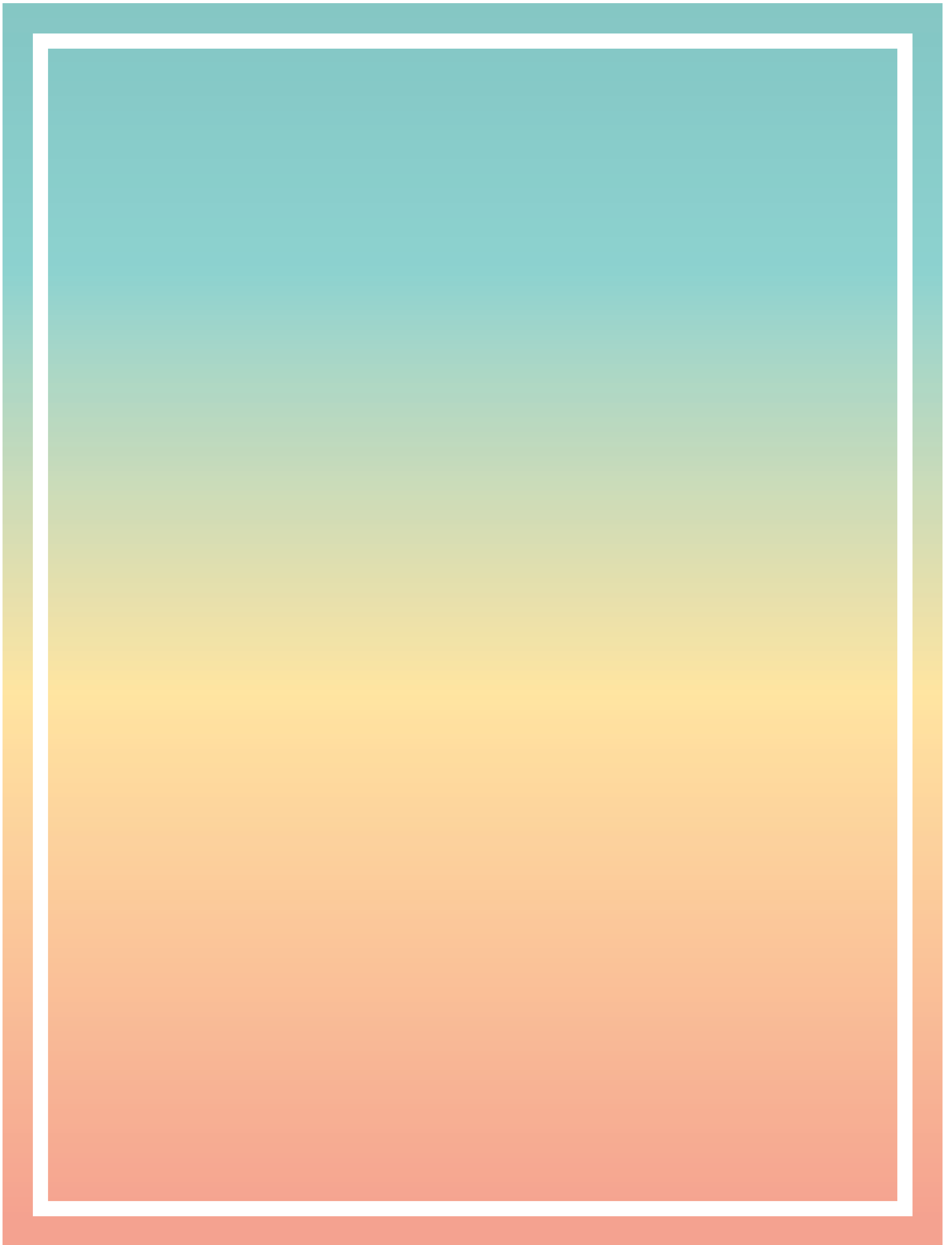

Cocktail Napkins

APRIL 2019 — The real Einstein quote that I was trying to reference is actually a paraphrase: "Everything should be made as simple as possible, but not simpler." This conceivably derives from something Einstein wrote, "It can scarcely be denied that the supreme goal of all theory is to make the irreducible basic elements as simple and as few as possible without having to surrender the adequate representation of a single datum of experience."

And tying it to our world, we have a similar one of those quotes that apparently was actually uttered, or emailed, to Bloomberg courtesy of one John McClain, a portfolio manager at Diamond Hill. He is officially anointed as today's "cycle whisperer." In reference to private equity firm Sycamore Partners, a firm which apparently is close to the lead in the "Dancing with the Credit Stars" for its work in structuring and restructuring the capital structure of Staples for the benefit of its clients and families—and to the highly likely detriment of new bondholders—he notes in regard to a recent refinancing of Staples debt: "This seems to be another credit agreement written on a cocktail napkin."

Espousing a simple investment idea on a cocktail napkin is pure genius. The Laffer Curve napkin brought lasting fame to economist Art Laffer. "Buy Amazon" would have been a nice one to stumble upon at a dinner in 2002, no further detail necessary. Sometimes it CAN be that easy, despite our efforts to make successful investing a lot more difficult than it has to be. And, since a cocktail napkin probably involves cocktails, one can always deny a bad idea the next day. Or just never remember it at all.

But, as of this writing, the Staples cocktail napkin seems to speak to us. Long time credit observer Marty Fridson notes that the percentage of corporate debt issuers blessed with the lowest rating handed out by Moody's was 19.7% in January of 1997. In January of 2008, it was 28%. It is now 43%.

According to numbers from a recent Bain study, private equity sponsors are paying an average multiple of 10.9x EBITDA vs. 9.9x in 2007. So, the only way to make the PowerPoint promised numbers work is...to use more leverage. Dutifully, Bain reports that 2018 buyouts are using an average of 6x leverage versus 4.9x in 2007. You may recall that 2007 was the year before something really bad happened.

We are also seeing the advent of "buyer and seller multiples." For each deal, the seller puts out a press release bragging about the multiple at which they sold. At the same time, the buyer puts out a press release touting an acquisition multiple 2 to 4 turns lower than what the seller claimed. Is today's environment a "safe place" for M&A where no one gets hurt and all sides have a great deal?

And for a moment let's ignore the implications of using EBITDA, a cash flow number that doesn't include reinvestment requirements. So let's make a statement upon which we can all agree: the state of accounting today is the worst we have ever seen in our careers. Specifically, the use of "adjusted" anything on even an income statement or worse a cashflow statement or worse a proxy statement, has dissolved into nearly complete BS and, in hindsight, will

likely to be seen as near fraudulent in many cases when the cycle finally turns. Thus, people are likely using more leverage on less real cash flow than these already inflated numbers are suggesting. If we aren't agreeing that this is somewhat scary, then I am sorry, but you need to look a little harder and dig out the cynical cap from the happy returns closet. And yes, there are still cycles.

Lastly on this point—before we move to its relevance for small cap value investing—is news from "a very large pension plan" with a pretty good record as the lead institutional bull piling into the trend du jour at the top. Because the plan needs to hit a politically determined 7% return target, it backs into that by hiring "risk/reward" strategies whose backward looking math plugs into the obviousness of achieving those returns in the future and weights things as such that they hit the 7% bogey. This strategy favors the flavor du jour which of course is private equity. All debates and absurd fees aside, the argument is that it is a necessary risk given the need to generate higher investment returns. The quote: "The new business model may or may not work. And it may or may not work now. But we will not know unless we try." Yup.

So, that is what bugs us the most about the world in which we invest. As we saw in the fourth quarter of 2018, minor changes in the risk appetite for credit has a large and unpleasant rollover into our equity world and we watch it closely. Things are no more "fine" and the willingness of people to extend credit on historically ridiculous terms is no more sustainable or less cyclical than it was 5 months ago. But, in the meantime, market participants continue to keep dancing as long as the music seems to be playing. And to add to Chuck Prince's fateful words on the weekend of the largest music festival in the US—Coachella—you can actually keep dancing with no music playing—via the Silent Disco. Come to think of it, that is not an inaccurate description of how Cove Street Capital works; as I am sure what we are doing on a daily basis compared to what the hedge funds on Showtime's Billions are doing would probably seem like Silent Disco if you looked in on us.

Many things do not change, despite our hopes and progressive dreams. It is truly a wonderful thing to Google back in time—let's say 100 years of financial history—and look at what the talking heads say at tops of markets, and then again at bottoms. Remove the date and you won't be able to distinguish the articles. Things like Uber and Lyft always go public at tops and are NOT signs of market strength. In fact, they are signs that very smart people who receive very high fees and aggressively use leverage want to take money off the table. And at very awful cyclical bottoms, there are hordes of nonsense printed about how people will be smarter and more conservative in their investing and consuming patterns and that we are on the brink of secular change in risk attitudes. We call BS.

Whining about the world aside, we have managed to do pretty well on an absolute and relative basis over the trailing 12 months in our core small cap strategy. Nothing changed about us or our process to rescue us from how dumb we looked for the year prior. Very simply, our largest positions started to work after a very…slow…period. As always, we have no idea why people suddenly woke up to the idea that broadcasting stocks indeed have a much shallower decline curve. Or that ViaSat (Ticker: VSAT) really is running the table on satellite broadband and that a DCF is really the tool to capture a negative upfront spend that allows you to reap the rewards in the future. Or that global warming might be a 100 year scenario with a probability attached to it, but in the meantime it can snow like hell in the Midwest and produce panic buying of road salt. Or that a company everyone loved to hate because it couldn't produce cash, but nonetheless was still a mission critical player in the industry, and was starting to be run in a competent fashion, could easily double or triple. But these are the ideas for which we have pounded the table until even our own Paul Hinkle would cringe when we told him what we were going to talk about at our next new client meeting.

Despite the nonsense du jour, the idea of value investing is not permanently impaired to the trash heap, even though we were recently told to our face that neither our strategy—smaller cap value—nor our fee structure—absurdly lower than the new low of "1 and half and 20"—were sexy enough. (I am sure there were thoughts of tossing me into that mix as well.) This comment was made to us at a Family Office conference that was heavy with great suits pitching cannabis, leveraged real estate, opportunity zone funds and educational "sidedoors" so that future generations won't squander the wealth created by their hard-working grandfather who still speaks with his immigrant accent. We may be grasping at straws, but then again we are based in LA so I doubt it.

However "sexy" one aspires to be in their personal life, investing in a sexy sector historically has produced decidedly unsexy returns to the buyer, but pitching such things remains a wealth enhancer for the seller and promoter. And to paraphrase my mother, if everyone else is doing it, it's probably not a great idea. The fact is that all "risk" assets go through long periods of poor performance and that's why it shouldn't take an advanced degree to understand the importance of diversifying across varying sources of risk, not avoiding them after periods of poor performance. "Size and value premiums," which last I checked, were/are the shizzle in quantitative investing, have strong historical evidence of persistence, pervasiveness, and statistical robustness as to why they should work for a very long time. Oh, and it just makes damn sense that less liquid and less researched companies of smaller size should create more chances of adding value in an active fee structure. So we stick to it.

Within our process, we do a lot of the things some people do: read 10K's; track management's "say/do" commentary; build thoughtful models to properly understand past facts and speculate about future outcomes; and use third-party

expert networks or build our own to better understand an industry and competitive positions. But, these are things that are just necessary to get into and stay in the big league ring. If you have no idea what you are doing because you haven't done the work, you inevitably will make bad decisions if things go wrong because you will get scared and emotional. And while it is difficult to "out information" a lot of the smart people out there, you sure as heck are at a disadvantage if you haven't made the basic effort to at least be at the plate to make an informed decision.

What I think we do well as a firm is religiously follow a process that methodically covers ground, and cultivates a self-awareness regarding ever-tempting behavioral mistakes. That combination enables us to see acorns as best they can be seen, and then be willing stuff our cheeks and weight the opportunities differently than can a number of our peers. We also REALLY try to think longer-term than do many of those who are on the other side of our decisions, and as noted above, that is also a huge competitive advantage if you can properly structure for it. And lastly, we try to continuously reassess what we previously thought was genius. This process purposefully tries to give no edge to seniority no matter how difficult it may be for some of us. And this "culture" is why I have managed to retain any number of younger analysts over the years, despite questions from the outside world to the contrary.

In closing, the going forward remains as unusual and uncertain as always, maybe particularly more so now. Most math and "anecdotes" seem suggestive to us that caution remains in order. But, as noted in what I thought was a good snag from London-based Capital Economics, "The real return from US equities in the coming decade could plausibly be less than a third of what it has been in the last 10 years (the average annual real return since 2009 has exceeded 15 per cent) and still tops the returns from other assets, notably Treasury bonds."

Within that backdrop, we study, we meet people, we get out of the office, and we wait for the businesses we like to reach prices that are reasonable. We look forward to the day that we can move from being a cautious little squirrel to a greedy one.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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