Some things and ideas: October 2019

Some random thoughts on articles that caught my attention in the last month. Note that I try to write notes on articles immediately after reading them, so there can be a little overlap in themes if an article grabs my attention early in the month and is similar to an article that I like later in the month.

A request:

- I'm just going to start blanket including this request in each month's post. One of the reasons frequency of posts / podcasts / other public stuff can fall off is because I look at them and wonder: "Is it really worth my time doing these for this small an audience?" A lot of work goes into all of these, and I hope that the output is generally of interest / high quality. If it is and there's someone you think would like this blog / the podcast, please share it with them. It would mean a lot; positive feedback / increased readership is what keeps the public posts coming!
  - This isn't meant to be a threat or anything! It's just frustrating to spend lots of time on something that you think is decently high quality and consistently see viewership numbers that would rival a local high school's newspaper or a North Korea / South Korea soccer match.
  - And a big thank you to everyone who reached out expressing how much they liked the blog. Honestly it means a lot to me!

Podcast: We did two podcasts this month . As always, you can find them on Spotify here.

- In the first episode at the start of the month, we

talked about We's failed IPO, the shift in September from growth to value stocks, and the chilled landscape for corporate M&A.
  - Global takeovers drop to Eight Year Low: came out after we did that podcast, but hit on many of the same points
- In the second episode, we discussed all the M&A in the high end luxury space: LVMH's bid for Tiffany (TIF) and the huge premium to take out Sotheby's (BID). Later, we discussed the NCAA's proposal to let student athletes profit off their image.thesecondepisod

Monthly value theory ponderings: Large cap stock style drift

- When I first launched my fund, I thought my focus would be generally on micro-cap stocks, with a particular focus on stocks trading at a discount to liquidation value. Those type of stocks are actually how I got my start investing, and a long time ago I wrote a now defunct blog that mainly covered those stocks.
- A funny thing happened after my fund launched though: the returns from investing in those micro-cap stocks were rather poor, and the majority of our fund's winners came from stocks in the $500m-$5B market cap range. There are a variety of reasons for this:
  - Some of it could be chalked up to small sample size (as I've mentioned many times, unless you have a 30 year track record or are running a quant strategy that makes hundreds of trades a day, I'd be very hesitant to learn too much or too firmly from historical investments. I.e. if you invest in one oil stock and it goes bankrupt, you probably don't want to learn the lesson "oil is impossible to make money," but you probably do want to be a bit more cautious around oil going forward. Even if you lost on 10 oil investments in a row, it could just be the environment or some really bad

luck despite the fact you were probabilisticly making good investments)

    - Some of it is just pure bad selection on my end. I found several companies that had nice assets and bad managers. I thought the price was cheap enough to counteract the bad management. I was wrong. Very wrong. Bad management at smaller companies is absolute death. Activist campaigns are too expensive to wage on small companies, and a bad management team will probably be willing to burn the company to the ground to fight off the activists and keep cashing those checks. I saw a few companies that burned multiple years worth of earnings on proxy expenses fighting off activists; when a company will burn that much money, even if the activists win there's unlikely to be a lot of value left.
    - Some of it was poor timing. One or two of the companies I invested in saw their stock prices do nothing or get cut in half for a year or three.... and then saw their share price explode higher. Unfortunately, they had become such smaller investments by the time that happened that they didn't have much effect on my portfolio, or over time I had lost my conviction in the company as they continued to produce middling results and sold right before the business exploded higher.
- Anyway, over time, my style has drifted a bit more towards large cap / better business quality.
    - Some of that drift is just the valuations I'm seeing: in general, I've found that a lot of large caps I analyze are better businesses and cheaper than some smaller caps. I'll use my largest position, Charter, as an example. It trades for ~10x next year's EBITDA. Small cap cable company Cable One (CABO) trades for >12x next year's EBITDA. Now, EBITDA is not a perfect valuation

metric, and forward earnings estimates are notoriously unreliable, but I use this as a simple example so let's just go with it. Charter is almost certainly a better business than Cable One, and it almost certainly has more room to boost earnings going forward (its margins are way behind Cable one, and that should normalize as Charter's pricing catches up and their integration gets further in the rearview mirror), yet CABO trades for a decent premium to Charter. Seems strange. I personally would rather own Charter all day versus Cable One, yet Charter's market cap is >10x CABO's and so should theoretically be much more efficient given the number of eyes on it.

    - Note that this was a pretty big simplification; some of the margin / valuation difference can be attributed to CABO having dropped most of their video business, so most of their earnings comes from the higher margin / multiple broadband business. Diving into that isn't the purpose of this post; the broad swaths of what I'm pointing out here are more important / accurate.

- Related to valuation, some of that drift is the really deep value opportunities drying up. We're ~ten years into a bull market (yes, there have been some near bear markets like Q4'18, but in general stocks have risen for the past ten years). That type of bull market tends to take away a lot of the "buy this company for less than liquidation value" opportunities.
- Some of that drift is the smaller cap opportunity set simply going away. I believe there are a lot less microcaps outstanding today than there were a decade or even five years ago, as increased public compliance costs and the rise of private equity

have pushed a lot of smaller companies to go private; in many cases, if you're looking at a small cap company and it hasn't been bought out / taken private, that's a mini red flag in and of itself.

- Why do I mention this? The goal of any fund manager is to outperform an index over a full market cycle (hopefully substantially!), and I wonder if that's possible buying into the largest companies in the index, even if you're doing it in a selective and concentrated way. I wonder if investors who are investing into larger cap companies are fighting the last war by doing so: over the past ~10 years, large caps have been the place to be, and anyone who focused on them has substantially outperformed. How likely is that to be the case going forward?
    - I mean, I honestly don't know. Let me give an example: if you came to me and said "My portfolio consists entirely of Berkshire, Wells Fargo, Facebook, Google, and Apple," I would look at that portfolio and probably like it. I don't own any of them, but honestly all of them seem reasonably undervalued and likely to do really well over time. They've got big moats, nice assets, conservative balance sheets, and they'll all probably buy back a lot of shares over the next few years. But you've invested in 5 of the largest companies in the world; is it really possible to outperform the index just going long 5 of the biggest companies in the world? I mean, that's like 10% of the S&P 500 index; can you outperform the index investing in its largest components?
        - And it's not limited to those five companies in the large cap space! Charter, Disney, Netflix, Comcast, and a few others are all companies I follow (either closely or loosely), and honestly I'd be pretty

positively inclined on any of them.

    - I also wonder if this is a "you never know who's been swimming naked until the tide goes out" situation. I would guess there are several investors who have done really well over the past few years from buying larger growth stocks and just holding them despite not having done a lot of differentiated research. I wonder if over the next few years investors who have stuck with smaller companies / doing their own differentiated work are going to see much better returns, and a few investors who have basically been hugging the largest companies in the index are going to be exposed as more index hugger than actual investor.
    - To date, my solution has been to have a bit of a blend of different investments. So yes, Charter is my largest position, and I own a lot of the MSG / IAC, but most of my smaller positions are on the very small cap / nanocap side, and even on the larger cap side most of my investments have some type of index under-representation or quirky accounting that keeps a lot of investors from getting involved. The hope is that combo gives me an interesting blend of situations / return profiles and keeps me turning over a bunch of different rocks looking for some super mispriced small cap. But I do wonder if my time, in the long run, would be better served focusing more heavily on the smaller cap side, and if my returns over a full market cycle would be better from doing so despite the fact my historical returns would have been better if I had done the reverse and ignored the smaller cap side in favor of focusing more heavily on larger caps.
- I don't know where I'm driving with this. But my readerrship consists mainly of individual investors investing their PAs and smaller managers (I'm sure

there's a larger manager or three in there who simply can't own anything but the largest companies, but simple demographics suggest those large managersare by far the minority of my readership), and I would suspect most of them have experienced some of the same issues or experiences I'm discussing over here. Writing's cathartic, so I figured I'd throw those thoughts out there.

Clearway (CWEN) update

- My thesis on Clearway won the VIC contest for early March 2019. so I figured I'd take the opportunity to provide a brief update (and toot my own horn a bit!)
- The thesis has played out pretty much as expected: PG&E has honored the PPAs so far, and I haven't seen any talks of recutting them. When the bankruptcy wraps, I'd expect the PPAs to emerge unscathed, and CWEN will get a huge cash inflow from the cash trapped at the PG&E assets, which will likely result in a big payout.
- As the uncertainty around the PG&E contracts has faded, CWEN's stock has responded in kind, with the stock trading in the $19-20 range recently, I think the stock is pretty fairly valued, and have largely exited.
- Anyway, I wanted to talk about the three takeaways I had from this investment.
    - First, investing into uncertainty cna be really profitable. PG&E was/is the major revenue source for CWEN, and the market shot first and asked questions way later. The PG&E assets were almost certain to be honered (based on both precedent and company incentives), and the asset level debt was non-recourse. Buying those assets for (effectively) free was an incredible opportunity; I wish I could find 5 to 10 of these a year!
    - Second, I find following people into investments is a bit overrated; you need to be able to do your

own due diligence and build your own conviction. But, in some situations, a knowledgeable party buying can be extremely helpful to solving some uncertainty. In this case, Apollo had likely done a ton of due diligence on CWEN's contracts / assets given they had invested across a ton of renewable assets, and they were aggressively buying CWEN stock. That should provide investors with a lot of comfort.

- Third, it's really easy in hindsight to have a winner and say "That should have been bigger," but I think that's the case for me here. Rereading my write up, I think that's clear: you had a bunch of contracted assets that were fairly simple to value, and the market had wiped out all the value for a set of assets that clearly had some value. The company dividended out basically all of their cash flow and the controlling shareholder owned a sizable chunk of equity, so while you could have some capital allocation concerns they would probably not be relevant until the PG&E issues were resolved and the share price was (hopefully) much higher. I had a bunch of calls with other investors were I would say something along the lines of "It just doesn't feel like there's any fundamental value risk here." Again, easy to say with hindsight, but the combo of those factors suggest this should have been a bigger position, certainly much bigger than I sized it.
    - Sizing is one of most difficult things in investing, and again it's really easy to bring hindsight into the equation. But whenever you have a big winner and look back and say "this should have been bigger," it's worth asking why it wasn't. Had you not done enough work to build extreme conviction on it? Were their some tail risks that kept you

from sizing it larger (i.e. if you are investing in a super undervalued company, but all of their value comes from a phase 3 drug that needs approval and the equity will basically be a zero if it doesn't get it, that probably needs to be sized a lot smaller than something like CWEN whose value is more stable.)? Did you have better opportunities that you didn't want to sell? For me, in CWEN's case, I think it was some combination of the first and third reason: I had done a lot of work on it, but I was still scared there was something I was missing (bankruptcy processes can be long and drawn out, and I was worried I was missing something basic that could crush CWEN's recovery value.... which shouldn't have been a big deal given you weren't paying for the PG&E assets, but it weighed on me!) and I think I overweighted some of the other stuff in my portfolio (for example, I'm long MSG and have been for a long time, but the time weighted risk reward on CWEN was much better than MSG earlier this year; I probably should have been trimming my MSG position to add more here).

- Update: of course I wrote this over the weekend... and CWEN's stock proceeded to drop ~15% on Monday as PG&E continued to be PG&E. The stock's recovered a lot of that drop in the ensuing days; I continue to think that the company will get made whole on their PG&E exposure one way or another.

Bonus pondering: stock comp and valuation

- I like investing. It's what I do for a living and I enjoy it. Do I think what I do is as important as some

of my friends who deliver babies or research cancer? No, probably not. But I don't think investing is a complete joke either; let me hop up on my investing high horse for a second and show some examples of where investing and proper valuation is absolutely critical.

- To start, consider wework's failed IPO (I mentioned this briefly on our Oct. 2 podcast). Imagine any employee who joined over the past year. I would guess they got a huge slug of equity for joining, and that equity was probably issued at valuations of $20B+. Those shares are going to be so underwater now that they're basically worthless. That's a mammoth hit for something that was completely out of your control as an employee; in fact, maybe you're doing a fantastic job of creating value at WeWork and your comp has been demolished simply because Softbank went insane for a year and valued WeWork like a tech growth company.
  - The reverse can be true too. What if you joined facebook right after their IPO and got stock options priced in the $20-30/range. You're up 6x on those in less than a decade. Good for you.... but did you really create as much value as those options are paying you?
  - It's also possible in the facebook scenario that being up so much on your shares creates a situation where you're "stuck" in your job; your options are so valuable that you can't leave your job and take a tax hit.
- Stock valuation can be a big concern for value investors too. In general, I don't care if my companies pay their employees in stock or cash; if the company wants to do stock, they could always go out and buy an equivalent amount of stock in the open market to avoid dilution (a "zero dilution policy; this of course assumes they have the cash to do so). But if a stock is undervalued enough, the dilution can make a big difference and have a much higher instrinsic cost that GAAP financials would

lead you to believe. For example, say that you're investing in a company whose intrinsic value is $100/share, but whose stock trades at just $20/share. Every share they issues is worth 5x what the market says it is; in effect, the company is way overpaying their employees, and that cost is coming directly out of investors pockets (in this scenario, if the company gives $20m/year in stock comp, because the stock is so undervalued, they're actually handing over $100m/year to their employees).
    - This is why I generally like "zero dilution" policies. It's a bit silly for companies to have one (why not just buyback the stock if you think it's undervalued and pass if you don't), but since I only buy stock in companies when I think they're undervalued I'm happy for any tool that will avoid dilution.

Bonus Bonus pondering: disclosures and guidance

- Two somewhat connected things I've been wondering about recently.
- First, a few companies I know of suggest some of their financial disclosures are their internal metrics / forecasts. For example, every Netflix earnings release includes a subscriber guidance number that includes the line "our guidance is our internal guidance, and is presented for accuracy, not conservatism". Another example: at their recent investor day, BAM (disclosure: long) noted that their annual presentations are the same presentations they use internally, and they frequently note that their intrinsic value calculations are the same calculations they use to measure value internally. I would say that's pretty rare; I believe most companies present their most conservative numbers when they guide to "the street", with an eye towards steering the street to numbers they can easily beat or at least make.

    - Here's my question: is there any evidence that companies that publish their internal numbers outperform? My gut says there's some shot they do, as publishing internal metrics and not trying to play the "steer the street low so we can beat" game suggests a company that treats their shareholders like partners and is more concerned with creating long term, sustainable value than beating quarterly numbers.
        - There are obvious issues with trying to use this as a metric for outperformance, but I do think it suggests more of a shareholder mindset and eye towards LT value creation.
    - I'd also be curious if there are any other companies that present their internal numbers / valuations. If memory serves, Spotify does something similar to Netflix (which makes sense given SPOT's CFO used to be Netflix CFO), but I can't instantly think of any others off the top of my head.
- Second, a lot of companies will publish long term financial models (for example, here's YELP's (disclosure: long)) that will provide guidance for where they think their steady state growth, margins, etc. are. Companies generally (but not always!) publish these LT targets this in conjunction with really disappointing earnings ("Hey, we know our current results are awful, but in a few years we are going to be minting money and look how cheap we are when you compare us to those numbers!!!!"). I'd be really curious how many of those companies actually end up hitting their LT targets; my guess would be that it's extremely low. I'd also be interested in how these companies, as a whole, perform after announcing that long term guidance. My guess would be they substantially under-perform after announcing that guidance, but again that's just a gut feeling and I don't have any firm data on it.

Gold star continuation

- I introduced the "Gold Star" process in my August 2019 blog link and followed up on it in September. My goal is to continue to do this going forward: every month, I want to read 40 10-Ks and hit the most recent earnings call for those companies (if they have them). Many of these will be new companies, but some will be brushing up on old favorites. The hope is the process helps to me to maintain the balance of reading broadly while learning about new companies and ensures I'm a bit more structured in my work. Anyway, here are the 40 I read this month:
- If you have thoughts on any of the companies above, I'd love to hear them. Or if you have suggestions for companies I should look at next month, I'm always open to suggestions (I tend to hit ~75% of the companies people ask me to look at, and I'll try to get back to you with thoughts on them if I have any / if I remember or you remind me).
- This month's companies are below. Looks like I got through ~25; I'd like to do more companies but a few of them I needed to go a bit deeper on and I also had a slew of major companies reporting earnings, so I'm relatively happy with the number of new companies I got to (or companies I hadn't looked at in a while I did a nice brush up on!).
    - DVD (can't remember if I posted this month or last)
    - FOX (I'm 100% convinced there's value in legacy media companies at today's prices; doing some brush up work and reading FOX's first standalone 10-k),
        - A quick thought on FOX: their current strategy is to go all in on live TV. I think that makes a lot of sense for companies living in the bundle world; heck, even Reed

Hastings praised them. But I'm not sure I think that leaves them super exposed to the bundle. Let me explain: other networks (say, NBC) have a combination of live (Sunday Night Football) and new shows (Good Place, Brooklyn 99, This is us, etc.). I think that's an interesting combo: the live part means you have to be included in the bundle and allows you to advertise your shows, while the shows lets you continue to build up a deep and up to date library for a streaming service. FOX doesn't have that; Fox is shifting increasingly towards live sports, which is great for guaranteeing inclusion in the bundle, but as the bundle unwinds (and legacy sports contracts come up and the sports leagues demand big increases), I wonder if FOX's long term positioning is going to be swept out from under them. Basically my worry is the same that Reed Hastings has had all along: all the economics of having sports rights while either eventually flow to the sports leagues, or the sports leagues will go D2C and create the economics for themselves, leaving anyone dependent on them out to dry.

- Let me give an example to make this a bit more concrete: Fox recently started airing WWE on Friday nights, and they are making an all out marketing push to make the new WWE FOX show successful. Early ratings have been really good. In the short term, that's great for FOX! Higher ratings means more advertising money, more money from cable partners on renewals, and more money from Fox affiliates (who in turn can demand more money from cable partners!). But in the long

run, I think that value accrues to the WWE, not Fox. In ~5 years, the FOX / WWE contract will expire, and WWE can go to every network and say "look at the ratings we get on FOX. Our fan base is bigger than ever. Pay us for our live sports and the fan base will come to you." FOX will have to pay up or lose WWE to a competitor.

    - Of course, that analysis is focused on the Fox network. Fox News is probably the majority of Fox's value, so take that with a big grain of salt. Still, I'd rather be evenly balance between sports / live and shows than entirely focused on sports. It seems way more synergistic.

- EYE
- IDT (disclosure: long a tracking position. I actually spent two days on it; I read last year's 10-K earlier in the month and then read the new one when filed later in the month.)
- STNG (interesting after CEO bought some ST call options the day after announcing a $100 ATM share issuance program)
    - Speaking of pumping, SmileDirectClub (SDC) put out a statement when analysts initiated on them. A little silly. I find the obsession both companies and investors have with companies getting analyst initiation a little puzzling; I know so many investors who talk about companies bemoaning their lack of analyst coverage as the only thing preventing the company getting the high multiple it deserves, but I feel like initiations are good for *maybe* a short term boost and then really nothing.
- MAC
- VAC (I've researched and mentioned timeshares

before, but with their investor day just happening decided to revisit and reread 10-k)

- BA (disclosure: short a small amount; mentioned a few of my thoughts in the June links post. Can't claim to have crazy amounts of conviction here, but the market doesn't seem to be factoring in any real long term damage to Boeing's franchise from the current Max issues and the longer this drags on the more I think their franchise could suffer a significant ding).
- CMCT (because of this insider buy at a substantial premium to current price)
- WEN (had an investor day and figured, "I love spicy nuggets; why not?!")
- USAP (because of this merger of equals proposal)
- SHEN (regional telecom player I've followed for a while; interesting assets but not sure how to value wireless business)
- TAST (interesting post on VIC, I've looked at them several time and the business performance never comes close to how good the story seems like it should be, and management's changing tone on their most recent acquisition scares me).
- QSR (if you're going to look at TAST and WEN, might as well hit QSR too! Come for the franchisee; stay for the tidbits about Canada's love of loyalty programs)
- Yum (if you're going to look at QSR, might as well do YUM)
- MCD (if you're going to do YUM and QSR, might as well do MCD)
- DPZ (if you're going to do.... well, you get the idea) (found the potential scale advantages in pizza fascinating)
- A smaller bank I don't want to publicize
- ABDC (more a special situations review than a reading of 10-k, but lord knows I spent enough

time on it!)
    - SPCE (morbidly curious; recently completed SPAC deal)
    - IDWM (followed them for a while; they own lots of IP, but I'm not sure how strong it is and the company burns a lot of cash)
    - GRUB (really interesting after getting slaughtered on earnings; the Q3'19 letter explaining the quarter and guidance is great)
    - TIF (in prep for podcast)

Sports media update: A core tenant of the monthly update: continued highlights of the increasing value of sports rights (mainly because of my love of MSG (disclosure: Long)).

- Smackdown? WWE challenger offers artistic freedom
    - Fox unleashes ad blitz to make good on $1B smackdown bet
- NFL TV ratings rebound is a rare bright spot for major networks
- AC Milan and Elliot: the hedge fund trying to crack Italian football
- Inside the deal that's bringing a sportsbook to Capital One Arena
- NBA's China furor opens door for Nets to become China's most popular team
    - NBA's crisis in China triggered substantial losses
    - Adam Silver's Fight to Save the NBA in China
- Big data coming to the NHL
- Investors get path to buy into MLB
- The dirty little secret everybody knows about (article on Sleep in the NBA. Sleep is a topic I think about a lot when it comes to improving performance, quality of life, etc.)
- Andrew Yang on what's wrong with the NY Knicks
- Billionaire seeks to raise $500m for DAZN
- North and South Korea played a world cup soccer

qualifier. No one saw it.
- Darkness has descended on Denver. Most of its sports teams are off TV
- Pizza Hut brand perception up 8 points in first season as NFL official sponsor

Other things I liked

- BPY (disclosure: long through BAM) on the drop in interest rates not being reflected in cap rates
  - I've mentioned this a few times, but I think in general stocks are currently priced to low given where interest rates are. Smart management teams / capital allocators are taking advantage of this arb by borrowing at LSD rates to buy back their stocks at attractive (and growing) free cash flow yields. Professor Damodarn has a blog post on this that calculates the equity risk premium and generally jives with that belief / BPY's argument.
- Interview with Barry Diller (IAC; disclosure: long; also a video interview and another one on CNBC. He's so good)
  - Interview with DotDash CEO (IAC portfolio company)
  - Interview with Shari Redstone (VIA / CBS controlling shareholder)
  - Interview with Daniel Ek (Spotify CEO; this is from last year but I don't think I saw it / posted then)
- Private Equity Flexes Muscle in Washington as Warren Picks Fight
  - Warren's views on private equity are obviously well known. PE is a major position for me (through BAM and KKR; disclosure; long both), and I tend to think while she'll be harsh on them she generally won't be able to do anything too harmful to their business model. Still, the stock market appears to be taking her vitriol pretty seriously....
    - I do wonder if some of these views would be

good for the credit of the current crop of private equity companies, as they would look to rapidly delever in front of those rules.

    - Blackstone CEO Schwarzman defends firm as profit climbs
    - Everything is private equity now
    - Onex notes that they're good at forecasting cost cutting, not revenue growth.
- Investors worried about AT&T's content game
    - Amazon clashes with Disney over App offering
- Music labels wary as Apple tries to bundle subscriptions
    - Spotify saved the music industry. Now what?
- Chaos scientist finds hidden risks that regulators miss
- The cheating scandal rocking the poker world
- A value investor defends value investing (interview with Greenblatt, author of YCBASMG, my favorite investing book)
- After Unloading Lionsgate, Where's John Malone Placing his bets
- How Boeing's managerial revolution created the 737 disaster
    - Boeing is dragging down the U.S. economy
    - Boeing's New Chairman is a boardroom force familiar with crisis
- American consumers might save the U.S. recycling industry
- Fast Food Chains heat up breakfast fight
- Independent hotels are disappearing as chains grow
- In house versus third party delivery: the debate rages
    - I tend agree with Domino's thinking that larger chains (like McDonalds) are being short sighted giving control of their consumers to a delivery platform, but no completely firm thoughts. I did think this clip from Pizza Hut / YUM was interesting on how their delivery force is a competitive advantage over time.