Some thoughts and opportunities from the Corona panic

As mentioned in my previous post, it's been a rough month. That applies to both me personally, to me as an investor (I had a.... very large position in AER), and I'm guessing to humanity as a whole.

I've taken to telling my wife that the current Corona scare (and scare is too light a term; it's a serious issue) and my failure to see how bad it was going to get is the moment I'll look back on when I'm an old man and raise my fist into the air and say "AHHH, my big (professional) regret!" I'm particularly miffed at myself because I saw how bungled the response was; in my March posts, my last bullet discusses how the administrations "bury your head in the sand" approach was likely to be much worse for the economy (and the country!) longer term. But I kind of thought the market (down 15-20% at the time) had already more then adjusted to that reality (15-20% is a major drop). I honestly just didn't see how bad this thing could get this quickly, and I didn't see how bad it could get for a bunch of different positions. I could say "to be fair, this pandemic caught a bunch of people flat footed", but I don't think you can be "fair" with this type of stuff; my job as a portfolio manager is to assess risks, and I completely missed how bad this one would be (and it's not just this one; the fact that my portfolio got hit so hard by the world stopping indicates that my portfolio was always vulnerable to this particular type of pandemic risk).

Anyway, I'll be licking my wounds and learning lessons from this for a long time, but I'll come out the other side (hopefully) a better, wiser investor and will recover from how bad this month has been in time.

Until then, here's my emerging house view of the virus impact. I post this because I don't think anyone firmly knows how this plays out, so if you have any thoughts or tweaks, I'd be very interested in hearing them.

My two overall takeaways are

1. This is going to be rough on the economy. Really rough. There's a decent chance wide swaths of businesses are going bankrupt.
2. Equity prices are probably way, way too low. There are plenty of well capitalized business that are trading way below any conservative estimate of future cash flows.

Let me start with the second point, because it's simple. There are a ton of well capitalized companies that are trading way below their earnings power right now, and they're likely to do really well when things start to clear up. I'll list some interesting examples later, but I just wanted to highlight that point.

Still, the trick is making it to the end game, because the near term is going to be rough. Really rough. My initial thought was, "So most businesses have a dip for a month or so. Big deal." That was laughably wrong and I'm borderline embarrassed I was thinking that way.

Tons of companies are going to go bankrupt. Anything consumer focused is obviously in a rough spot. Hotels, restaurants, and casinos are all way down, and I think the market is probably directionally right on them. These are high fixed cost businesses, and revenues are about to go to zero for a few months. That's a disaster.

Take Red Robin (RRGB), which I was long but sold this month because I just thought the risk/reward was better elsewhere even though shares had been decimated in the past month. Their monthly lease payments run ~$10m. They have $30m in cash on the balance sheet at quarter end; they probably made a little

bit more during the first two months of the year but not a crazy amount. I'm guessing basically all of their restaurants are to-go and delivery only right now (I searched a bit on their store finder website, and every one I saw was to-go only, but I could be off). I don't think RRGB's takeout business is fantastic; let's assume for now that they're doing zero revenue. Revenues go to zero, and suddenly RRGB is drawing down their cash balance to pay their rent. Their cash balance lasts three months of rent payments (assuming every other expense has gone directly to zero).... then what? Sure, they've got a revolver they can draw, but is a bank going to be eager to let them? And their revolver has covenants; if earnings go to zero / go negative, they're going to blow through those covenants. If their covenants are blown, never mind if the bank is eager for RRGB to draw down or not; a bank simply isn't going to let them. (A little cherry on top: restaurants run with negative working capital as their customers pay upfront but they pay employees and suppliers a few weeks later, so as revenues go to zero they have a cash drag from negative working capital unwind).

You can play around with the numbers in a bunch of different ways, but however I do it RRGB runs out of cash in about six months if things don't go back to semi-normal before then. And it seems a real stretch to believe things will go back to semi-normal by then; I'm sure people will be leaving their apartments but I doubt restaurants are approaching traffic levels even 75% of what they were before the virus at that point.

So RRGB probably runs out of cash in the next six months or so. They'll need to draw down their revolver, but they'll have blown covenants so the bank probably won't let them. That means RRGB needs to restructure.

That's not to say RRGB has no equity value longer term. I'm sure two or three years from now restaurants are back to normal, and RRGB has a nice brand and a semi-loyal following.

There is value here. The issue is there's a restructuring between now and realizing that value, and I'm not sure how much of the value will be left for current equity holders.

One of the best investments of all time was Ackman investing into GGP during the financial crisis. He invested, supported them through bankruptcy, and made a killing when they emerged. Perhaps you're thinking of doing the same thing now- by a restaurant company trading below its long term earnings potential, suffer through the restructuring, and profit on the back end. In normal times, that could be profitable. But there are a lot of differences. First, GGP was unique, profitable real estate. Restaurants in general are commodity businesses, and if this analysis is right there's about to be a whole wave of bankruptcies. If you're investing into a company with unique assets in bankruptcy, you're a lot more likely to find someone to come into the equity and preserve value. But if there are 100 different commoditized restaurant chains filing in the next year, why would anyone support the equity of any of them? There are plenty you could get control through in bankruptcy, wipe out the current equity holders, and keep all that upside for yourself.

So I think there is a lot of pain ahead for restaurant companies. The same applies for a lot of hotel companies and casino companies; there's almost certainly value on the back end, but there's some chance of a restructuring between now and then. Companies simply don't plan for revenues to instantly drop by 90% for months on end, and many of these companies run ~4-5x leverage. That's reasonable leverage when assets are worth ~15x and have decent visibility into near term bookings / cash flow. But when revenue is suddenly zero for multiple months on end, that spells trouble. Covenants get tripped. Interest expense continues to accrue while no cash is coming in. It's not a great situation. The good news is that most of the hotel companies and some of the casino companies own their assets (the hotel / casino) instead of leasing them,

so their fixed cost burden is a lot lower than restaurants. And I suspect that lenders are going to take a good deal more comfort in hard asset real asset value being extending / amending loans than they will for restaurants. Still, a bunch of these guys are going to need amendments on their loans, and if 20 different hotels and casinos are going to banks looking for amendments, that could get kind of pricey. With a bunch of these stocks down 75%+, it's entirely possible the market is properly discounting the pain here already, but I'm not comfortable with how long it's going to take for any of these to get back to normal. It's also worth wondering what normal is: filling hotel rooms is a competitive game, and if 9 months from now people are travelling at 80% the rate they were a year ago, the competition on room pricing is going to be fierce.

Again, this isn't to say there isn't a bunch of value on the other side. A few months ago, the market was telling you hotel companies were worth 10-15x EBITDA. Today, the market is saying they're worth 6-7x. While near to medium term earnings are going to be awful, I see no reason why earnings three years out will be seriously impacted by this. So there's probably value to be found if you can find a hotel or casino with good assets and a long enough cash runway to get to those normal earnings. But when you do the math on something like a four month shutdown followed by a full year or so of very low occupancy and room rates, there aren't a bunch of hotel companies with a balance sheet strong enough to make it fully through that.

The one exception I'm kind of wondering about? Time share companies. Many of them are down in kind with hotel companies (>60-70%). I can see why the market is shooting first and asking questions later: occupancy is going to be awful for a long time. Still, these companies have an advantage that normal hotels don't: their recurring club management fee stream. Even if you assume that all other income streams go to

zero, the time shares club management fees would be enough to keep the timeshare companies breakeven. Now, obviously that's a big simplification: if occupancy is zero because there's a global travel halt, obviously there's going to be some ownership cancellations or owners will demand timeshares give them some form of makewhole on the back-end. But I think that earnings stream does show how the timeshares start with a really big leg up on normal hospitality / hotel companies. The timeshare companies also have generally low leverage and all have some unsecuritized receivables that could be monetized to bring leverage down even further. Of course, the low leverage assumes a trailing earnings number that likely has no meaning in the near term, and the unsecuritized receivables is only an asset if securitization markets are open and consumers aren't defaulting en mass. Neither of those is a given, but I do think it's an interesting spot.

Speaking of consumers, it's going to be just awful for them. Consider the restaurants we just talked about: every restaurant that shuts down has dozens of waiters, cooks, etc. who is out of a job. Bars shutting down puts bartenders out. Every gym I know of is shut down and laying off staff, and hotels with no occupancy are going to be furloughing their staff left and right. It's a disaster for consumers, and it's got the potential to launch a severe economic recession.

It's really tough to handicap how that plays out. Wide swaths of the economy are literally going to zero overnight, and all of their employees are suddenly out of work. It has the potential to cause an incredibly deep consumer recession. There's really only one way out of that: mammoth government stimulus.

I get that a lot of people hate stimulus. I consider myself somewhat of a liberterian, so in general I'd probably be somewhat opposed to stimulus. But we're not talking about something normal here. We're talking about a disease where people literally cannot go to work because, if they do,

they'll spread it. That's a huge negative externality, and the place for government is to solve / correct negative externalities. I think you need the government to step in here and literally just hand people money. Again, there was no preparing for this for a lot of people: you had a job, and now you're told "don't show up for the next six months, because if you you're going to help spread a disease that will kill millions." That's insane! Governments need to just be blasting money out to every citizen.

It's tough to dive too much further in the economy, because the more down that road you get the worse and worse it gets. If every restaurant is going bankrupt and huge amounts of the workforce are unemployed, bank loan books are going to be absolute disasters. Think of a small town bank: it's probably got a small business loan to the local restaurant, maybe a mortgage to the restaurant's owner and manager, etc. All of those loans could go from solid to at risk in literally the blink of an eye. Do that for basically every business in town and you've got the makings of a financial crisis. Again, you probably need the government to step in and mammothly stimulate to avoid all that.

Ok, that was pretty grim. So let's wrap it up by talking about a few places I'm seeing opportunities. Clearly, a ton of funds have blown up or liquidated this month. That's both scary and sad (I used to have a little schadenfreude when I heard of other funds blowing up, but after this month I have literally nothing but empathy), but it's certainly created some opportunities. Every spread trade I'm aware of has blown out to absolute records. For example, Liberty Sirius (LSXMK) is currently trading for ~65% of NAV, where typically it's traded for ~75-80% of NAV. Buying Liberty Sirius today creates a controlling stake in Sirius at ~$3.15/share versus Sirius's current price of ~$4.80/share (and down from mid-$6s literally a month ago). That's pretty interesting.

I think the push back here is that Liberty could have some

cross contamination issues from FWONA. It's possible, but I think that's a pretty tail scenario. First, I think it's radically unlikely FWONA goes bankrupt. Second, even if they did, the majority of FWONA's debt is at a non-recourse subsidiary. If you assumed LXSMA had to cover all of FWONA's holding company recourse debt in full (i.e. all of FWONA's assets were worth nothing and LSXMA had to pay all their corporate level debt), LSXMA would still be trading for <80% of NAV.

So I don't think the reason LSXMA's spread has widened is because of issues at FWONA. Nor do I think it's leverage issues at LSXMA: LSXMA is very reasonably levered (their SIRI stake covers their debt something like 10x over, and that ignores that they have ~half of their debt covered by cash and a small investment in iHeart). The simplest answer is probably the right one here: LSXMA's discount has ballooned because funds have been blowing up and have been forced buyers of SIRI (to cover their hedge) and sellers of LSXMA.

There are a bunch of other interesting plays here. All of my old favorites are at multi-year wides to their underlying assets (GLIBA, IAC, etc.), so it's really chose your own adventure. If you know of an SOTP or tracking stock with an underlying asset you like, now is probably the time to be looking at it, as I doubt the spread to its asset value has ever been wider.

Speaking of spreads, vanilla merger arb is really interesting right now. The IRR on some of these deals are absolutely insane. Some of the widening IRR has been driven by widening downside (i.e. if a stock is getting taken out at $20 and its downside is $15, it will trade much closer to $20 than if its downside was $5), but I suspect the majority of this is simply funds desperate for liquidity. I've listed four deals below; I can't claim to be an expert on any of them but I have gone through the merger contract and followed all of them loosely for a while, and I'd guess that all of them eventually close.

- BREW: takeout price $16.50, current price $13.15
- RESI: takeout price $12.50, current price <$9
- TIF: takeout price $135, current price $126 (this was much wider until a press report came out today that LVMH was considering buying TIF shares on the open market)
- TCO: takeout price $52.50; current price $43.15

Again, any of those above deals could fall apart; supposedly rock solid deals got demolished all the time in the financial crisis. But all of these are strategic and/or synergestic deals (Simon has been trying to buy TCO for almost 20 years!) and all are backed by reasonably solid contracts.

Ok, that's it for now. Markets are swinging so quickly currently that there could be a whole new set of opportunities by next week (or this afternoon). Who knows! It's a fantastic time to be an investor (though not such a fantastic time to look at your P&L).