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Letter to investors, Q1 2020

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned –21.69% net in Q1 2020, as reported by our fund administrator. As of March 31st, 2020, the top ten positions comprised approximately 64% of the portfolio, and the portfolio held approximately 27% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020 YTD	-21.7%	-19.6%

Occasional bouts of extreme volatility are a known and expected feature of the stock market. Predicting when they occur or what specifically will set them off, in this case the exponential spread of a serious respiratory disease, Covid-19, is another matter entirely. Nothing in life is free – the price of being able to participate in the compounding nature of equity ownership is the occasional stretch of time with uncomfortable paper losses. Stocks have done very well over long periods of time precisely because of the "risk premium" they earn as compensation for these drawdowns.

As I write this in early April, markets have staged impressive partial recoveries from the March 23rd lows, probably fueled by some combination of increased Fed stimulus (a further $2.3tr), optimism that social distancing has begun to help "flatten the curve, and potential for Russia and Saudi Arabia to temporarily put aside their recent spat over oil and cut production. I am not a macro economist and will not try to time the market. However, given the supply chain disruptions, unprecedented 17m in US Jobless Claims, reported malfunctioning of the Payroll Protection Program, and stresses to the credit markets, I wonder if markets reflect the full extent of the damage that coronavirus is having to corporate profitability and the economy. I believe this damage across many industries could well have knock on effects on the global economy. For example CarMax, a portfolio company that I greatly admire, recently announced they would furlough 15,000 associates, institute a hiring freeze, reduce inventory levels, reduce marketing spend, cease store expansion activity and remodels, and halt their share repurchase program.

Bear markets rarely move in straight lines, and historically have tended not to bottom until after a solution to the original problem has been found. For example, during the Great Financial Crisis of 2008, markets did not trough until March 2009 after the American Recovery and Reinvestment Act of 2009 was signed into law (despite multiple preceding FOMC rate cuts, TARP, and other government interventions). As for the current problem, current estimates are a vaccine is at minimum 6 to18 months away, and we are still waiting for the manufacture and distribution of large quantities of reliable antibody tests which may allow for a coordinated gradual resumption of normal work. I believe we are going to have to live with many uncertainties until then. The next couple of quarters of earnings will be telling, and we may have the opportunity to deploy our relatively large cash balance at more attractive prices.

This was an active quarter for the portfolio in response to the market volatility. We are left with a significantly upgraded portfolio and still have plenty of cash to deploy opportunistically. I bought and sold hedges, sold the weakest names in the portfolio, and initiated positions in some high quality companies where prices became attractive. Positioning of the portfolio has been quite deliberate. In keeping with the modified barbell theme I outlined in last years series of letters, we own robust businesses that on the whole are likely to withstand these difficult conditions and perhaps even emerge stronger. Our public holding companies and alternative asset managers are run by highly aligned, outstanding capital allocators with the proclivity to buy assets at advantageous prices during times of stress. We have also significantly added to the number of competitively advantaged businesses that are poised to benefit from the inexorable move towards software/cloud computing which the difficult circumstances presented by Covid-19 will only serve to accelerate.

<u>Discussion on a selection of portfolio positions with an average weight over 1%:</u>

Positions with an average weight over 1% of the portfolio throughout the quarter were: Alliance Data Systems Corp., Alphabet Inc., Amazon Inc., Brookfield Asset Management, Burford Capital Ltd, CarMax Inc., Ceridian HCM Holding Inc. (via options), Colfax Corp, CRH Medical Corp., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., GCI Liberty Inc., KKR & Co Inc., Naspers Ltd., Oaktree Specialty Lending Co., Onesoft Solutions Inc., Prosus NV, S&P500 Index (options), Tencent Holding Ltd., Viemed Healthcare Inc., and Wandisco Plc.[1]

Hedges:
I initiated hedges via out-of-the-money put options on the S&P500 index soon after the Fed announced a surprise 0.5% rate cut in response to the coronavirus situation. While the Fed's action underscored the gravity of the soon-to-be-declared pandemic,[2] it was a monetary response to an impending health crisis, and would therefore be wholly ineffective in arresting the spread. I reasoned that the virus had spread from China to Italy and internationally, thereby signifying this had grown from a regional to a global problem. Moreover, given the virus' R0 of approximately 2.5 (meaning that statically every infected person further infected 2.5 people, on average),[3] it was clear there was now real risk of uncontrollable exponential spread. I took the hedges off about a week and a half later as the index began to fall and implied volatility, as represented by the VIX index, spiked to the high 70's, a level similar to the peak during the 2008 crisis.

Exits:
I exited our positions in Alliance Data Systems, CRH Medical, Oaktree Specialty Lending, and Viemed Healthcare; and initiated new positions in Alphabet, Amazon, Brookfield Asset Management, Ceridian, Colfax, and KKR.

Alliance Data has been a disappointment. I based my original thesis on a belief that the company's core operations remained valuable to their customers, while an activist-led strategy to sell underperforming divisions and use proceeds to pay down debt and make accretive share buybacks had the potential for significant value creation. As time passed it became clear that degradation in the business was more severe than management had initially communicated. Moreover, management was in a state of extreme flux with 2 successive CEO changes in a matter of months. With the advent of the Covid-19 and its potential for massive disruption to credit quality and retail, the accumulation of negative developments outweighed the extremely cheap valuation, and I (belatedly) decided to move on to better opportunities.

CRH Medical and Viemed Healthcare are two small cap healthcare companies, the former is a roll-up of gastrointestinal anesthesiology providers, and the latter provides registered nurses and ventilators to help very sick patients suffering advanced Chronic Obstructive Pulmonary Disease. Both share a number of attractive attributes, including high returns on invested capital, a record of strong historical growth, long runways ahead of them for further growth, ambitious management teams, and attractive valuations when I first bought them. However, both are subject to occasional pricing pressure as the Center for Medicare & Medicaid Services tries to reign in healthcare costs by changing rates every few years. These hits to revenue have historically provided good entry points to acquire shares, as the market has tended to temporarily over-react to the news, ignoring the fact that the businesses have, over time, continued to grow at robust rates. Overall, I would characterize these as good businesses with good long term prospects, but clearly not "great" given their lack of control over their own pricing. Market volatility presented the opportunity to redeploy capital into larger/stronger/better businesses.

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[1] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.
[2] The WHO declared the novel Coronavirus a pandemic on March 11th
[3] https://www.who.int/docs/default-source/coronaviruse/who-china-joint-mission-on-covid-19-final-report.pdf

Similarly, while I have tremendous respect for the team at Oaktree Specialty Lending (OCSL), I took the opportunity to redeploy cash into Brookfield Asset Management, which has been on my watchlist for some time as I waited for an attractive entry point. Brookfield owns Oaktree Capital, the parent company of OCSL.

Current holdings:
Exor's portfolio companies were particularly hard hit given their significant presence in Italy, one of the epicenters of the virus. CNH Industrial, Ferrari, and Fiat all had to make difficult decisions to close factories as Italy instituted widespread lockdowns. The companies are well capitalized, and have successfully tapped credit markets where needed (e.g. Fiat arranged a €3bn bridge loan). Assuming Exor's deal to sell PartnerRe to Covea for $9bn still goes through, Exor will have a total of $13bn in cash for future acquisitions ($9bn from selling PartnerRe, and previously disclosed $3.9bn by 2020 from cash flow generation and dividends, including the $1.6bn special dividend from the Fiat-Peugeot deal). Even allowing for some reasonable depletion in cash reserves and impairment to values given the state of the world, this is a significant amount of cash as compared to Exor's market capitalization of €12bn.

Fairfax came out of 2019 benefitting from a "hardening" [4] insurance market, with robust premium pricing trends, and gains on investments. As a result it was able to grow book value per share 14.8%, just shy of Premium Watsa's stated goal of 15% per year. Capitalization is solid with $1.1bn in cash and investments at the holding company and no significant debt maturities until 2022. The company has historically taken advantage of periods of market turmoil to make attractive investments.

Brookfield Asset Management owns prime real estate, critical infrastructure, and renewable assets globally. It is extremely well positioned to benefit from the approx. $25 trillion allocation to alternative assets globally over the next decade. Its scale, extensive global network of local operating teams, and access to large institutional capital makes it one of the few organizations around the world with the resources and operating skill to find and purchase attractive infrastructure assets, often at prices lower than replacement value. While the company's real estate assets in particular are undoubtedly under some pressure right now, the portfolio is "funded almost exclusively with asset-level, non-recourse financing with an average term to maturity of more than 5 years and virtually no financial covenants" [5] and the parent company not only has extensive access to $12bn in bank lines and $5bn in non-core assets that could be liquidated in a crunch, but also has approximately $30bn of uninvested capital from its latest fundraising to put to work.[6] Finally the company should benefit from its 62% ownership of Oaktree Capital, one of the premiere distressed debt shops, that has historically thrived during periods of credit dislocation.

KKR is one of the preeminent private equity managers. The business model is quite simply to use both their balance sheet ($16bn) and client funds ($218bn in AUM) to buy companies/assets, grow their value through a combination of operational improvement and financial engineering, and sell at a premium. In this way KKR earns management fees on fee-paying AUM (a recurring earning stream, especially on capital locked in for 8+years), earns performance fees based on the rates of return generated, and grows the value of its balance sheet. Despite its size, KKR still has plenty of room to grow earnings as it scales relatively new strategies, such as in real estate, healthcare, energy, and hedge funds, by a factor of 4-5x over the next decade, and then harvest performance fees as the strategies mature. Current conditions will certainly impact KKR's portfolio companies, especially given their liberal use of debt. I expect it to leverage its in-house full service Capital Markets division, which has raised cumulatively approx. $1tr in equity and debit for both KKR companies an external clients since inception in 2007, and political access to find creative financing solutions. As point of reference, businesses backed by the private equity industry employ more than 8.8 million Americans at over 35,000 companies, accounting for 5% of the United States' GDP. [7] This gives the industry significant clout, perhaps explaining why it is lobbying to have access to the $377 billion of small business loans and grants baked into the U.S.'s $2 trillion coronavirus relief

[4] Market conditions with high demand for insurance coverage and a reduced supply, resulting in higher premiums
[5] https://bpy.brookfield.com/~/media/Files/B/Brookfield-BPY-IR-V2/letters-to-unitholders/2020/bpy-covid-19-ltu.pdf
[6] https://bam.brookfield.com/~/media/Files/B/Brookfield-BAM-IR-V2/documents/%20Update_for_Brookfield_Shareholders_3-23-2020.pdf
[7] According to the Institutional Limited Partners Association, a lobbying group which represents CalPERs and other public investors

bill.[8] As of year end 2019, KKR could reasonably be valued at ~$35 per share, by adding the balance sheet value of $19.26 per share to the KKR fee generating business value of $16 per share ($1.67 per share in after tax distributable earnings valued at a reasonable 10x). Even allowing for significant write downs to the portfolio in the next couple of quarters given market conditions, KKR is priced with a margin of safety in the low $20's where we bought the shares.

Burford Capital provides litigation finance, in which it funds legal claims for a share of any proceeds. Outcomes are usually binary, with a total loss if Burford's client loses their case, and the potential for multiples return should the client win; though most of the time wins come in the form of settlements between the litigating parties, leading to smaller but quicker and more certain profits. Returns on investment have been outstanding, with IRRs over 30%. The industry itself is nascent, but with a very large potential Total Addressable Market, as approximately $800bn[9] is spent on litigation globally each year. The outcome of legal cases has little to do with market conditions, making litigation finance a non-correlated asset class, and Burford makes the case repeatedly that, if anything, the volume of litigation goes up during tougher economic times. At current prices Burford trades for less than the value of its litigation claims, while collection of a few large cases could provide meaningful upside. Burford has been a battleground stock ever since it was the subject of a short repot in August 2019 which claimed the company is dishonest in the treatment of its fair value accounting. The nature of the business is such that the company necessarily has to make estimates on the value of its assets, as most alternative asset managers do. While on balance my work has lead me to disagree with the short report, I have sized the investment with respect to the risks.

GCI Liberty derives much of its value from its shareholding of Charter Communications, the largest pure play cable operator in the US. Charter is a beneficiary of work from home/social distancing. While there is likely to be some temporary slowdown in cable subscriber growth due to more limited installs during lockdowns, there is also likely to be increased demand for higher tiers of home broadband. Given the high margin nature of broadband service, this might even benefit profitability in the short term, while longer term, human nature is such that customers will be reluctant to switch back to slower internet speeds.

We added Alphabet and Amazon to the portfolio. These are of course well known and understood companies and, together with existing holdings Tencent/Naspers/Prosus, have some of the strongest economic moats in existence in business today. It is difficult to imagine a world (at least in the next several years) in which these companies with their massive cash balances (~$32bn Alphabet, ~$115bn Amazon) face real existential risk. If anything, the current crisis has only accelerated the cloud/online and e-commerce trends. Well known as these companies are, I do not believe the market (certainly not today) accounts for their future earnings power, in particular Amazon which is coming of a multi-year capex investment cycle with significant avenues for future growth.

WANdisco has become a larger part of the portfolio simply because the share price has held up reasonably well over the quarter relative to other holdings. For a company of its modest size it has a deep pool of sophisticated shareholders who, if you'll remember from my writeup last quarter, wisely raised funds on shareholder friendly terms to minimize liquidity risk until the Microsoft partnership started delivering revenues. I think it is reasonable to assume current events might slow progress temporarily but, if anything, corporations will be incentivized to develop business analytics to help them compete in a more challenging business climate. During the quarter the company announced work with Microsoft is progressing, and they won a $1m contract.

Ceridian is a SAAS-native payroll processor, run by an exceptional founder, serving mid to large size enterprises, that has been steadily winning business from legacy companies such as Automatic Data Processing due to its ability to calculate payroll in real time. This "continuous calculation" enables payroll administrators to access their data throughout the pay period and gives them more time for reviews and audits, minimizing unprocessed errors which have to be carried over and corrected in the next pay period. This core functionality has allowed the company to develop an employee electronic payment feature which it will roll out over the next few years, presenting a significant monetization opportunity as it expands into its large addressable international market. The share price

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[8] https://www.bloomberg.com/opinion/articles/2020-04-02/coronavirus-private-equity-wants-in-on-small-business-bailout
[9] TheCityUK, Legal Excellence, Internationally Renowned – UK Legal Services 2017 via Burford 2018 Annual Report

more than doubled last year as I was in the midst of my diligence, but I refused to chase. However I had the opportunity to initiate, via short puts, a starter position in March. It is reasonable to assume the company's prospects will be muted in the short term given the dramatic escalation in forced unemployment, so I will continue to monitor it closely.

Colfax is a roll-up in the welding and medical device space (e.g. artificial shoulders and knees) industries with attractive characteristics and secular tailwinds under more normal conditions. It was founded by the Rales brothers who found incredible success compounding the value of Danaher over several decades, growing by acquisition and employing the Danaher Business System - a comprehensive set of business practices to fully integrate acquired businesses and improve margins. Colefax uses essentially the same playbook and tools.

Onesoft Solutions is essentially a pre-revenue Canadian microcap company with software that helps oil and gas pipeline operators identify structural weaknesses that lead to explosions that have caused 300 deaths, thousands of injuries and over $9bn in damages over the last 20 years.[10] Crossroads Systems is a family office backed microcap company with $140m of deferred tax assets that acquired a real estate developer specializing in the purchase and rehabilitation of single family homes which are then resold at an affordable price to underserved Hispanic families in Texas. It uses its designation as a Community Development Financial Institution to access loans on favorable terms. I will update investors on these companies as they disclose operating results and any significant news over the next few quarters.

Closing thoughts

On a more human level, my gratitude goes to frontline healthcare and essential workers who put themselves at risk in our collective service, and my thoughts to those who have been personally affected by this virus. I look forward to better days ahead.

Samer Hakoura
Alphyn Capital Management, LLC
April 2020

[10] Source: PHMSA (the USA Pipeline Regulator)

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