Interim letter to BrightGate Focus co-investors

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2nd half of 2020

27th November 2020, Madrid

"When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done"

John Maynard Keynes, The General Theory (Ch.12)

Dear co-investors,

First, we hope that both you and your families are well. BrightGate Capital sends our best to all of you during these difficult times, and we hope that you and your family and friends have not been affected.

I am writing the Fund's second letter in conditions as unprecedented as those when I wrote the first one in June. Despite excellent news on several vaccines, which can potentially clarify the path back to normality during the second half of next year, the tech stocks that rallied during the darkest moments of the crisis have not stopped their advancements, despite the fact that the new normal should imply less "work from home". Cyclical stocks have rallied along those lately and, in general, the euphoria that prevails in the markets is at levels hardly ever seen. To back up such a statement, just consider that in November the Dow has had its best month since 1987, the Russell 2000 the best month in its history, the S&P Energy and the S&P Industrials more of the same, and the S&P Financials the best month since 2009. Although the Fund has strongly benefitted from these dynamics, I am aware that the current euphoria will end up being fleeting, and the balance sheet, the quality and the valuations at which we underwrite our investments will matter now more than ever.

All the cheap narratives told both by the press and market participants alike to justify such dynamics obfuscate the true macroeconomic nature of the matter. From a philosophical standpoint, the events we have gone through have been a gigantic experiment *that has falsified the belief that, at the macroeconomic level, valuations are given by the discounted future cash flows that the business sector will generate as a whole*. According to the traditional theory (which is also the view of 99% of market participants), stock markets drop during economic crises because the market anticipates future corporate earnings to be lower, which leads the market to reduce overall valuations. When things eventually improve and the visibility of future profits improves, stock markets go up because, according to the conventional wisdom, discounted profits will be higher.

From my point of view (something that I explored in depth in my Ph.D. thesis), the reason why valuations drop when a crisis hits is not because future profits will be lower, but rather because of the supply and demand of financial assets. In a crisis, governments' automatic stabilizers create government deficits, as taxes are usually diminished and government expenditures, in general, increase. This deficit is financed through public debt, which (in the absence of Central Banks) ends up in private hands. If private funds (pensions, endowments, mutual funds, etc.) cannot absorb these additional assets, government bonds yields increase, which in turn forces private funds to unwind their positions in other assets, falling the price of those, until the overall supply-demand equilibrium is eventually re-established. Furthermore, the fall of economic activity during a crisis reduces overall savings (the famous paradox of thrift), so the ability of the private sector to absorb additional government assets is weaker than ever.

Following Popper's falsification principle, in order to refute a theory only an observation against it is needed, and the events of the last few months have amply proved that the traditional theory is wrong. The difference between the current crisis and others is that the gargantuan additional supply of government bonds has ended up being absorbed by the Central Banks, alleviating the private sector from undertaking such a task. Given that there has not been a supply-demand mismatch as in other crises (Central Banks demand has outstripped the fall in the private sector demand for financial assets), valuations have not dropped, but rather the contrary, despite the huge drop in profits this year – and the expected drop in coming years.

Although one could argue that we have finally found the Holy Grail of the markets that never dropped, there are two important remarks in this regard. First, Central Banks have severed the mechanism through which (some) income redistribution occurred during a crisis: although it is undeniably true that in an economic recession the most disadvantaged people were those who usually lost their jobs, the fall in valuations led to a less uneven wealth distribution, balancing in part the former effect. It is impossible to determine how long current democracies can endure such dynamics, but the political extremism, which is a clear consequence of those, is already among us. The second thought is that, although asset valuations do not fall, investors should not be relieved in the least, because lofty current valuations imply lower future returns. In this regard, the generational divide between those who hold assets and want to keep current valuations high (older generations) and those wo do not hold much assets, but want to compound current savings (younger generations), will be another factor to watch in the coming years.

In the present letter I will discuss in depth the recent acquisitions performed by the Fund, and as I promised in the previous missive, I have added a small appendix that describes in detail how we deal with the accounting in BrightGate Focus and *how we link it to company valuations in a wholly organic manner*.

I end this introduction as I did last time, with a reminder that stocks' future returns (up to 7 years or a decade) will likely be negative from current levels – even assuming low levels of inflation. I do not have the faintest idea of which event will trigger more reasonable valuations (as Taleb says, such events are intrinsically impossible to foresee, so it is a fool's errand to spend time trying), but a decade is a lot of years and the event will end up happening, despite the current apparent omnipotence of Central Banks. Although the day-to-day in the markets is what nudges us to make investment decisions when offering new investment opportunities (even for the ones, like me, who spend several days without taking a glance at the quotes), it is paramount not to lose sight of the grand long-run dynamics and to be ready for them.

Commentary on new holdings

On November 26th, the year-to-date of the Fund has been -4.6%, in line with European and global indices, but behind the S&P500 and the rest of the US indices. During the last few weeks the Fund has experienced larger gains than the indices, despite that, paradoxically, as I explain below, most of the investments are not related to a *"reflation trade"*, neither to a *"value reversal"* nor to any other slogan *du jour* in the markets.

The invested part of the portfolio has been gradually increased over the last few months, as investment opportunities have appeared – and as I have expanded my investment universe. Currently, we are invested in 18 names (17 issuers, and 16 if Fannie and Freddie are considered the same issuer), following the Fund's concentration philosophy. The invested share of the Fund is 85%, being the high yield and convertible share 25%, equities held for the long run 51% and special situations 9%. The yield to maturity of our bonds is 10.4%, with a duration of 2.9. Finally, our portfolio of compounders trades (weighted by the size of each position) at an EV/NOA of 16.3x, EV/NOI of 2.4x, with a RNOA of 41.3%.[1]

As I mentioned in the previous letter, the main reason why the invested share is not even larger yet is due to the fact that current valuations are unrivalled from a historical perspective, and hence the medium/long-run returns will be mediocre. Given the attractive prices at which our holdings trade, I firmly believe that the portfolio, despite its share in cash, will not fall behind if markets keep going up, and at the same time will have an extra protection in case the exuberance in the markets vanishes at some point.

I will detail now the investments undertook over the last few months. There has not been any significant news on the positions mentioned in our last letter (Check Point, Consol/Alliance, HC2, Berkshire, Philip Morris CR and Scully Royalty), so I will not rehearse their investment thesis here:

- **DRAM-memory manufacturers (Samsung Electronics, SK hynix, Micron Technologies):** taken as a whole, memory manufacturers account for the highest exposition of the Fund to a particular industry, above 20% (9.5% in SEC, 6.8% in SK hynix and 5% in Micron). Although each name has its own idiosyncrasies, the common thesis is: DRAM-manufacturing is an industry that over the last decade has become ultra-concentrated (with these three manufacturers controlling more than 95% of the market), the barriers to entry are colossal, technological dynamics ("the end of Moore's Law") will be favourable to rationalise capacity, and finally demand tailwinds will be very strong.[2] However, the valuations at which these companies trade suggest unattractive prospects. In general, there has been a big dichotomy in the semiconductor industry between capital-light businesses (AMD, Nvidia, Qualcomm) and capital-heavy ones (TSMC, Samsung), where the market has been favouring the former, despite the fact that Intel's recent problems have brought to the forefront the crucial importance of the manufacturing process in this sector. In the case of memory manufacturers, the market has focused on their high capital intensity,

[1] EV/NOA: *Enterprise Value to Net Operating Assets*. EV/NOI: *Enterprise value to Net Operating Income*. RNOA: *Return on Net Operating Assets*. The way in which I structure the accounting and the multiples is explained in detail in the Appendix.

[2] The three memory manufacturers also produce NAND memory, used to storage data. I think that in the following years NAND will be less attractive than DRAM for some reasons that I will not explored here, but in any case, the investment thesis on these names is not predicated on the NAND segment. For those avid readers, I did a presentation on SEC several weeks ago, where I summarise in depth the dynamics of the industry, and I will be happy to share it.

their high cyclicality, and the (always) little visibility in the short run. However, from a long-run perspective, the returns on capital have been phenomenal, 20% in the case of SEC, 17% in SK hynix's and 15% in Micron's. The three of them have grown their asset volumes at a healthy clip (SEC at 9%, SK hynix at 19% and Micron at 15%), and without hampering their incremental returns. Despite this profitable growth and the aforementioned dynamics, SEC trades an EV/NOA of 1.9x, SK hynix at 1.4x and Micron at 1.9x, leaving ample upside to their share prices. The relative positioning that I have made in the fund between the three has been based on the relative technological leadership in DRAM, being SEC the first one, SK hynix the second and Micron the third. Although SK hynix is the cheapest name of the three without any apparent reason (it still commands an advantage in DRAM over Micron, but it trades at a discount of 30% in terms of EV/NOA, despite having had historically better RNOAs than Micron), the reason why SEC is the main position is to hedge the potential risk of an irrational competitive behaviour by themselves, adding more capacity than needed. In this scenario, which cannot be ruled out and is the largest risk to the thesis, SEC will curiously be the producer with less to lose, not only due to its exposure to other businesses (the margins of its mobile business would grow, *ceteris paribus*), but because of its technological leadership. The other main risk is Chinese competition, although I think that such a possibility in DRAM is almost non-existent in the short term, for the only company with some likelihood of producing at a scale over the next few years (Changxin Memory Technologies) has a very weak IP foundation, to put it mildly.

- **Pilgrim's Pride:** Pilgrim's is the second largest chicken producer in the US, and its largest shareholder is the Brazilian company JBS. The chicken industry in the US is relatively concentrated (Tyson and Pilgrim's together control 40% of the market) and the current structure has been stable over the last decade. It is a cyclical industry, due both to the chicken and to the corn and soybean prices, which represent more than 50% of the cost of a chicken, and the business in general has been quite profitable. Since its bankruptcy filing in 2008 after an aggressive and ill-timed series of acquisitions, Pilgrim's has emerged as a very efficient producer with a conservative balance sheet. Its product portfolio varies from fresh products (where Pilgrim's produces a great range of chickens with an average intermediate size, around two and a half kilos) to ready-to-cook products with its own brand. I think that Pilgrim's has, on average, a better business than its competitors: whereas Sanderson Farms has always been able to produce at a lower cost because it produces large chickens (around three kilos); having a narrower product portfolio is a hindrance in times when the distribution channel matters, as we have seen during the pandemic with the closures of restaurants. On the other hand, Pilgrim's' processing plants are larger than Tyson's (900k chickens per week in the case of Tyson versus 1.2 millions in the case of Pilgrim's), and that has led to a better asset turnover for Pilgrim's and better RNOAs. Chicken producers have been adversely affected by the pandemic, given the inability (in the short run) of processing plants to move production from the foodservice channel to supermarkets. Pilgrim's trade at an EV/NOA '19 of 1.5x, a conservative one if one takes into account the average RNOAs of 17% over the last decade. Our target price is somewhere between 2x-2.4x EV/NOA – for an upside from purchasing prices of 100%. Debt is manageable and spread over time, and one of the few risks of the thesis, price-fixing litigation, has been favourably resolved lately.

- **Lukoil:** despite the large amount of listed companies devoted to oil production all over the world, it is important to grasp just how few of them offer good assets, solid balance sheets and a diversified business (upstream plus downstream), given that the best assets are either held by government companies (Aramco), or by companies whose business has increasingly less to do with oil (BP, Shell), or by those companies whose capital allocation decisions are not optimal (Exxon with *shale*). Fortunately, Lukoil does not fall into any of these buckets. It is the second largest Russian oil producer, it is vertically integrated with refineries and service stations (and with a small petrochemical business), it has minimal debt, and most of its assets are conventional fields in Western Siberia that produce with low costs, which are also denominated in rubles, helping thus Lukoil protect its returns during turbulent times. Shareholder total remuneration is attractive: using numbers from 2019, at current prices the shareholder yield would amount to 13%. Capital allocation has historically been good, and it has improved over time because Lukoil has stopped investing in international assets (where it has had mixed experiences) and it is now focusing on its local assets, especially in its refining area. Lukoil's RNOA over the last decade has been 12.5%, higher (and less volatile) than most of their competitors', but at the same time Lukoil trades at an EV/NOA of 0.8x. Although, as I argued in the last letter, oil short-run dynamics are not flattering at all (even with the introduction of a vaccine), Lukoil will be one of the producers that will emerge from this cycle, and at current valuations the potential stream of profits is attractive.

- **PBF Logistics:** we have bought PBF Logistics' (PBFX) bonds maturing in 2023, with a yield to maturity above 10%, but I estimate that in a year and a half the total return will be 20% (13% in capital gains up to par value, and the remaining in coupons) and with a very minimal risk. PBFX's main assets are oil pipelines and storage assets that serve PBFX's sponsor, PBF Energy. After a reasonable, but ill-timed, strategic acquisition late last year (Martinez refinery in California), PBF Energy has serious solvency problems, given that its refineries have been operating well below 85% of capacity (the threshold needed to operate a refinery in a profitable fashion) due to the drop in gasoline (and kerosene) demand. PBFX's bonds are dropped in tandem with PBF's, due to worries of permanent closures of its refineries, and in which case PBFX's assets would not be worth much because they would lose their main customer. However, I think these worries have been overstated, because the only non-competitive refineries in PBF's portfolio where those operating in the East Coast, and one of those has already been closed, though it will keep functioning together with another PBF's nearby refinery. For the rest of refineries (one in the Gulf of Mexico, one in Ohio and two in California) I do not foresee any closure, for the refineries in the Gulf of Mexico and Ohio have advantageous positions when sourcing different types of crude (the latter imports Canadian crude), whereas in California a sizable rationalization of refining capacity has already occurred (by Marathon and Phillips 66), so I estimate that the Californian market will become profitable again in the second quarter of next year. PBFX has kept its commitment to buy back debt, and in the meantime its contracts (with minimum volume commitments) shield it from a new demand drop in the next few months.

I will keep monitoring economic conditions during the winter, which I foresee to be much harsher than what many analysts and most international institutions expect. As I mentioned in my previous letter, I still think that as the economic crisis becomes more evident, investment opportunities will gradually appear.

In February I will send you another letter with an end-of-the-year update and with the most significant developments of our investments. In the meantime, I wish you a Happy Christmas.

Yours sincerely,

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Appendix I. BrightGate Focus brief manual on accounting and valuation

I think it is the right time to write some words on how I thought about the nexus between accounting and valuation, and how such a framework informs my investment decisions. As you have seen in these letters, the summary metrics that I provide usually go unreported in other funds, and here I will argue why these metrics have more informative content than the traditional ones, and how they are indissolubly tied both to a firms' core business and their accounting. In other words, these metrics are the ones I would like to receive if I were in your place trying to obtain a clear overview of the Fund's portfolio.

Although it is usually argued that valuation is not a differential part of the investment process, for "everything has already been invented", I cannot but disagree with such a statement. Although in the end the success of an investment boils down to the knowledge of the business and its own future dynamics, a correct study of the valuation and the accounting allows a better understanding of the business and to avoid serious mistakes later.

The exposition that follows is necessarily a simplification of our financial models, but it will be enough to grasp the conceptual framework.[3] The method that I employ to value business is the residual income model (or economic profits, as they are known in the academic literature), which says that the value of every asset is given by its current book value in the balance sheet plus those future discounted earnings obtained above the cost of capital – residual or economic earnings. If we have an asset with a book value of 100€, and we expect it will yield returns of 7% (7€ of profits at perpetuity), and our cost of capital is 7%, the asset should be valued at book value – no more, no less.

In mathematical terms:

$$EV = NOA + \frac{NOI - r * NOA}{r - g} = NOA + \frac{(RNOA - r) * NOA}{r - g}$$

Where *NOA* is net operating assets (net worth plus net financial debt), *NOI* is the net operating income (net of taxes), *RNOA* is the return on net operating assets (net operating income divided by net operating assets), r is the discount rate and g is the (residual earnings) growth rate.[4] As it can be checked in the second term of the expression, if the expected return is equal to our cost of capital the term cancels out, so the value of the company would be equal to its net operating assets.

It must immediately be pointed out that the residual income model, although mathematically equivalent to the free cash flow model, has some important advantages versus the latter in practice. First, the residual income model allows recognising some part of the value right now (current *NOAs*), and it does not differ the whole value up to some point in the future, as the free cash flow model does, so uncertainty is greatly reduced – it is easier to figure out what we have now than to carry out a forecast 7 years into the future. Second, the residual income model can be applied to those companies that are growing, which are still in their investment stage and hence do not produce any free cash flows,

[3] For those who want a more detailed reading, see Stephen Penman (2012) *Accounting for Value*, Columbia University Press.

[4] Operating assets are those needed to conduct the daily functioning of a firm, whereas net operating assets are equal operating assets (inventories, receivables, PP&E, goodwill) less operating liabilities (trade payables, deferred revenues, tax payables). On the other hand, net operating income is usually equal (though not always) to EBIT less associated taxes (without the fiscal shield derived from interest payments), less those items that go directly to equity without going through the income statements (and which are usually recorded net of taxes), as adjustments to defined benefit plans, foreign currency translation adjustments and changes in value of certain derivatives.

whereas in order to value these companies through the free cash flow model one has to make the heroic assumption that the company will stop investing at some point in the future, and from there on it will reap the fruits of its investments – a hazardous task and with a dubious practical utility.

On the other hand, if we compare the residual income model against one method widely used by analysts, the multiples, the residual income model calculates the intrinsic value of an asset based on its own fundamentals, and not based on what others may be thinking. Actually, if one labels himself as an "active investor", it is difficult to find a worse method to perform a valuation, for the multiples assume that the firm under consideration is not properly valued, where its comparables are, and so the valuation gap does not make any sense. Obviously, although this situation can happen from time to time, it is not a promising starting point for the success of an investment. All in all, *in a valuation where one wants to calculate a price, other prices should not be used as inputs of the model (i.e. market expectation as input of the model), because it is basically an autoreferential exercise.*

Finally, when one employs the residual income model, a little-appreciated but fundamental advantage emerges. The method directly connects the accounting reality of the firm (operating assets, returns) with its valuation. In order to calculate the value of an asset one only needs to get a handle on the *RNOA* (which, according to Dupont's formula, is given by the margins of the business and the asset turnover) and on the residual earnings expected growth – and nothing else.

So far, the theory. Why do the three portfolio metrics that I report (*RNOA, EV/NOA, EV/NOI*) provide a good overview of the portfolio and its upside potential? If in the previous expression we divide both terms by NOA and reorganise, we get:

$$\frac{EV}{NOA} = \frac{RNOA - g}{r - g}$$

That is to say, the *EV/NOA* multiple (which is an unlevered price/book ratio) can be expressed as a function of *RNOA*, r and g. And finally, if we want to be conservative and assume that the firm will not have any growth in the future, the expression is boiled down even more: [5]

$$\frac{EV}{NOA} = \frac{RNOA - g}{r - g} \xrightarrow{g=0} \frac{RNOA}{r}$$

For instance, Pilgrim's Pride, which was introduced earlier, closed on 25th of November at 19.3$ per share, which multiplied by 250 million of shares and adding net debt and minorities yielded an Enterprise Value of $6.8bn. Given that Pilgrim's' operating assets at the end of 2019 were around $4.5bn., the implicit *EV/NOA* was 1.5 times. How realistic is this valuation? Over the last decade, Pilgrim's obtained an average *RNOA* of 17%, and it was able to grow its residual earnings in a reasonable manner. If we are conservative and we assume zero future growth (the chicken industry has been growing at 2-3% over the last decade, gaining market share to beef and pork thanks to its price competitiveness, and I expect this trend to remain alive after an economic crisis like the current one) and we apply a discount rate of, say, 8%, Pilgrim's valuation would be:

[5] Given that the *EV/NOI* (an unlevered *PER*) is simply the *EV/NOA* times the inverse of the *RNOA*, the *EV/NOI* without growth would be expressed as $\frac{EV}{NOI} = \frac{1}{r}$, or the inverse of the required rate of return.

$$\frac{EV}{NOA} = \frac{RNOA}{r} = \frac{17\%}{8\%} = 2{,}13x$$

If the knowledge of our business is accurate and Pilgrim's earns 17% in the future, the share should trade at 2.1 times net operating assets, and not at the 1.5 that currently trades. We could also do some reverse engineering to calculate the implicit yield we are locking in when buying the stock at current levels. Given that Pilgrim's is trading at an *EV/NOA* of 1.5, for a *RNOA* of 17%, the implicit return is:

$$\frac{EV}{NOA} = \frac{RNOA}{r} = 1{,}5x = \frac{17\%}{¿?} \rightarrow r = 11{,}3\%$$

Therefore, the process to value a business can be boiled down, simplistically, to:

1. Understanding what determines the *RNOA* of a company, what has been its evolution and what could be its future path. The *RNOA* is simply the *margin times the asset turnover, so residual earnings force us to understand how a company sets prices and its cost structure (margin), as well as the efficiency when deploying the assets (turnover).*
2. Understanding *whether the company will keep growing its asset base and whether the firm will reinvest it at a profitable rate* (g). It is pretty worthless, for instance, to undertake a large acquisition to increase accounting earnings (and leave analysts happy) if the incremental return of that investment does not clear the cost of capital.

Summing up, when trying to gauge the upside potential of the BrightGate Focus portfolio, *I would advise our investors to take for each stock the RNOA*[6] *column and divide it by a discount rate at 8% (assuming conservatively a 0% growth rate), so as to obtain a target EV/NOA, which can be compared against the actual one for every share* – in order to ascertain the potential gain or loss. I think it is a simpler, more elegant and transparent method than the conventional one, which is to set target prices for every share – for which investors do not have any clue of how they have been obtained. Thanks to the way we report in BrightGate Focus, i) our investors can quickly assess what have been the historical returns of our businesses (returns that, alas, will likely not be the same in the future), so they know such an important metric, which also forces them to think as "owners" of these businesses, and ii) our investors can apply the discount rate that they think is most appropriate to their personal needs.

From this standpoint, it is no wonder that Buffett has been consistently presenting Berkshire's book value in his annual letters on the very first page…

[6] For simplicity, I have opted to report in the monthly factsheets the average RNOA of the last three years. Although it is an arbitrary choice, I have tried to strike a compromise between presenting simply the RNOA of the last year (which may be irrelevant in cyclical industries) or the RNOA over the last decade, which can be either misleading in the case of companies with permanent changes in their profitability, or just impossible in companies with few years of track record.

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