CELESTE
Funds Management

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Hard assets and valuation….

The impact of the Covid-19 pandemic on the fabric of modern society has been extraordinary. The economic cost is still being assessed and felt. The reality is, these costs will continue to grow and will be borne by us all for many decades to come. The impact on lives, livelihoods, the economy and wider society may never be able to be accurately calculated. The initial panic and chaos appear to have subsided, however there remains an inescapable desire for a vaccine and a reversion back to a more 'normal' way of life.

While much is still left to be written about the Covid-19 period, we have through the whole period noted one thing…..life finds a way. Changed conditions lead to changed behaviors and people subsequently adapt both their views and behaviour. Information remains patchy and incomplete but humans assess it, react and adapt again. And so it has been with investment markets. They plummeted in a white knuckle ride of panic and fear only to roar back to life a month later driven by stimulus and a view that the virus was treatable, survivable and transient. Markets seem to have adopted a process of assess, digest, respond and iterate post this initial recovery phase. Volatility has remained high on a day to day basis as news flow tilts one way or another. Despite the strong recovery in markets and seemingly full valuations, there remains stock opportunities for active investors.

In periods of economic dislocation there is often some debate around the validity of valuation and how it is linked to, or supported by, historic multiples. Valuation discussions gain attention when there has been a collapse in revenues, earnings and cash flows. In the case of Covid-19, there have been questions asked around some business models and whether they will survive in the new post virus world – one with more online transactions, more working from home, mixed employee productivity and more unpredictable government restrictions.

Valuation is a vital part of whether you will generate return (alpha) from owning a stock. To understand valuation you also have to have a view on the company's Board & Management and what strategy they will decide for running the company. You must assess the business model and how the company is positioning within its industry. You also have to trust that the financial accounts that you are looking at reflect the financial performance and cash flow of the business. A huge part of your valuation is what you think the company will do in the future. You must assess how it will grow revenue, manage costs and generate profit. You have to assess how much capital it will need to grow and what free cash it will have to repay debt and pay dividends. You must make assumptions. In times when there is great uncertainty, it is difficult to make assumptions.

It is fair to say that valuation assumptions will have some anchor to what the company has achieved in the past around revenue growth, margins, returns and cash flow conversion. These will then be adjusted (both up and down) to reflect competition levels,

capital intensity, contract wins and additional strategies. You must assess the risk that each of these assumptions entails and run scenarios around how changes in each affect the likely value. It is important to assess which assumptions are key to creating valuation upside, alpha generation and which assumptions, if not met, may lead to capital loss.

At Celeste, after framing up the risk reward scenarios we seek to buy a stock where we feel we have an asymmetric skew in returns, meaning limited downside in the share price and a significant skew to the upside, based on modest assumptions playing out. We like to buy stocks where we feel we have the share price underpinned by very modest or often slightly lower assumptions. It is here, that stocks that have hard assets on their balance sheet play an important role.

We have spoken about how markets will look at the operating metrics of a company: revenue, costs, profit and cash flow to assess valuation. But if, like in the Covid-19 crisis, these have been seriously impacted…. what do you do? You can choose not to invest because it's safe, but it means that sometimes when the market has overreacted you will miss out on an opportunity by being too cautious. Alternatively you can look to assess how long it will be before a normal year might return for revenues and earnings. You can value the stock based on there being a period of weaker earnings prior to growth and profitability returning. So while you make an assumption that things get better at some point, your ability to time this outcome is extremely challenging.

Sometimes you are lucky and get a solid company that has had a negative revenue, earnings or cash flow impact. Typically the share price has fallen as investors sell, not sure when earnings might recover. The opportunity here is to look at the quality of the assets on the balance sheet and see what they might be worth to someone in the same industry or new to the space that might want to buy them. If these assets are in the books at a conservative valuation (less any debt the company has) you may be able to buy the stock for a price that is underpinned by "asset backing". In this instance, you then have a similar asymmetric skew in returns that we spoke about previously. If the share price falls much more it is likely that the company will be acquired, broken up and sold off in pieces (or management may just choose to sell assets). The upside to the share price occurs when earnings recover and investors begin to pay higher historic multiples.

At the height of the Covid-19 crisis, Event Hospitality & Leisure (EVT) traded at $6/share down from a 12 month high of closer to $15/share. EVT runs the Event cinema chain, Rydges and QT Hotel chains and the Thredbo Ski and Mountain Biking Resort. Covid is bad for cinemas, not great for hotels and difficult for resorts. Profitability will be severely impacted for several years. EVT made $250m in EBITDA in both the FY18 & FY19 financial years. The stock crashed, the outlook was bleak and hard to forecast…. what did we do?

Firstly we looked at the debt. EVT has $420m of debt but they had agreed to sell a German cinema asset for $300m, so on receipt of the sale proceeds they will have $120m of debt. They have banking facilities of $750m that they can use to fund their operations through the Covid-19 weakness. In fact using the debt to cover operating expenses (which had been aggressively lowered) implied that EVT had multiple years of funding

for their business waiting for conditions to recover. So was it going broke?….in our view no.

We then looked at the value of the assets on the balance sheet to see what they were and what they were worth….they were land and buildings on which the cinemas and hotel operations sat. This was land that had been meticulously acquired as the founder Sir Norman Rydge and then son, Alan Rydge built the company, founded in 1910. This land was prime CBD real estate in metro locations…all very desirous for property developers & hotel operators. This also included a 50 year lease on the key Thredbo asset. So valuing these assets at cost was $1.2bn. If we deducted the $120m debt, this valued the company in a conservative break up scenario at $6.70/share.

We then looked at what the land and assets might be worth at market value. Accounting standards make companies value their assets at market value every three years so that the accounts reflect true & fair values for shareholders to see. The market value of the assets was closer to $1.9bn. We wanted to be conservative and so we subtracted the 30% capital gains tax the company would have to pay if it sold those assets and then we also subtracted the $120m of company debt. Under this scenario the stock was worth $9.80/share.

So we then had a view that the raw asset backing, less the debt, less any capital gains tax paid was well above the trading price. From a risk return skew, knowing that the asset backing covered the current share price meant that we were getting the income and cash flow stream the business was going to generate into the future for free. So the call around the exact quantum of earnings and timing of recovery became more a secondary issue, the driving question being .....do we think that hotels, cinemas and ski resorts go back to some normality when restrictions ease and a vaccine is eventually discovered? If they do, will EVT make $100m in EBITDA, maybe $150m or potentially closer to the historic $250m? Clearly time will tell but it seems very unlikely that the assets will see patronage levels lower than lockdown and with a reasonable level of patronage/occupancy they will generate significantly more than $0m in perpetuity.

With asset backing above the current price, investors are going to receive the income stream EVT generates in future years for free. Even if these earnings are potentially lower than those earned historically. Time will reveal the extent of the recovery and as forecasting becomes a little easier we expect the share price will recover. So while it's hard to do, when investors run away from a stock with solid asset backing but an uncertain outlook, it's often sensible to run towards it.

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