This article is authored by MOI Global instructor Patrick Brennan, portfolio manager at Brennan Asset Management, based in San Francisco.

Patrick is a featured instructor at Best Ideas 2021.

While markets outside the US have rallied substantially from the March lows, many have still posted negative returns during 2020 and vastly trailed their US brethren for multiple years. We will discuss two updates on previously profiled names that appear to offer something closer to a "Heads I win a lot, tails I lose little" proposition: Permanent TSB (TSB) and Megacable (Mega).

Permanent TSB

TSB is one of several banks nationalized by the Irish government in the wake of a housing collapse. The Irish government sold shares in TSB in 2015 at €4.50 per share, but the government retains a 75 percent interest. TSB is down over 84 percent from the IPO and trades at ~15 percent of book value. Through a combination of organic cures as well as securitizations, TSB had reduced its non-performing loan (NPL) levels from roughly 26 percent in late 2018 to a pro-forma level of 6 percent in December 2019.

Over the last several years, the Irish economy had been one of the strongest throughout Europe benefiting from low unemployment, substantial exposure to technology companies, including the US behemoths, and surging house prices. But, just as TSB had line of sight towards a further reduction in NPL levels and a likely removal of dividend blockers, COVID hit and TSB and Irish banking shares tumbled. Some luck of the Irish.

Without question, TSB screens awfully with a tiny market capitalization, elevated NPLs and limited earnings/losses. That said, the forward setup is far more favorable than meets the eye. TSB's recent losses/low ROE reflect a scale issue, not a balance sheet problem. TSB sits on substantial capital with a Tier One CET ratio of 15.7% versus management targets of just over 13% despite substantial COVID additions during 2020.

As TSB's loan books is nearly totally comprised of residential housing loans (roughly 15% share of the Irish market) with little commercial sector exposure currently (soon to change), TSB was isolated from the worst COVID impact. That said, generous government support has helped contain the more dire COVID scenarios and recent vaccine deployment should fuel a substantial recovery and provide an economic backdrop far better than what was originally assumed when TSB set COVID reserves.

Assuming further progress on NPL sales/securitizations, additional cost reductions and incremental progress on adding residential mortgages and a newfound focus on growing the commercial book, TSB can likely earn mid-single-digit returns on equity. While these returns may sound pedestrian, the resulting dividend stream would be substantial relative to TSB's puny market capitalization. And then there is the possibility of far higher returns.

The Irish banking market is dominated by two goliaths – Allied Irish Bank (AIB) and Bank of Ireland (BOI). Government officials have clamored for a strong number 3 competitor for years. Long rumored merger candidate Ulster (a subsidiary of the NatWest Group – formerly Royal Bank of Scotland) has announced that it is exploring a sale/runoff of the bank. TSB is the most likely merger partner – a deal with AIB or BOI would not be allowed because of market concentration – and TSB could make an offer that allows NatWest to immediately return more capital than a prolonged runoff.

Assuming cost cuts of 20-30% of the combined companies' cost bases, it is possible that a merger could generate €170-250 million of cost savings versus TSB's ~€360 million market capitalization. Even at low-single-digit multiple, TSB could be worth multiples of current levels. If an Ulster deal does not materialize and the bank instead decides a long winddown, TSB would be in a prime position to pick off portions of Ulster's loan book.

As noted, TSB has the capital to absorb far higher loan balances and any pickup combined with further cost savings can ultimately produce a meaningful dividend stream. The government claims it wants to sell shares closer to book value or the price it sold shares during the 2015 IPO, implying ~6x upside from current levels. While we doubt the government would sell near current prices, we suspect a happy middle ground might exist and any exit would be an obvious catalyst for the stock.

Megacable

Mega is the second largest high-speed cable company in Mexico with roughly 3.9 million unique subscribers. Mega shares have underperformed the past couple of years, with the declines attributed to a combination of policy concerns from Mexican president Andrés Manuel López Obrador (AMLO) and a COVID induced slowdown that negatively impacted the company's historically faster growing enterprise division.

Additionally, there are concerns regarding Mega's increased capital spending including a significant voluntarily fiber overbuild covering roughly half its customers. Finally, Mega is locally listed in Mexico, with no ADR, and has a relatively illiquid float. The concerns appear overstated, creating an attractive entry point for an unleveraged cable name with compelling growth prospects.

While AMLO has been far from a business-friendly president, thus far, his policies have been neutral to the telecom sector with no negative impact for Mega. Mega's enterprise business did suffer EBITDA declines in Q2 and Q3 (following advances of 30% and 24% in 2018 and 2019 respectively), driven by a weak government contract environment, including the elimination of a specific education contract.

By contrast, Mega's core residential cable business (80%+ total revenue) proved particularly resilient during the pandemic, generating total EBITDA growth of 7 percent during the first nine months of 2020. We continue to see high single digit/low double digit growth going forward, with the enterprise segment growing closer to 15 percent annually.

Megacable is overbuilding itself with fiber covering ~50 percent of its footprint, and this will drive elevated capex for the next 18 months. Ultimately, we believe that the spending will prove worthwhile as the fiber network will discourage overbuilders and drive reductions in operating expenses and maintenance capex spend.

Finally, Megacable is an obvious acquisition target and we believe the company would receive significant interest from multiple parties should the controlling family decide to sell. Televisa has been a long-rumored merger partner given the substantial synergies that could be achieved between the two companies. We also believe there would be considerable interest from other LATAM cable operators looking to enter the Mexican cable market.

Despite the obvious takeover value, double digit growth potential and unleveraged balance sheet, Mega shares trade at just over 5x our 2022E EBITDA, providing a highly skewed risk/reward opportunity.