

Same Concerns, Different Perceptions

This article is excerpted from a letter by MOI Global instructor Patrick Brennan, portfolio manager of Brennan Asset Management, based in Napa, California.

What a difference three months make. The underlying concerns - weaker economic growth in the US and abroad, an inverted curve with short-term interest rates above longer-term rates, trade concerns, Brexit - have not gone away. But, more dovish comments from the Federal Reserve drastically changed investor sentiment and drove a rally in risk assets during the first part of 2019. We understand that many are used to investment letters which discuss each of these developments at length, but, as stated in multiple past letters, we have little to no ability to successfully forecast future macroeconomic events. Of course, historical records suggest that professional economists also struggle, with total odds of predicting a recession perhaps only marginally better than successfully forecasting that number-one seed Virginia would somehow lose in the first round of the NCAA basketball tournament in 2018 and then manage to win the entire tournament the following year (No comment on our pool results). Uncertainty is the only constant certainty. We will hazard a guess that markets will soon begin worrying that some of the more radical ideas of self-proclaimed socialists (with less discussion about socialism's historical track record in other parts of the world) could actually become the professed policy of the next president of the United States. The proverbial "wall of worry" might soon include the possibility that a crazy US president could be replaced by an equally crazy populist with far fewer market-friendly policies. We'll save that happy discussion for another letter.

Cable: We Hate You... We Love You... We...

Moving from the macro to micro, we still see substantial opportunity in several of our names. In our last quarterly letter, we provided a more detailed synopsis of the investment rationale for our largest names, including commentary on why the selling of our various cable names - Charter (CHTR) derivatives LBRDK/GLIBA, Liberty Global (LGI), and Liberty Latin America (LILAK) - was likely overdone. All three groups of cable names rallied for differing reasons during the first part of 2019. So, we again rhetorically ask what has changed? The answer is the same - very little. While there are nuances with each name, we would generally describe all three as regional oligopolies with steady, recurring cash flow. If we simply marked our position to the operating performance of the assets, it would likely look something like a line moving on a 45 degree angle from the bottom left of the page to the top right (with perhaps more variation in the case of LGI). Of course, all three businesses have leverage and are susceptible to broad selling on "risk off" days. Given the size of the holdings, we want to offer a quick comment on the names. In an attempt to keep readers from immediately tearing up this letter, we will limit ourselves to a couple of quick comments - please see our past letters for more details.

CHTR's stock rerated following strong Q4 results, including a substantial cut in forward capex spending. In December of last year, when the company's stock was plunging, we thought CHTR would generate substantial free cash flow over the next several years. In February of this year, when the stock was soaring following Q4 results, we thought that...Charter would generate substantial free cash flow over the next several years. Incrementally, the only real new piece of information might be that the initial 5G rollout - the alleged competitive threat

to cable and source of substantial angst for many — appears to have gone slightly worse than our already low expectations – please call us if you’d like to discuss this point in more detail. We own CHTR at a discount via LBRDK/GLIBA and anticipate holding the name for several years.

In Q4, LILAK suffered the steepest decline of the various cable names, but the stock has also rallied the strongest. The company reported solid fourth quarter results and announced an acquisition of 87.5 percent of (less hurricane prone) Caribbean cable provider United Telecommunication Services for an implied value of \$189 million, implying a roughly 6x pre-synergy 2018 EBITDA multiple. After speaking with the company, we believe the synergies could be substantial. We expect further deals over the coming year. Given the leverage and exposure to LATAM markets, continued volatility is nearly assured. Of course, as discussed in prior letters, lower penetration levels, fragmented markets and the possibility of further deals all likely allow the greatest upside of all the cable names we currently own.

Finally, there is Liberty Global. In past letters, we described how the various binary risks, including Brexit and the regulatory risks associated with the sale of assets to Vodafone (VOD), along with past operational miscues drove LGI to nearly impossibly low implied valuations. Since our last letter, LGI announced a sale of its worst market (Switzerland) – potentially the worst European cable market outside of France – to Sunrise Communications for over 9x our 2019 EBITDA estimate. As previously noted, LGI’s management team deserves criticism for past operational miscues, but we believe they are doing a phenomenal job of arbitraging the amazingly wide gulf between public and private values for European cable assets. As more evidence surfaced that the VOD/Sunrise deals would likely close (if the deals close, LGI will have ~1x net leverage, nearly guaranteeing large repurchases), we increased our already substantial position. While risks remain, the odds of deal closings have risen substantially since the start of the year, a time when we already thought a closing was highly likely. If the deals close as expected, LGI is still far too cheap, given the stability of the business and the prospect of substantial repurchases.

During the first quarter, we began purchasing another emerging market telecom name. Given the recent run in the stock, we were not able to build a full position and therefore we will save a more detailed discussion for another letter.

Investors Backtrack From MKL... Run Away From QRTEA/TSB

We did not avoid every pothole during the first quarter. As investors flocked to cable, they managed to run fast and furiously from two of our other holdings, Qurate Retail Group (QRTEA) and Permanent TSB Group Holdings PLC (TSB), while backtracking from longtime holding Markel (MKL). In past letters, we have described QRTEA as something akin to the ugly stepchild of the Liberty family of companies. Even as the company reported consistent free cash flow, the stock perpetually traded at high free cash flow yields and often at a meaningful discount to structurally challenged brick and mortar retailers. When the company posted a disappointing quarter (Q3 2016, Q1 2018 and now Q4 2018), shares were punished. Without question, the 2018 fourth quarter was disappointing with EBITDA declines across QRTEA, HSN and zulily. Perhaps the quarter finally proved the secular bear thesis? We think the problem with this narrative is that QRTEA also posted record new customer growth and made meaningful progress on turning around HSN. Furthermore, zulily was coming off record results through the first nine months of 2018.

Without a doubt, retailing is a difficult business. The macro outlook in Europe (QRTEA has operations in the UK, Germany and Italy after closing its France division) is more challenging

and any shorter-term weakness will inevitably trigger the “Amazon is going to kill this business” reaction. But, QRTEA continues to have a very loyal customer base and converts a large percentage of its EBITDA to free cash flow. Amazingly, the sell-off in QRTEA shares has come as debt levels are at near multi-decade lows and makes the current 16%/21% 2019/2020 free cash flow yields even more amazing. At current levels, investors are assuming QRTEA’s cash flow will decline at a mid-single-digit rate in perpetuity. We suspect the business will ultimately perform far better or – wait for it – actually grow and that the Liberty team will keep repurchasing stock. Assuming another 80 basis points of margin contraction over the next several years in the core QRTEA business, continued declines at HSN (but giving credit for cost synergies) and slowing gains at ZU, we project that the roughly \$1.1-\$1.4 billion of annual cash flow will allow QRTEA to repurchase 50% of its shares over the next 5 years, assuming the stock rebounds at a 20% CAGR. If we were to keep all assumptions constant but assume the stock stays flat, QRTEA would repurchase roughly 75% (that is not a typo) of outstanding stock. While QRTEA will sell-off on risk-off days or if quarterly results come in shy of expectations, we think the resiliency of the free cash flow is far stronger than implied by current prices.

We described our investment in TSB in our Q3 2018 letter. As a refresher, Ireland had an even greater housing boom and subsequent bust than the United States. The Irish government was forced to essentially nationalize the banking industry, and it continues to be a large equity holder in the largest banks (75 percent in the case of TSB). Irish reserve requirements are among the strictest in all of Europe, and the country has among the slowest/most cumbersome foreclosure processes in all of Europe. Government officials still score political points by castigating banking executives. Sounds attractive, right?!

That knee-jerk negative reaction from reading the last paragraph has been shared by TSB investors thus far in 2019. Unlike QRTEA, there really has not been any specific negative news at TSB. In fact, the loan reduction and capital build have actually been slightly ahead of our original expectations. Instead, the fallout has mostly been external factors – higher capital required than anticipated, a delay in European interest rate expectations and ongoing Brexit concerns. We are acutely aware of the piles of dead bodies (mostly those of value investors) who have invested in European financials, drawn to the flame of cheap valuations and the tantalizing possibility of increased lending/higher interest rates. So why TSB versus all the other beaten down European financial names? In short, we think Ireland’s economy is much stronger than other European countries and its housing market remains red hot. Additionally, TSB is far cheaper than those of other European financials (saying something), but, more importantly, it will likely have the ability to return substantial amounts of capital even if interest rates don’t budge. Unheralded CEO Jeremy Masding, who arguably has one of the worst CEO jobs of all time, has done a good job at managing the political backlash after executing multiple non-performing loan sales and he has done this with strict government imposed compensation limits. We believe there will be further sales in 2019 at levels at or above existing marks and that dividends could be approved later in 2019. The government wants to be repaid on its TSB investment and therefore there is a mutual incentive between the government and minority shareholders for payments to begin. Additionally, a highly accretive merger with Ulster – a deal that could conceivably double TSB’s share price – cannot be ruled out. At under 0.3x tangible book value, little has to go right for shares to rerate.

Longtime holding Markel (MKL) reported that its 2018 book value per share shrank 4 percent year-over-year as the company suffered the fallout from write-downs in its Insurance Linked Security (ILS) Business, primarily at CATCo, due to catastrophe-related charges. Furthermore,

there was a regulatory investigation into CATCo's reserve process (unrelated to underwriting at MKL's core insurance business) which Markel could not discuss in detail as MKL engaged outside counsel to investigate CATCo's reserve process. As we write this letter, the independent third party found no evidence that CATCo personnel acted in bad faith in setting reserves or making disclosures. Markel devoted a substantial portion of its annual letter to explaining the ILS securities market – think catastrophe bonds/investments which have pressured the traditional reinsurance market. MKL described how this market continues to attract capital and the recent acquisitions/investments (CATCo, Nephila, State National), despite recent setbacks, positioned Markel as a leader in a market that will continue to expand over time. The combination of consistently generating lower cost or negative cost float and honestly reinvesting for the long-term (in existing insurance businesses as well as public and private companies) is a fantastic model that has generated substantial value over time. We believe this will continue to be the case for many years to come.

Finally, with tax returns recently filed, we wanted to share a couple of comments from clients regarding our past letter – comments other than, “There is no shame in keeping letters to under 5 pages, cough, cough.” Some noted that they enjoyed the discussion of The Blackstone Group L.P. (BX) converting to C-Corp. I quickly jumped in, assuming clients were drawing parallels between K1 names and Liberty tracking stocks, how it was wise for BX to remain a partnership and to avoid taxes despite the difficult K1. But, I was quickly stopped (or more accurately told to stop talking) as clients bemoaned, in-between a couple of words that would be less than appropriate to print in a family friendly letter, that “I could care less how much BX pays in taxes – that BX K1 was the worst thing I’ve ever seen in my life. I will do ANYTHING to make that go away.” After personally dealing with BX's K1, we are more empathetic to the complaints. We remain highly confident that BX will continue raising billions of assets with multi-year lock-up periods and will enjoy the benefit of marketing its positions to model versus marking names like QRTEA, LILAK and TSB on a daily basis like we are forced to do. We also believe that willingly paying more in taxes is rarely, if ever, a good idea. But, after going blind staring at pages of K1 adjustments in the early morning hours, we must concede our tax efficiency comments rang a bit hollow and that earnings volatility is far from the only reason BX trades at a discount. In short, our partners have a point. Of course, this also suggests that the ultimate rerating in BX shares from its recent announcement that it will convert into a C-Corp (no more K1s!) may prove greater than we initially thought.