COMMENTARY

September 8th, 2017

Dear clients and colleagues,

Are capital markets feeling the combined effect of: the rise of passive investing (indexing), the ever shortening time horizon of public equity investors (average holding period is now approximately six months.), the rise of quantitative strategies and momentum investing, and the enormous amount of money being directed to private equity? As we reflect on capital markets and whether or not these factors are having an impact, we wonder if capital markets are hurting the real economy by doing a poor job of allocating savers capital to companies that deserve it.

A few weeks ago at an investor's conference, we met with the CEO of Chef's Warehouse (CHEF US), a distributor of specialty food products focused on chefs who own and operate fine dining restaurants (50-100 seats). Since going public in 2011, Chef's warehouse has grown sales from $330 million in 2011 to $1.3 Billion this year. Through those years, the company has maintained its profitability with a gross margin of approximately 25%. When asked about the competition, he said, "Yes Amazon is a competitor. Except we need to make money and they don't!" This is not very encouraging of where the investor's mind-set is today but it is very telling.

In November 2015, we wrote a commentary about the liquidity premium detailing how private companies are now selling at a premium to public companies and are not subject to the short-term horizon public companies are now facing.

One of the largest holdings in our portfolio, IWG PLC, the operator of Regus, the leader in flexible workspace, is up 2% in the last 12 months. That is despite growing revenues of 9% and earnings of 17%. Exactly one month ago, the company stock price lost more than 10% upon reporting results. What was so terrible? Actually, the company is so confident in its growth prospects that it increased guidance for new location openings to 310 from the 280 previously reported, translating to more spending on capital expenditure. Management's positive outlook was also reflected by a 13% increase in its dividend. But the market did not seem to agree.

With over 3,000 locations in more than 100 countries, IWG (Regus) is the leader in this fast growing industry of leasing flexible workspace. The company does over US$3 Billion in sales and has generated in excess of $150 million in free cash flow in the last 12 months. Yet its market cap is US$3.5 Billion and the company sells for 14x 2018 earnings per share and 6.1 next year ebitda.

Well, one could ask what is wrong with that.

WeWork is a private company that currently has 207 centers, less than what Regus will open this year alone and is one of IWG's main competitors. It is not yet profitable, but its market value is over US$20 Billion and it recently received a fresh investment of $4 Billion by Softbank's new technology fund.

$4 Billion in fresh money along with all the money being given to similar companies in the industry will no doubt hurt the profitability for all the companies in this space as they may have to secure expensive leases while foregoing profitability. So, what is IWG to do? We believe it is adopting the correct strategy.

It is becoming an attractive target for Private Equity as buying the company would immediately bring critical mass and would be much cheaper than building a similar footprint. Not the best long-term outcome for long-term focused public equity investors.

More recently, on July 7th, we wrote a commentary about Amazon. Our argument was that the company's competitive advantage is overstated.

Turns out we are not alone in our thesis. BCA recently published a paper that looked at Amazon financials and reached the conclusion that despite its sales growth, Amazon's cash flow is not improving and that this growth has been funded by share price growth and debt. Other studies have also highlighted that Amazon's existing businesses are seeing slower growth, which could possibly explain Amazon's rush to expand into new businesses.

But how is this hurting the real economy?

In addition to the arguments we made in our July commentary on Amazon, investors are now weighing in.

Famous hedge fund manager Paul Singer recently argued that passive investing is "devouring capitalism". Bernstein, a wellknown money management firm, argued that the rise of passive management undermines the entire system of capitalism. With indexing, the stock market rewards larger companies particularly those whose stock prices are rising. This insures that the most valuable company remains so and keeps going up. There are no valuation or profit criteria to drive the decision.

Companies actually creating economic wealth, as measured by profitable growth, are often penalized by making investment decisions that may lower profits in the short term.

Whether we look at IWG, Dick's sporting goods or Wal-Mart, the incumbent with the competitive advantage is now often penalized by a stock market or private equity interests that reward the challenger whose business model is based on growth and not on profit.

This is a misallocation of capital and it is quite dangerous for the real economy.

One example of this abnormal situation is the dwindling number of IPOs. The average number of Initial Public Offerings has fallen by more than half from 1996 to 2016. Small cap IPOs have declined even more.
Many emerging companies' business models are better fitted to private markets where they are able to pursue growth at any cost, often unregulated and without public scrutiny.

Another perverse effect has been to drive public companies to share buybacks instead of investing for growth.

Incumbent companies that should use their competitive advantage and positive cash flow to fight the threat of challengers get penalized for sacrificing short-term profits for faster growth, giving the younger company an unfair advantage.

What will be the outcome?

We believe we will see increased privatizations as well as mergers and acquisitions. This may be a positive outcome in the short term but probably not in the long term.

We also believe that the end of QE and excessive liquidity will improve the situation.

Poor future results for private equity funds may also improve the situation. After all, if they can't IPO their holdings, how will they realize returns?

In the meantime, we continue to focus on quality companies with strong quality metrics such as sales growth, high profit margins and lower debt. This approach has been proven over the long term and in market corrections in the past.

Have a good week,

The Global Alpha Team