COMMENTARY

May 8, 2020

Dear Clients and Colleagues:

As we grapple with opening the economy, many of our companies have warned us that the next two quarters will be difficult. Our companies have been nimble internally when it comes to cutting costs, preserving cash and organizing secure labor shifts. However, most sector supply chains are disrupted following extensive closures, as well as a virus that has spread geographically at different timelines. Companies' unwillingness or inability to forecast past the next two quarters has allowed the US$2 trillion stimulus to fuel the recent bear market rally.

Commercial markets are set to "partially" resynchronize, as we saw in China. With bankruptcies in the United States (US) headed towards 1 million and 35 million lost jobs, even the most optimistic scenarios don't expect full short term recovery. In addition, consumer confidence can only begin to recover once the economy is permanently reopened, which means having the virus under some sort of control. In April, the Consumer Confidence Index shot straight down at a record pace, with no bottom, to 2016 levels.

Science is trying to give us somewhat of a timeline. With positive clinical trials and quick approval announced last week, Gilead's drug Remdesivir offers a glimmer of hope. According to the US government and many industry experts, the drug will become the standard of care in the US for patients about to go on ventilators. A study involving 1,000 hospitalized patients revealed that Remdesivir reduces critical care time by 31%. Death rates also improved.

Are those numbers enough to restore confidence as of now?

The answer is unfortunately no for now. Should treatments lead to death rates decreasing to rates comparable to that of the flu, it would help restore confidence. Every year, 45 million US citizens get the flu, with a mortality rate below 0.14%, or 61,000 deaths in 2019. Researchers from Columbia University recently estimated that only 1 in 12 cases of COVID-19 in the U.S. are documented, which they claim translates to an infection fatality rate of about 0.6%. So even with Gilead's drug at 27% improvement in death rates (as trending in the study) and an extremely low COVID-19 fatality rate estimated by the Columbia University researchers, COVID-19 will be four times deadlier than the flu in the next six months.

The drug's supply will not be enough to meet global demand in May 2020. Gilead expects 120,000 treatments by mid-May, which doesn't cover the global hospitalization demand of 200,000.

Fortunately, June production is forecasted to exceed 260,000 doses. In contrast, vaccines require hundreds of millions of doses and a 12-month minimum lead time to orchestrate production.

In the upcoming quarters, we will continue to monitor cash. Companies who were in the middle of large capital expansion projects, low on cash, with end consumers as direct customers are operating in difficult conditions. Capital project costs can quickly get out of control, especially with an unreliable supply chain. Small changes to pro forma revenue forecasts quickly render negative rates of return.

We profile four companies who completed major capital projects in the last two years and have therefore de-risked capex pressure on free cash flow. In addition, their products and services are less discretionary purchases. This list is certainly not exhaustive, as many of our companies are in similar scenarios, since holding equities post capex expenditures represents an excellent time to benefit from increased earnings.

Ormat Technologies (ORA:US)

Based in Israel, Ormat is a leading renewable energy company specializing in geothermal power. Ormat recently completed the rebuild of its Puna geothermal facility in Hawaii for 38 MW of its 900MW capacity. The facility had been shut down since 2018 due to volcano damage. Although Ormat consistently spends on growth capex, this mostly involves rural area build-outs. The company has three out of ten pipeline projects due for delivery in the next 12 months. Revenues are very stable thanks to long-term power purchase agreements. Ormat also supplies products to the geothermal industry, which could prove favorable in a supply constraint environment. As a utility company, Ormat is underlevered. It has $1.3 billion in debt on $3.6 billion of assets.

Raffles Medical (RFMD:SP)

Raffles is a Singapore-based hospital owner and operator. Raffles has significantly increased its growth capex in the last few years, adding a recently completed 400-bed hospital in Shanghai and an extension to its Singapore network. The company is predicting a capex drop from $70 million to $25 million in 2020. All of its expansion projects were funded from operations. The debt to EBITDA ratio is 0.5.

ANI Pharmaceuticals (ANIP:US)

ANI is a Minnesota-based generic and brand-name drug manufacturer. The generic industry has been under competitive pressure for several years. Companies such as ANI have been migrating to brand-name products that can hold margins for longer periods. ANI paid $75 million to acquire the rights to a drug called Corticotrophin from Merck in 2015, a critical product in autoimmune disease with an $800 million addressable market. ANI has spent $100 million out of its operational profits setting up manufacturing and regulatory filing. The company expects to launch the product in 2020. The debt to EBITDA ratio is 1.4.

Federal Signal (FSS:US)

Based in Illinois, Federal Signal manufactures safety, signaling and communications equipment. The company is the leading supplier of municipal cleaning equipment for sewers and streets. Federal Signal increased its capital spending in 2019 by 125% to $40 million. The company spent over $25 million on one facility that is 90% completed and opening soon. The Vactor facility will be the finishing hub for many of its manufactured equipment. The debt to EBITDA ratio is 1.1.

Have a nice weekend.

The Global Alpha team