COMMENTARY

March 6, 2020

Dear clients and colleagues,

This week, two people from our team attended Raymond James' 41st Annual Institutional Investors Conference, one of the largest investor conferences held in the United States (US) each year. Despite concerns regarding the coronavirus outbreak, very few companies or investors cancelled; there were over 2,000 attendees this year, including 900 institutional money managers and over 300 presenting companies.

This conference is always held during the first week of March in Orlando, and we have attended every year for the last twenty years. The conference covers most of the industries present in our investment universe. One of the benefits of attending this conference each year is that it acts as a reference point and gives us a good feel for how the economy has progressed over the last 12 months. A notable difference this year was how environmental, social and governance (ESG) has become a main topic for the majority of companies.

A few observations:

Orlando continues to be a favourite tourism destination for families and 2019 saw a record of over 79 million tourists, up 6% from 2018. About 125,000 rooms are available, an increase of 2.5% from 2018. Occupancy rates at all hotels remain high, around 80%, with average revenue per room flat around $100.

Florida has no confirmed cases of coronavirus yet. Further, we did not see people taking extraordinary measures, such as wearing masks or following special procedures, at the airport or in public places. Major attractions have not yet seen any decline in activity. Very few group cancellations have occurred so far, as Orlando is a major conference location.

That situation may change rapidly, however. The worst scenario may not necessarily be the virus itself; prior outbreaks, such as severe acute respiratory syndrome (SARS) and H1N1, saw a temporary hit, followed by a quick recovery. The worst scenario would come from a financial crisis like in 2008-2009, which hit Orlando and the rest of the US very hard.

Overall sentiment:

The general tone of the conference was upbeat. There were definitively no strong negative views; most firms believe the impact on the supply chain from the coronavirus will be limited. Most companies expressed optimism about the US economy and very few mentioned labour shortages, unlike in 2018 and 2019. Wages went up rapidly in the last three years and companies have seen a 3% increase in 2020. Most companies believe they will be able to offset those wages by increasing prices and have indicated they have some ability to raise prices. Further, companies mentioned positively the phase one trade deal with China, although there are still many tariffs in place. Companies will continue to diversify their supply chain and bring production closer to clients.

American companies continue to be aggressive using leverage on the balance sheet and aggressively buying back shares in their companies. This is a behavior we rarely observe outside North America. We have noticed in the past few years that leverage ratios have gone up. Many companies in the consumer and industrial sectors mentioned feeling comfortable with a leverage of 2 to 3.5x debt-to-EBITDA. In addition, no company mentioned a strong US Dollar as being a drag on profits yet.

Existing holdings: Positive feedback

PRA Group (PRAA US: $38.44)
PRA Group is one of the largest debt buyers. PRA's business model is based on purchasing pools of consumer debt from banks and other creditors, at a discount to the full amount owed. The company then tries to recover two to three times the purchase price over a period of years. The company operates in 17 Countries and employs 5,400 employees.

In 2019, they purchased US$1.2B of new debt and have a remaining US$6.8 in estimated recoveries.
The company is extremely positive about the outlook. The European market has fewer buyers due to overleverage of many companies operating; the US remains stable. Stricter regulation has favored larger companies. From an ESG perspective, PRA Group does not charge any fees or interest. Although not wished, a deteriorating credit situation on the part of consumers would be a positive for PRA Group.

Farmland Partners (FPI US: $6.24)
Farmland Partners is the largest farmland REIT in the US. It currently sells at a discount of 45% to its Net Asset Value (NAV)

Farmland is an attractive asset that gives a yield of 3 to 4% annually on top of 2 to 3% capital appreciation. In the last year, the company has sold some assets at a profit to what it paid for and has repurchased shares. It will continue to do so in the next 12 months. The company echoed what we heard from other agriculture related companies like John Deere last week, as well as some our holdings, Titan Machinery, Bucher, and Lindsay, which we met this week in Omaha, noting that US farm income will most likely increase, driven by stable to rising commodity prices ahead.

Wintrust Financial (WTFC US: $48.02)
Wintrust is the largest community bank in the Chicago area. It currently ranks third with a 6% market share. The co-founders are still heading the company, 28 years after its founding. They highlighted a very strong local economy and very attractive growth opportunities.

Envestnet (ENV US: $72.41)
The company supplies the platform to financial adviser and planners. Currently about 35% of all advisors are on the platform. Very strong competitive advantage.

What do we think today?

Before the first cases of the coronavirus were diagnosed, we became increasingly negative about the US economy. The very low oil and gas prices are wreaking havoc on the sector. We believe that the first quarter results will see a record amount of bankruptcies. Already, over half the high yield debt issued by the sector is now CCC or Default.

How important was the growth in the energy sector, particularly the shale oil sector was for the overall US economy? We will find out soon. Now that the coronavirus outbreak is spreading, prompting major Central Banks to do emergency cuts in interest rates. Bond yields are at an all-time low and we view a potential recession in the fourth quarter of this year or the first quarter of next year as a distinct possibility.

What is most at risk? Many companies are already pricing a recession. Small Cap indexes, normally a good proxy of the strength of the economy have significantly underperformed larger caps in the last few years, a trend continuing this year. What is most expensive, are the large cap technology stocks. By most indicators, the weight of the top five companies in the S&P 500, a new high of over 18%, five technology companies, the underperformance of the cyclical sectors, and energy and commodities, indicates a complacency that does not bode well. In addition, the high likelihood of a global digital tax before the end of the year, and many antitrust lawsuits around the world does also not bode well for the sector, regardless or a recession or not.

In this scenario, buying companies who have maintained financial flexibility and operating in large addressable market at a reasonable valuation and having a well-diversified portfolio across countries, currencies and industries should reward patient investors.

Have a great weekend.

The Global Alpha team