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1Q20 FV Quarterly Report

In Q1, FV had its worst result ever, down -26.4% net of fees. It is of little solace that the broader market was down as well, with the S&P 500 falling -19.4%.

Since inception, FV has returned 8.7% annualized vs 7.5% for the S&P 500.[1]

Name	1Q20	Since Inception	Annualized
FV - Gross	-26.0%	47.2%	10.6%
FV - Net	-26.4%	37.7%	8.7%
SPY	-19.4%	32.0%	7.5%

The catalyst for the drop in markets was of course COVID-19, which continues to wreak havoc on the world's health and economy. Perhaps the most dramatic illustration of the pandemic's impact in the US is the near 19 million Americans who filed a new unemployment claim in April -- an unprecedented figure five times higher than the worst month of the Great Recession. Some businesses have been hit harder than others, with restaurants, hotels, events, travel, and financial stocks among the most impacted.

Value investing came under particular assault, with the S&P 500 Value Index falling -25.4% and the Russell 2000 Value Index falling -35.8%. In recent quarters, we have written ad nauseum about the historic relative attractiveness of value names. Yet that did not stop value from underperforming growth once again. We will have much more to say on that topic soon; for now, suffice to say that the value spread is now at all-time highs according to our calculations. Value has never been cheaper relative to growth.

As much ink has been spilled on the broad macroeconomic impacts of COVID-19, including by us, in this letter we have taken a narrower look at the effect of the economic shutdown on our portfolio strategy and on some of our most-impacted investments. We've also included a discussion of two new purchases that we made in Q1.

Portfolio commentary

Prior to the crisis, we were not enamored of the available opportunity set. Therefore, in Fundamental Value, we maintained a relatively low exposure on both sides of our book. We entered February 87% gross long and -9% gross short.

Maintaining excess capacity while other investors are complacent allows one to be a buyer in times of stress, when others want to -- or need to -- sell. We did not expect the stress to come in the form it did, or to come as quickly as it did. But when it did come, we were ready to deploy capital, and quickly.

At the height of the panic, companies' values fluctuated wildly. Financial time was compressed by an order of magnitude or more over its prior level; the monthly volatility in the S&P 500 Index went from a low of 7% annualized to a high of nearly 90%.

Our conservative positioning gave us significant flexibility to add to our current holdings and acquire new positions at deeply discounted market prices. By the end of the quarter, our exposure had increased to 110% gross on the long side and -15% gross on the short side.

This level of activity is far outside the norm for us. Before March, we had averaged share purchases of roughly 4% of NAV per month since inception. In the month of March, we purchased shares worth over 30% of NAV.

While the pace of purchases in March was an aberration, we do not view it as a deviation from our principles. In Fundamental Value, our strategy relies on looking past short-term difficulties and distractions and through to the underlying earnings power of a business. We did not shy away from that philosophy in the first quarter; instead, we doubled down.

Many companies have been severely affected by the pandemic, and these companies have all seen their market prices collapse. Undoubtedly, many companies will see their earnings significantly impaired in the new normal, and others will go bankrupt before we get there.

But we believe that we have identified companies that are fundamentally sound and conservatively financed. We believe that the long-term earnings power of these companies has not been destroyed, as they provide services that will still be desired in the new normal. We believe these businesses are conservatively financed, and will be solvent on the other side of this upheaval, whenever that may be. We believe that market prices for these companies imply apocalyptic scenarios unlikely to come to pass. And we believe that even in a highly pessimistic stress-test, investment returns are still compelling.

We like to say that the bireme, the ancient warship that is our namesake, was “fast and agile with the strength to survive stormy seas.” Clearly, we were fast and agile during the first quarter; however, to our deep regret, we did not weather the stormy seas nearly as well as we would have liked. As it is impossible to bottom-tick the market, buying stocks while they are cratering will often feel like catching a falling knife. However, those who wait for pandemic-induced uncertainty to pass will have missed the opportunity.

We do not pretend to know how long or how severe the economic downturn will be. There has been much pain in the past few months, and, unfortunately, that is certain to continue in the near term. Furthermore, the intermediate term looks menacing as well -- more menacing than buoyant stock market indices are pricing in, we believe -- with imminent reopenings possibly portending new waves of infection in the summer or fall.

But we think we have found stocks trading at prices that more than discount the uncertainty ahead. These stocks are liquid, solvent and provide valuable services. For those willing to endure the pain of the near- and intermediate-term, we think the long-term rewards will be substantial.

Investment updates

HCA Healthcare

Hospitals have been battling on two fronts during the current outbreak: the physical and the financial. On the physical front, hospitals in COVID-19 hotspots have been scrambling to expand ICU wards and working staff overtime to care for the influx of patients. Meanwhile, revenue has fallen off a cliff, even for hospitals in relatively unaffected areas.

The problem is that everything besides COVID-19 treatments and absolute emergencies are on hold. This includes elective surgeries, checkups, physical therapy appointments, and most other revenue-generating care that hospitals provide. Even baby deliveries have been affected, with newborns and parents staying for one night instead of two or three. JP Morgan estimated that hospital revenue fell 50% in recent weeks.

The $2 trillion emergency spending bill signed by Trump into law March 27th includes some relief for hospitals. Here are a few of the provisions that will impact HCA:

- $100b for healthcare providers who have lost revenue due to COVID-19
- 20% bump to Medicare rates related to COVID-19 treatment
- Postpones 2% cut to Medicare payment rates until 12/31/20
- Prepayment of funds for future Medicare treatments

These benefits are sorely needed to shore up the finances of the many lower-margin hospitals around the US. And like the SBA loans enabled by the CARES Act, the funds earmarked for healthcare facilities may be used up fairly quickly: based on $1.2 trillion in annual hospital revenue, a 50% drop in revenue implies a mere two month runway for the $100b.

We are confident that HCA -- as one of the largest and most politically savvy healthcare providers in the country -- will get its share of this money.

Cost cuts are another way that hospitals are managing the crisis. Leaders at hospitals such as St. Claire in Kentucky and Lifespan in Rhode Island are making dramatic cost cuts during these unprecedented times, including furloughing large swaths of staff. Hospital groups are even delaying bonuses owed to physicians in a bid to conserve cash. HCA itself has described a multi-tiered cost cutting plan that will be implemented if revenue shortfalls continue. We believe these measures, while brutal for affected staff members, will allow conservatively-financed hospitals to emerge from this crisis relatively intact.

We estimate HCA could burn $4b in cash in the next two quarters, assuming COVID-19 impacts extend into Q3 and they are able to reduce employee costs by 25%. At YE 2019, the firm had $3.2b available on its senior secured credit facility and $600m in cash. This money alone would nearly cover the shortfall of the next two quarters, and the company has already received $4b in advanced payments from Medicare. As a final backstop, HCA could likely borrow an additional $15b if they (and their lenders) were willing to increase leverage to 5x pre-COVID EBITDA, an amount they have managed successfully in the past.

At some point, immediate coronavirus concerns will ease, and hospitals will return to a more normal operating environment. Yet the economy will still be left to recover from the extensive damage inflicted. Some have posited a V-shaped economic recovery, while others think there will be a much more protracted and painful recession. There is a concern in the market that HCA's reimbursement rates will continue to be depressed in a prolonged recession scenario given the concomitant increase in Medicare and Medicaid patients (Medicare and Medicaid pay lower prices than private insurers). However, HCA generated an EBITDA margin of 19% in 2009, in line with 2019 levels. Thus, we feel comfortable with the stability of HCA's margins even in a deep recession. This is a business that has performed well through a wide variety of economic environments, including the Great Recession, and typically had more debt than it has today. Furthermore, we view long-term depressed reimbursement rates unlikely, as any reduction in average hospital reimbursement rates would bankrupt low-margin rural hospitals, a politically unpalatable result -- and the exact reason why the CARES Act postponed Medicare reimbursement cuts.

We were shocked to see HCA initially trade down more than 50% in mid-March, in line with hotel companies and online travel agents. HCA will likely earn $11-12 in EPS when the COVID-19 crisis companies and online travel agents. HCA will likely earn $11-12 in EPS when the COVID-19 crisis recedes, and we think the stock will trade back towards $150. Therefore, during Q1 we added we added ~80% to our shareholdings at an average price of roughly $90.

Kite Realty Group

Just a few weeks ago we highlighted our best-performing investment of Q4 2019: strip-center REIT Kite Realty (KRG). The world is quite different now.

We wrote that Kite's focus on grocery stores and service businesses positioned the company well, relative to mall operators, in a world of growing ecommerce -- an advantage that was not reflected in its market price. Unfortunately, COVID-19 has severely impacted service businesses, including restaurants, most of whom have been forced to close or reduce capacity. As a result, KRG stock fell as much as 63%, from $19 to $7.

At $7 per share, KRG traded for an 18% dividend yield and an implied 12.3% capitalization rate, rare numbers in the real estate world outside of failing properties. We do not think KRG is failing. We do not think this is the last time that people will work out in gyms, sit down at restaurants, get their nails done, or pick up their dry cleaning. It is our view that most of these businesses will survive and eventually pay rent again, although there will likely be a 6-12 month period of shared pain between tenants, employees, landlords, banks, and taxpayers.

While Kite may breach some debt covenants if tenants don't pay Q2 rent, we think lenders are highly likely to grant amendments. Nearly every commercial real estate company is in the same position as KRG and banks have strong incentives to grant leniency to fundamentally solvent borrowers. KRG has $350m in cash on their balance sheet, representing nearly three years of expenses.

As consumers slowly return to service businesses, we think KRG will return to trading at much higher prices.

Booking Holdings

As the world's premier online travel agent, Booking Holdings has seen their business evaporate since mid-March. In fact, a recent filing indicates that gross bookings on their platform are down more than 85%.

Booking, unlike some travel-related businesses, is well-positioned in two major respects: a variable cost structure and a strong balance sheet.

Their marketing spend, which totaled nearly $5b in 2019, will be quickly flexed downward as demand for travel wanes. Their costs to process credit card transactions will also drop as bookings fall. All in all, we expect Booking's expenses to decline by over $3b in 2020 and a further $1b in 2021 if travel restrictions persist. This should allow them to burn only about $3b of cash through year end 2021.

That amount would be less than half of the $7.2b in cash and short-term investments on the company's balance sheet as of 12/31/19. But out of an abundance of caution, the company made some additional moves to bolster their reserves.

Their first action was to amend the covenant on their $2b revolving credit facility, which had previously required less than 4x debt to EBITDA. The company changed this to a minimum liquidity requirement of $5.5b.Then Booking borrowed a sum of $4b over multiple bond issuances. This will allow the company to remain solvent even if the pandemic lasts for much longer than expected.

While their stock price will remain sensitive to COVID-19-related developments, we think Booking's earnings power of >$100 per share should return by 2023 and perhaps sooner if vaccines, treatment, or herd immunity develop more quickly than expected. It is also possible that weakened hotel operators may come to rely on OTAs more than ever after this crisis, as they did after 2008.

We believe the stock is undervalued at current market prices.

Wells Fargo

We added two positions in the quarter. One of them was megabank Wells Fargo.

The COVID-19 crisis caused a lot of pain for bank investors during the first quarter, and Wells Fargo was no exception. In fact, the stock was dropping even before the virus reached NYC, down about 13% in January while the broader market was flat. WFC then proceeded to fall 47% to its lows on the year around $25. We invested towards the end of the quarter, with an average price of ~$27.50.

What we saw in Wells Fargo was a bank with a long history of solid, growing earnings that is facing a number of short- to medium-term problems:

- Business-practice issues of its own making.
- Potential COVID-19 related loan losses.
- Falling interest rates.

We could fill many pages with discussion of the firm's client relations and HR scandals -- opening accounts for clients without their permission, putting wealth management clients in unsuitable investment products, failing to respond to HR complaints, gender bias in hiring and promotion, illegally repossessing borrower motor vehicles, etc. The market has punished the stock since these issues came to light, with WFC underperforming peers by 50% since 2015.

Wells Fargo today reminds us of Facebook in Q4 2018 (which we wrote about here). In both cases, investors unduly shunned a fundamentally sound company that made mistakes involving breaches of customer trust. While admittedly reprehensible, the scandals at both FB and WFC are more impactful to social media sentiment than to long-term free cash flows.

Availability bias causes human beings to place disproportionate weight on this type of story. Breaches of customer trust rightfully disgust the public, and investors find it distasteful to be long a company whose CEO is chastised by Congress. Our investment strategy is predicated on identifying and exploiting these investor biases; we thrive on situations where short-term issues obfuscate the underlying health and long-term earnings power of a business.

The vast majority of revenue for Wells Fargo is generated by interest on loans, and we don't see much evidence that the long-term volume or credit quality of these loans have been affected by the scandals of the past three years.

In fact, Wells Fargo's relationship with consumers and businesses appears to be healthy. All of the following key metrics are flat-to-up since 2016: loans (flat), deposits (flat), customer checking accounts (+3%), debit card purchase volume (+21%), consumer card purchase volume (+17%), commercial card purchase volume (+28%), and branch visit satisfaction score (+3%). But even these figures understate the health of WFC's business: the lack of growth in the loan book is due entirely to an asset cap put in place by regulators to punish the company for its transgressions. If not for that cap, loans and deposits would almost certainly have grown.

For this 168-year-old franchise, we paid less than 7 times trailing earnings.

We do expect those earnings to fall in the short term as COVID-19-related loan loss provisions hit the income statement. However, WFC's balance sheet and core profitability provides plenty of margin to absorb these losses. Wells Fargo's net charge-offs peaked at 2.2% of average loans outstanding during the financial crisis. While this level of net charge-offs would've been enough to wipe out last year's earnings, it would not have impaired the firm's book equity (assuming that dividends and buybacks were suspended temporarily).

Our base case is that the current crisis will be extremely sharp in the short term, but not worse than the financial crisis in the long term vis-à-vis unemployment, home prices, and loan defaults.

For one, consumers are in a better position. In 2008, debt service payments (mostly due to high mortgage payments) were over 13% of disposable income. Today, that number is below 10%. US households' equity in their homes has doubled since year-end 2008, to almost $20 trillion today. Second, the banking sector -- whose meltdown exacerbated if not caused the 2008 crisis -- is much better capitalized, with Tier 1 common equity ratios up from about 8% in 2007 to 12% today.[2]

Interest rates have fallen substantially -- mortgage rates, for example, have fallen by about half a percent in the last year -- and thus Wells Fargo will generate less net interest income. Current Street estimates are for $43.9b in net interest income, a decline of $3.3b versus 2019. Given that lower interest rates are prevalent across the yield curve, we expect this to continue for the foreseeable future.

However, we believe Wells Fargo has a significant opportunity to offset much of that lost income by cutting costs. The firm's "efficiency ratio," the ratio of non-interest expenses to revenue, has become one of the worst in the industry in recent years. Partly this is due to the firm's regulatory problems, which we estimate have cost $5b per year in legal fees, settlements, and compliance costs. As they put these issues behind them, we think they should be able to achieve an efficiency ratio similar to their peers at JP Morgan and Bank of America. This implies they may be able to shed $8-10b of total costs, which would more than offset the lost interest income from lower rates. Management has stated that they are focused on this task.

Over time, we estimate that WFC will be able to generate about $15-18b of profits per year, only slightly lower than the $18-20b they generated between 2017 and 2019. The stock trades at 6-7.5x the new earnings level, which we find quite cheap given the long-term stability of the business and the stickiness of client accounts.

RCI Hospitality

We increased our investment in RCI Hospitality in the quarter.

RICK is a publicly-traded owner of night clubs and restaurants. The company has been dramatically impacted by COVID-19, with all of its locations unsurprisingly deemed "non-essential." The stock has fallen from a pre-COVID level of about $25 per share to an intraday low of $7 per share, the largest decline in any stock we own. Prior to this drop, we had a tiny toehold position of <.5% of NAV with a cost basis of around $15. We began buying in earnest when the price dropped below $10 per share.

Over the years RICK has shown that its business model is superior to many consumer-facing service businesses. RICK boasts:

- Ownership of the vast majority of its real estate
- A history of greater than 20% EBITDA and 10% pre-tax margins
- Profitability during previous downturns, including '08-'09
- Mostly inept and poorly funded competitors

RICK does have $141m of total debt (about 3x adjusted EBITDA), but this is offset by the value of their owned locations. According to their lender, Centennial Bank -- who made this determination in its "sole discretion" -- RICK's $90m in mortgage debt was less than 65% of the fair value of their real estate in October 2019. The 65% loan-to-value (LTV) level was key because it triggered a $250k per month reduction in RICK's interest payments to Centennial. We are confident, given Centennial's incentives under this arrangement, that their estimate of the fair value of RICK's properties was conservative.

RICK's property value has likely declined by 10% due to COVID-19, in line with other commercial property, per Green Street. But even accounting for this decline, a starting LTV of 60% implies the company may be able to borrow an additional $15-20m against these assets if Centennial will lend to an 80% LTV. This would give RICK significant additional runway to navigate further shutdowns. The company has now reopened 10 of their restaurants in Texas and says they have the cash to operate until the end of September without further borrowing.

We believe RICK will make it through the crisis and that investors buying it at less than 3x potential FCF will be handsomely rewarded.

We are grateful for your business and your trust, and a special thank you to those who have referred friends and family. There is no greater compliment.

- Bireme Capital

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[1] Net calculations assume a 1.75% management fee. Fee structures and returns vary between clients. FV inception was 6/6/2016.

[2] See page 31 here.

The performance in the charts is the performance of the securities in all Bireme accounts ("Bireme Master Account") and the strategies that make up the account holdings from inception through 3/31/2020. The performance in the tables is the performance from inception and from 1/1/2020 through 3/31/2020. Past performance is not indicative of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses and is not based on actual advisory client assets. Index performance does include the reinvestment of dividends and other distributions. The performance in the Bireme Master Account is shown as net of 1.75% advisory fees. Some clients may receive services at a lower advisory fee with a performance fee based on the gains in the account. Returns are shown net of fees at the account level, and gross of fees at the individual strategy level. For current performance information, please contact us at (813) 603-2615.

Sources: Bloomberg Finance LP, Interactive Brokers LLC, S&P Compustat, Bireme Capital LLC.