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Moving Up the Capital Structure

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Income Strategy 1Q 2020 Letter

Income Strategy lost 38.4% (net of fees) in the first calendar quarter of 2020, the worst quarter in the Strategy's history. While the Strategy had a drawdown almost as large between August 2014 and February 2016, the ferocity and compressed timeline of this drop were both unprecedented. As recently as the 20th of February, the Strategy was ahead of their unmanaged benchmark for the quarter. Then, the world changed, with public health concerns taking precedence over everything else. In a matter of days, the US economy went from a state of solid expansion to one of the worst recessions in US history, with current unemployment levels likely eclipsing anything we have seen since the Great Depression. While we were focused on the virus and its potential health effects, we failed to predict the extent of economic and cultural pain that various institutions would self-inflict to preserve healthcare capacity and possibly save a subset of the population; we use the word "possibly" because there is no counterfactual, vaccine or cure so far.

We have always attempted to construct a procyclical, income-generating portfolio whose holdings should grow in value with an expanding economy and rising prices. Probabilistically speaking, growth and progress are the normal state of affairs. Unfortunately, a closed economy cannot grow, and prices are unlikely to rise when nobody is buying anything. Few assets, other than cash, have done well since the middle of February. Our holdings skew toward smaller companies trading at lower multiples, which is a group that has done particularly poorly. The Russell 2000 Value Index, which tracks the performance of 2,000 such companies, recorded its worst calendar quarter since its 1979 inception, declining 36.1%.

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Despite the murky outlook, the market is likely to bottom before the epidemiological fact pattern does, because the market is a forward-looking discounting mechanism. As of this writing in mid-April, the S&P 500 has rallied almost 30% in just three weeks from its March low, which is a powerful signal that the COVID-19 fallout could be a short-lived phenomenon. The entire world is focused on solving this issue, and betting against human progress has historically been a bad bet, especially for long-term investors. It is probably not a coincidence that the rebound has occurred as talk of "reopening" the economy has increased.

Conversely, human decision-making caused the collapse, and it is not clear how people will react to future infection spikes. The only other periods in market history with this extent of ongoing volatility were the Great Depression and the Global Financial Crisis, which both witnessed market declines much larger than what we have seen so far. The longer we proceed in lockdown, the more the economic damage grows and the harder it becomes to put Humpty Dumpty back together again. While the fiscal stimulus was a nice start, the probability is slim that public-sector employees working from home can efficiently get the money where it needs to go. The longer entities and people go without revenue, the harder it could be for them to meet their obligations, which compounds the administrative backlog and restructuring workload at a time when courts are working at limited capacity.

With such a unique backdrop, the important question now is, "What are the implications for portfolio positioning?" The short answer is that we are putting more of the portfolio into high-yield bonds. There are two reasons for this. First, "dividend" is becoming a dirty word in polite company. S&P dividend futures contracts are projecting a drop of over 20% for the market's dividend this year and another double-digit drop again next year. Dividend futures are also projecting that after next year, the market's dividends will begin to grow slightly in 2022 but not get back to this year's level until 2023, and at no point in the foreseeable future are they likely to return to last year's level. The futures would paint an even uglier picture if they focused on small-cap companies. This is problematic for a strategy whose primary goal is income. While management teams can suspend or eliminate dividends, they cannot reduce interest payments unless they plan on spending time in court.

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In addition to mandatory interest payments, the other reason for owning debt over dividend-paying equities in this environment is valuation and future return probabilities. Today's pricing environment is not dissimilar to the one that gave rise to the strategy in 2008-09, as we believe investors can now get equity-like returns from many fixed-income securities. High-yield bonds trade at a similar spread over Treasuries as they did in early 2016, late 2011 and at times during the financial crisis, all of which turned out to be good entry points into the strategy. There are a handful of long-dated bonds trading at massive discounts to par which provide not only big upside to pre-corona levels, but also offer reasonable recoveries relative to current prices if we are wrong and the world gets worse before it gets better. There have also been a number of high-profile, first-lien senior secured offerings that we think provide compelling rates of return with limited downside probability. At the end of the first quarter, 47% of the portfolio was in bonds and preferred securities, and it's likely to be higher than that by the end of this quarter.

As always, we continue to be the largest investors in the Income Strategy and welcome any questions or thoughts.

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Strategy Highlights by Tyler Grason, CFA

Top Contributors

- While **CenturyLink (CTL)** common stock fell 26.89% over the quarter, our timely sale of shares resulted in a 9.50% gain over the period it was held in the portfolio. The company reported Q4 revenue of $5.57B (-3.6% Year-over-Year (Y/Y)), 1% ahead of consensus while Earnings before Income, Taxes, Depreciation and Amortization (EBITDA) of $2.28B (-1% Y/Y) was in-line. Leverage stands at 3.7x and management continues to target 2.75x-3.25x over the next few years. Guidance for Fiscal Year 2020 includes EBITDA of $9.0B-$9.2B and free cash flow (FCF) of $3.1B-$3.4B, a 28% FCF yield at the midpoint. CenturyLink also announced the successful extension and repricing of its senior secured credit facilities.

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- In similar fashion, **National CineMedia (NCMI)** declined -54.15% in Q1, but due to our timely sale, shares returned 6.28% over the period held. The company reported revenue of $147.2M, topping estimates of $140.1M on stronger national ad demand (+13% Y/Y). Operating income before depreciation and amortization (OIBDA) of $83.5M was in-line. Management noted a boost in ad demand following their shift to ad slots five minutes prior to show time.

Top Detractors

- **Diebold Nixdorf 8.5% unsecured bond due 2024** was the top detractor over the quarter, falling 28.79% despite posting solid results. Fourth quarter Earnings Per Share (EPS) of $0.47 was a bit under consensus of $0.50 on in-line revenues of $1.15B, while EBITDA of $131M was +5% Y/Y. Gross profit of $270.4M saw gross margin expansion to 26.3% (+320 basis points (bps) Y/Y). Net leverage improved to 4.4x, down 0.3x turns sequentially and down from 5.5x as of year-end 2018. Management reaffirmed 2020 guidance, where they see revenue of $4.2B-$4.3B, EBITDA of $430M-$470M, cash from operations of $170M-$200M, capital expenditure (capex) of $70M, and FCF of $100M-$130M. Further, management raised their DN Now cost savings target to $440M (from $400M) through 2021. In response to COVID-19, Diebold drew $325.9M on their revolver to proactively manage potential disruptions in installation activity. Further, the company should benefit from the Department of Homeland Security (DHS) deeming ATMs critical infrastructure.

- Theme park operator **Cedar Fair (FUN)** fell 66.15% during the period with travel and leisure stocks after President Trump restricted travel to the US and government agencies recommended the restriction of large crowds in response to COVID-19. That said, the company reported solid Q4 results with revenue of $257M and EBITDA of $54.6M, slightly below consensus of $267M and $64.7M, respectively, on one fewer week of operations Y/Y. On a same-week basis, revenue rose +13% Y/Y driven by a +16% increase in visits while out-of-park spend came in higher than expected at +9.1%. The long-term outlook remains intact with management noting early season sales are +40% (following the 50% increase in 3Q19).

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Management also introduced a new long-term EBITDA target of $600M by 2024 (3.5% compound annual growth rate (CAGR)). In addition, insiders including CEO Richard Zimmerman purchased over 50,000 shares totaling $1.97M.

- While **William Hill (WMH LN)** declined 63.84% over the quarter, our elimination of the position driven by the temporary dividend suspension resulted in a decrease of 81.15% for Q1. Share price weakness stemmed from the global suspension and cancellation of sporting events, as well as the closure of retail locations amid the COVID-19 outbreak. For FY19, William Hill reported revenue of £1,582M ($1,979M), missing consensus of £1,640M ($2,051M) by 3.5%. EBITDA of £271M ($339M) beat estimates of £246M ($308M) while Earnings Before Income and Taxes (EBIT) of £147M ($184M) was 2% above consensus and at the top end of management's guidance of £143M-£148M ($179M-$185M). For FY20, management sees a £200M-£230M ($250M-$288M) EBITDA impact from a five month suspension of football, the cancellation of major horseracing events, and the closure of UK retail shops.

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