

July 20, 2020

Locking Up Margins of Safety

Bill Miller IV, CFA, CMT and Tyler Grason, CFA

Income Strategy 2Q 2020 Letter

In the second quarter of 2020, the *Miller Income Strategy* gained 21.7% versus 9.6% for the unmanaged benchmark. A top focus has been replacing income lost to COVID-related dividend suspensions while maintaining the potential for capital appreciation in the event of an economic rebound, which could arise from more financially-motivated institutional behavior, a medical breakthrough, or some combination. The two avenues for replacing foregone cash distributions have been 1) moving up the capital structure into long-dated fixed-income securities with potentially significant upside valuation skew, and 2) adding new high-yielding equities that are off the beaten path. One of our latest additions falls into the second category and is also now a top position — The GEO Group (GEO).

Income Strategy is no stranger to the private corrections company, as we bought GEO stock in 2016 after the Obama administration declared they would phase out the use of private prisons. The share price dropped in half almost overnight, but we thought the price reaction was too severe after reviewing the contract structures, cash flows and asset values; we exited the position after realizing a substantial gain. We now believe the shares again offer a compelling value proposition, as the company trades at a lower price today than it did in 2016 when there was a directive to wind down private corrections at the federal level (it is important to note that state governments are also a major client of private providers). However, the company now owns and operates more facilities than it did in 2016 and there is no directive to end their use. The CEO is a major shareholder and recently increased his stake by 20%, purchasing over \$6 million worth of stock to bring his total holding north of \$30 million. The Board just affirmed the dividend, which implies an annualized yield above 15% as of this writing, and it is covered by free cash flow.

[Privacy](#) - [Terms](#)

Obviously the investment is not without risk, and we believe the two biggest risks are 1) volatility tied to headlines (perceived risk), and 2) justice reform (real risk). Headline risk could come in the form of political news or a dividend cut. The only other publicly traded competitor recently suspended its dividend while it studies its optimal corporate structure, noting that the REIT requirement to pay out earnings limits financial flexibility and that other structures could “better serve the interests of the Company, our shareholders, our employees, (and) individuals in our care within our facilities” along with government partners and debtholders. All of this invites the question, “What is the true hierarchy of those stakeholder priorities?” Since the dividend cut, every piece of the capital structure now trades at a lower price and higher implied cost of financing than before the suspension, though the journey is still a work in progress. GEO previously traded at a valuation discount to its publicly traded peer but now trades at a premium, despite more debt, perhaps because the equity market is less concerned about principal-agent issues with GEO.

In previous memos, we have flagged that dividend suspensions have zero effect on the theoretical intrinsic value of an enterprise when there is no alternative plan to do anything with the cash. However, making a major capital allocation change like a dividend suspension, absent a more value-accretive plan, raises real process concerns. Why would a company eliminate a source of return for shareholders prior to devising a higher-return plan for the retained earnings? It is worth noting that GEO announced the addition of a banker to its Board to help it evaluate its own strategy over the next year, which is a much better first step to thinking about capital allocation changes than an outright dividend suspension with no alternative.

While quotation risk implies changes in price, real risk implies changes in fundamental value. Criminal justice reform is the biggest likely source of real risk, especially when you consider that criminal justice reform gave birth to the industry. Harsher sentencing guidelines in the ‘80s created a need for correctional facility growth, and the private sector stepped in to fill the void, growing its share of the total correctional population to just under 10%. Today, the incarceration rate in the US is significantly higher than in other developed countries, which likely means that the aggregate population will fall over time, presenting a bit of a secular headwind, though the private sector could still grow if it takes market

share at a greater rate. Still, we estimate that it would cost the government ~\$5.6B to replace GEO's beds, equating to a replacement cost value north of \$20/share.

It is important to realize we are not making any ethical value judgements about the relative efficacy of private prisons. The bet is that the assets and contracts associated with GEO are worth substantially more than where the stock currently trades. However, very few people or entities with means would elect a government service offering over a private sector offering. Taxpayers who dislike the behavior of private prison operators should alter the objective function and contract structures in relation to measurable public operator outcomes, rather than try and eliminate the existence of the private sector. One other important idea — since much of the risk in the portfolio is tied to economic growth, the idiosyncratic nature of the fundamental risk here justifies a much larger position in the portfolio than one might expect; unlike most real-estate investments, there is little cyclical risk tied to COVID-19 other than elevated sanitation costs as 100% of GEO's tenants are investment-grade.

The GEO Group position is one of many. We could write in much more depth about this name or any of our others, but we wanted to share the high-level thoughts on our newest position whose prospects excite us. As always, we remain the largest investors in the Strategy and appreciate your support.

Bill Miller IV, CFA, CMT

Strategy Highlights by Tyler Grason, CFA

Top Contributors

- **Apollo Global Management (APO)** was the top contributor over the quarter, advancing 50.6% in conjunction with the broad equity market and solid Q1 results. The company reported Q1 distributable earnings of \$0.37, below consensus of \$0.49 and the dividend of \$0.42/share (3.4% annualized yield). Fee-related earnings of \$0.52 showed more resiliency driven by ~90% of capital in long-dated funds and perpetual vehicles with less mark-to-market volatility. Fundraising remained robust with \$7Bn of inflows over the period, bringing

total assets under management to \$315.5Bn and permanent capital to \$162Bn (51% of total assets under management). Apollo deployed \$5.1Bn in capital in Q1 while dry powder remained elevated at \$41Bn.

- **The Chemours Co (CC)** rose 76.8% during the quarter after reporting Q1 earnings before income, taxes, depreciation and amortization (EBITDA) of \$257M, topping consensus of \$218M by 18% on margins of 19.7% (consensus of 16.5%). Earnings Per Share (EPS) of \$0.71 topped estimates of \$0.45 by 58% and nicely covered the quarterly dividend of \$0.25/share (6.4% annualized yield). Free cash flow of \$(62)M improved \$115M Year-over-Year (Y/Y) with total liquidity of \$1.4Bn as of quarter end. Management withdrew Fiscal Year 2020 (FY20) guidance due to demand uncertainty in certain end markets.
- **Diebold Nixdorf 8.5% unsecured bond due 2024** jumped 24.7% over the period. The company reported Q1 EBITDA of \$89M (+38% Y/Y), beating analyst estimates of \$62M by 43% with margin expansion of 350 basis points (bps) driven by DN Now initiatives. Net Debt/EBITDA of 4.4x was unchanged sequentially but down from 5.6x Y/Y. Management guided to FY20 cost savings of \$130M and introduced an additional \$80M-\$100M of incremental savings. As part of the company's business update in late June, management announced year-to-date (YTD) through May revenue of \$1.4Bn and EBITDA of \$149.7M, including margin expansion of 380bps and operating profit growth of 93.3% Y/Y. Additionally, the company re-established FY20 guidance with revenue of \$3.7Bn-\$3.9Bn, EBITDA of \$400M-\$440M (+10% Y/Y), and Free Cash Flow (FCF) breakeven. Lastly, multiple insiders purchased 70,155 shares totaling \$326,500.

Top Detractors

- **GTT Communications 7.875% unsecured bond due 2024** was the top detractor over the quarter, falling -15.2%. The company reported Q1 revenue of \$424.7M and EBITDA of \$89.3M, both missing consensus of \$428.1M and \$106.6M, respectively due to on-premise restrictions from the pandemic. Management withdrew FY20 free cash flow guidance of

\$175M-\$200M and suspended sales rep hiring due to uncertainty regarding COVID-19. Weakness also stemmed from reports that first round bids for the company's infrastructure business came in at \$1.5Bn, below prior estimates of \$2.0Bn, as well as the sudden departure of CEO Rick Calder.

- **Gannett (GCI)** declined -39.5% during the time the Fund held the name, though Gannett reported Q1 results that were better than feared. Revenue of \$948.7M and EBITDA of \$99.1M both topped estimates of \$945.5M and \$97.5M, respectively. Management maintained both guidance of \$100M-\$125M in real estate sales and \$300M in annual synergy savings by the end of 2021.
- **Ultra Petroleum 7.125% unsecured bond due 2025** dropped -89.3% over the period, though its small weight meant only 40bps of value detractor. The company filed for Chapter 11 restructuring as a result of the challenging commodity price environment and elevated debt levels. Ultra secured a commitment for financing of up to \$25M from first lien debtholders and will seek to eliminate up to \$2.0Bn in debt from their balance sheet.

Related Posts

Bill Miller's [2Q Market Letter](#)

Christy Siegel's [2Q 2020 Market Highlights](#)

[2Q 2020 Infographic](#)

Past performance is no guarantee of future results. For important additional information on Income Strategy performance, please click on the [Income Strategy GIPS Composite Disclosure](#). This additional information applies to such performance for all time periods.

[Privacy](#) - [Terms](#)

Investment Risks: All investments are subject to risk, including possible loss of principal.

The views expressed in this report reflect those of Miller Value Partners portfolio manager(s) as of the date of the report. Any views are subject to change at any time based on market or other conditions, and Miller Value Partners disclaims any responsibility to update such views. The information presented should not be considered a recommendation to purchase or sell any security and should not be relied upon as investment advice. It should not be assumed that any purchase or sale decisions will be profitable or will equal the performance of any security mentioned. Past performance is no guarantee of future results.

©2020 Miller Value Partners, LLC