

## First Quarter 2020 Quarterly Commentary

NAV increase, net	PF 2019 1Q 2020	
WBCP	18.14%	-35.79%
S&P 400	9.11%	-29.70%

Inception of White Brook Capital Partners was August 16, 2019

Performance figures are provided by the administrator, PF 2019 figures are audited

Performance is net of all realized and accrued fees

Given the unprecedented circumstances we're currently experiencing with the global pandemic, I wanted to start by extending my thoughts and wishes for your and your family's health. While there is still uncertainty ahead and the medical, social and economic situation is rapidly evolving, the focus of this letter will be three-fold:

- Latest Portfolio Commentary and Market Discussion
- Investment Themes we're currently observing
- Portfolio Review in light of Covid-19

### Portfolio Commentary

At quarter end, the Fund was 96.07% invested across 12 positions. For the first quarter 2020, the Fund's NAV decreased by 35.79% vs the S&P midcap index down 29.70% underperforming by over 600 basis points. In my view, given market instability, with equal probability we could have been down double or a quarter of that amount.

During the first quarter, every position except for Covanta Holdings Corp (CVA) declined in value. Top detractors from the Fund were Goodyear Tire & Rubber (GT), Coty Inc (COTY), and Mosaic Inc (MOS). On a sector basis, our investments in the consumer cyclical, basic materials, and telecommunications were the top detractors to Fund performance.

During the quarter, the Fund initiated a new position in IAC Interactive Corp (IAC) and exited Covanta Holdings Corp (CVA).

### Market Discussion

At the end of the quarter, fixed income (bonds), mortgage securities, foreign exchange, oil, other commodities, real estate, and equity markets were unmoored from value. Since the end of the quarter, the Fed and Treasury have enacted multiple vehicles to stabilize broken debt markets ensuring large businesses can borrow from public investors and the banks, and providing grants and loans to keep small and medium businesses from going out of business. There should be significant concerns about the efficacy of these grants. With a large percentage of restaurants almost assuredly going out of business and demand likely slow to materialize for a whole host of goods and services as the economy reopens, many of these grants will go to businesses that end up bankrupt. A deflationary economy where pricing power does not exist is likely and it's unclear how small businesses will be able to compete.

As a student, I worked for two well-regarded professors at the University of Chicago Law School examining small business bankruptcies. The takeaways were numerous and better left to their work, but one that struck me at the time was that **the exact properties that make a business a good small business in life, are worthless in its death**. As going concerns, a business's intangible assets - its intellectual property - create the competitive advantage necessary for it to succeed. A restaurant's hot peppers and prawns might be a uniquely well spiced dish that pleases all tongues. But to a bankruptcy court those intangible assets are difficult to value and deemed worthless. After all, if the shrimp was better, maybe the restaurant would have succeeded. Meanwhile, **the undifferentiated assets can be used by another business** - the company car, the stove, the pizza oven, the cash register, etc. They retain their value well. In a normal environment that's a prized feature of the American bankruptcy code. It allows an entrepreneur to try again - their debts having been paid via the sale of their hard assets. They can take their intellectual property to the next venture. A mass extinction event, like the one we're in danger of experiencing, where a large percentage of businesses have to go through a liquidation proceeding diminishes the value of those hard assets and the possible recoveries, dampening lenders' ability to recycle capital and the renewal effect of small business bankruptcy. It's potentially a major source of weakness in the economy moving forward.

Large bankruptcies are more complicated than small business bankruptcies. They are less efficacious and I think misunderstood by the American public. While some bankruptcy proceedings are pre-packaged and decided upon before filing, many going concern proceedings are violent processes that see no pre-bankruptcy stakeholder better off. Opportunistic so-called "vulture investors" have the ability to complicate the process, extracting value that does not

favor the sustainability of the business, the employees, or other benign stakeholders. Backroom deals that accommodate those investors and sacrifice a more “just” outcome for all stakeholders in favor of an unbalanced solution that favors most are common. It would be unfair to say the bankruptcy process isn’t governed by rules, but not that unfair. The American economic system cannot afford to allow necessary industries to be subject to that process if it doesn’t have to.

## **Equity Market Discussion**

Covid’s impact on the equity market has been greater than I expected thus far. While I had a sense of the virulence of the disease, the incompetence of the Federal response surprised me - resulting in greater loss of life and a deeper economic slowdown than I imagined. From the beginning of the epidemic, there’ve only been two developments that matter: the ability to test quickly and widely, and the ability to treat after infection. While it appears a quick test and a treatment are both within reach, significant bottlenecks that limit their application will prevent a return to “normal” as it was. It also seems clear that finding that new normal personally and as a society now, is important as Covid-19 will be with us for years and our collective reluctance to do so will only enhance our discomfort personally and financially.

Much of the discussion around an L shaped vs a U shaped recovery is misplaced. As a refinement on an earlier letter’s discussion - when markets are orderly, **the stock market reacts to an improvement in the economy 4-6 months ahead of time.** Contractions are rarely telegraphed, however, so it **reacts to signs of contractions in the economy and uncertainty in real time.** In early April, the combined actions of the Fed and the Treasury have repaired debt markets and the equity market has partially recovered. As of April 10, the worst estimates of the coronavirus death toll for this first round are significantly less than initially expected and the equity market has substantially priced that in as well.

While the moves were confounding for many, it’s important to remember that the market is not the economy, but it is related to the economy. The first two weeks of April, correcting to the upside after experiencing positive surprises to the likely US death rate, have left a market that is relatively rich on what consensus believes is the next two years of earnings. But market consensus is playing small ball, focused on the next several quarters, and not focused on the outer years, which this time have a much wider range of possible outcomes. Consensus is that first quarter numbers will be mostly ok but with bad commentary about second quarter. The second quarter will mark the bottom of reported earnings, with smart management teams

talking down the third quarter. The third quarter will surprise to the upside off low numbers, and the fourth quarter will report next year and therefore isn't worth focusing on too much. The third quarter will also see us officially call the stoppage a depression or recession, and will mark the low point with economic growth in 2022 and 2023 - dependent on the duration and severity of subsequent waves of Covid-19 infections. It's impossible to gauge the number of small business, large enterprise, and personal bankruptcies and to predict subsequent Covid waves so haircuts are applied to base case projections. There's not real detail or critical thinking at this point, and developments that seem to point to one range of outcomes or another impact the level of the market.

Some market commentators believe the market will hit new lows as companies report either 1st or 2nd quarter earnings. I think the time shifting mechanism of the market, where it simultaneously can choose to price in the present or the future makes timing the market and those prognostications a fool's errand. Investors will be able to understand a company's balance sheet by mid July or August and every company will be prioritizing cash flow in the second half. For some this will be a major reversal of company strategy and it means that previous guidance can't be relied upon. Instead, the priority for companies will be to stringently review every line of their operating expense and capital lines. For items that are necessary for their business, business will still be good, while more discretionary items are likely to take a hit until the consumer is able to start spending again.

## **Investment Themes**

I think there are 5 tenants for future investment:

- 1. Deflationary pressures that were beginning to subside in 2019 will be back.**

Demand destruction means that there will be surplus inventory available. Over the course of 2020 companies that rely on increasing prices to drive their business model, devoid of the protection of selling to the uber wealthy or the protection of significant innovation will struggle. At the same time global stimulus measures around the globe allow firms that should not be able to operate, to continue to compete. Their attempts to spread fixed costs over more units will mean that pricing power, in the absence of differentiating innovation or customer cost savings will be difficult to exercise.

## **2. Companies that *produce* only in one geography are at a distinct disadvantage.**

At the beginning of the crisis, in the aftermath of the China trade war, having a diversified supply chain that relied on China was seen as a distinct disadvantage. As long as a vaccine eludes us, companies that produce goods will need redundancy to survive and there are a few ways they can achieve that goal:

- A. Co-locate and have facilities produce in more than one geography;
- B. Time shift production by building significant inventory;
- C. Employ more people to be able to sustain production in the face of an illness at their facilities;
- D. Automate everything possible.

With the exception of the last, each measure lowers company margins as developing ingrained “slack” that allows for companies to shut down for short periods consumes cash flow. But they are necessary to be a reliable partner.

At the same time, experiencing Covid-19 is likely to have the medium term effect of convincing companies that an efficient capital structure has less debt than has been promulgated. Running with less debt means less large acquisition activity. Over the past 10 years, very large strategic deals were easily financed with low cost debt. With debt available, even large deals done at high multiples were accretive to earnings. Post crisis the level of acceptable debt is likely to be lower, limiting transformational merger activity.

## **3. Technology adoption for work will change certain processes forever.**

All likely outcomes suggest that a geography’s emergence from lockdown will be slow and uneven. Technology that enables work from home, even if employees aren’t expected to always work from home will be a requirement for business continuity for the next several years.

Adoption has been slow for years, particularly in regulated areas and government - creating an environment where freedom of information act requests have endangered employees’ lives due to files not being accessible online. Similarly telemedicine is essentially a work from home product for the nation’s doctors. Changes both legislatively

and by insurance companies removing some of the barriers to treating over the phone and through video conferences drastically changes how we experience health care in the US. For years there have been shortages of nurses and doctors and investing in health care real estate has been a fairly safe and lucrative opportunity. Telemedicine reduces the need for all the same way it reduces the need for a physical office for other white collar work, while also increasing the comfort for the patient - making life easier for all of us.

#### **4. Real world, confirmable, trust building exercises allow us to resume activities.**

For work and play to resume, expressive displays of safety are necessary. I'll never forget walking into the Meadowlands to watch the first Manning Bowl with my cousin who had recently returned from the Green Zone in Iraq. After we passed through the patdown, he turned to me and said that's not really going to do anything. But the security was a necessary show for patrons to feel safe. Society needs those expressive displays of mock safety.

Masks solve that problem. Until we have easily accessible treatment, they will be a common part of life. The easiest path to opening the economy and keeping it open is to require culturally that everyone wear a mask. While it's impossible to ensure that everyone's hands are clean or that people aren't asymptomatic, masks are a big showy gesture that are also somewhat effective. Masks remove the potential for people to have a heart attack because they heard someone in the back sneeze on an airplane. The cottage industry that has developed on Etsy of fashionable masks should be somewhat longlasting. Similarly, hand sanitizer developed by our lotion purveyors that don't smell like a hospital will improve our lives. There's industry to be had within Covid's disruption and smart companies are rising to fill that void and allow us to work and play.

Aside from formal protective measures to prevent infection, activities need to be adopted for small group settings. Although several states have stopped home construction activities during the stoppage, most have allowed it to continue because of the ease in preventing widespread infection. Work crews are typically small, familiar with one another, and can keep each other honest and therefore continue to work while limiting the spread. Automobiles will be more frequently used - smaller batches and easier cleaning than a bus. To deliver a good that has a supply chain, checkpoints that thoroughly clean the payload are necessary.

Similarly sports like boating, golf, and tennis - all of which can be experienced with a limited number of people and in the case of the latter tens of feet of social distancing are quite simply better than others until we can easily treat ourselves for Covid-19. As long as people don't lick their fingers while they're playing, the question is will Roger Federer, Rafael Nadal, and Novak Djokovic pick up their own balls.

## **5. Commercial real estate will suffer.**

In recent years it's become evident that we're over retailled with too many stores for a populace that is increasingly buying online. Covid-19 exacerbates these problems as Class A locations that were previously insulated due to the quality of their tenant suffer. At the same time, other possible occupants, restaurants have their own severe difficulties. With no good alternatives, it's likely that concessions will be made to the tenant. While real estate development is often thought to have a "heads I win, tails you lose" relationship with their tenants, that paradigm has ended.

At the same time, employers' adoption of technology will reveal that a more distributed workforce can continue to be productive while lowering costs. The previously "safe" investment of commercial real estate is proving anything but safe. I quite simply would avoid it.

## **Portfolio Review**

Right now, the investable universe has essentially divided into four categories:

1. Weakened: Those whose competitive position/industry has been weakened by Covid-19
2. Neutral/Strengthened: Those whose competitive position/industry is unchanged or has been strengthened by Covid-19
3. Recovery: Those who are seriously affected by the shutdown, but by year 2 or 3 will be fine
4. Mispriced: Those that are priced like they will never make it to year 2, but are in categories 1-3

### **Category 1: Weakened**

**Itron (ITRI):** Itron sells services that allow utilities and municipalities to save money or charge for services. As a leader in the industry, they will continue to exist and their hard assets are already products with relatively thin gross margins for an oligopolistic industry structure. They also sell software services that allow a municipality to manage their infrastructure. The problem is that municipalities globally will be more indebted and more restrained in their spending on these ultimately money saving programs with less than 3 year paybacks. Ultimately, weaker players won't be able to survive lower spending levels, further consolidating the industry, but it is a guessing game to know whether Itron's improved market and technology position can outrun the temporarily smaller budgets over the medium term. At this point our belief is that it will but we will continue to monitor.

## **Category 2: Neutral/Strengthened**

**Box (BOX):** Box's competitive position and industry are strengthened by Covid-19. Their service aids a location agnostic work force that is necessary for the future for almost every company. While regulated industries have been amongst the last to adopt collaborative work from anywhere technologies, Covid-19 catalyzes its adoption. Additionally, advanced data loss prevention and security features ensure that human resource changes that might be necessary in the future won't harm the sanctity of a business's files. The price of the stock is beyond reasonable even while other SaaS companies are richer while their businesses are more stressed in an environment that favors spending on fundamental technology and not the "nice to have" infrastructure others purvey. While a slowdown in bookings is likely for the 1st calendar quarter, especially given that Box gave away the product to new customers for 90 days, we expect business trends and the stock to improve considerably from here.

**Brunswick (BC):** Brunswick's strong balance sheet and technology leadership strengthens its competitive positioning within the industry. The industry is likely to be weaker in the short term as the consumer will have less capital to spend on large discretionary items. Brunswick's boats cater to the higher end of the spending spectrum and should be somewhat more insulated to economic degradation than their peers. Additionally, any vacation dollars that are unlikely to be spent, can now be spent on upgrading boats where Brunswick owned Mercury is the parts and technology leader. Boating as a recreation is better than its competition as it can be done within the family unit or with trusted others.

**First Solar (FSLR):** First Solar's position should be strengthened by Covid-19. The Company is significantly back ordered and while that backlog should lighten somewhat as utility expansion needs are temporarily postponed, I expect revisions to be limited. Residential solar installations will be far more limited as a combination of stay at home orders and the discretionary-ness of rooftop solar becomes clear. First Solar has distributed manufacturing and a proven product making travel less necessary than for their competitors as well.

**IAC Interactive Inc (IAC):** IAC is a new position. It's essentially an internet focused private equity firm run by a team that becomes owner operators when it buys and turns its investments and then spins them to its investors and reruns the process. It is on the cusp of spinning two holdings that have suffered during the shut down but should be dominant after it reopens in Match Holdings (MTCH) and Angi Home Services (ANGI). When they are spun out later this year, Barry Diller will have a lot of cash and a lot of targets. A situation that always benefits investors. IAC fell into mid cap land during the market tumult and we used the opportunity to buy shares.

**Mohawk Industries (MHK):** Discussed in the letter, while home purchases and new construction projects are paused and will result in a difficult 2nd quarter, my expectation is that projects in process continue and in states where they were halted, resume soon after economies are more opened. Travel budgets are also likely to be diverted to home improvement projects which should benefit Mohawk. The Company is basically an owner-operator with the Chairman owning a significant stake and making conservative decisions for the long term.

### **Category 3: Recovery**

**Discovery (DISCA):** Ratings are up significantly since Covid-19, but advertising budgets have been cut in half. Discovery is programming that the whole family can enjoy unlike some of the other options and I expect them to earn their share when budgets come back online. While free cash flow is likely to come in much lower than previously expected, I still believe it to be a significant free cash flow generator well poised to succeed when national advertisers can earn money and need to advertise again.

**Goodyear Tire (GT):** Goodyear Tire is severely impacted by the stoppage in new vehicle sales, work from home, and the economic stoppage. When the economy reopens, however, the replacement tire industry should be stronger. Strained consumers will go longer before

replacing tires, but automobile travel is likely to be a substitute for air travel until a vaccination can be broadly deployed.

**Natus Medical (NTUS):** Natus has been harmed as procedures that require its devices have been suspended. I believe that hospital procedures should snap back soon after, perhaps even before, the general economic shutdown is lifted and Natus should continue little affected after the shutdown.

#### **Category 4: Mispriced**

**Broadmark Realty (BRMK):** Broadmark Realty's competitive position is significantly enhanced, while the industry as a whole is more challenged. Broadmark is a relatively small lender and should be able to profitably grow through industry weakness. Broadmark provides short term, secured loans at a maximum of 65% loan to value to contractors and other home builders focused on midrise and below residential construction. They have conservative underwriting practices that have resulted in a ~ .6% default on their loans and de-minimus losses over the past 10 years.

After the 2008 crisis, regulations made banks unwilling to use their balance sheets to lend to this market. Their primary competition became CLO's, mortgage REITs, business development companies, and other pirate lenders. Most of those entities are highly levered creating potential asset/liability mismatch or are built to securitize debt which doesn't work in this environment. On the other hand, Broadmark has net cash and only started a captive REIT after the Covid crisis began. If you're a property developer and have projects going forward, Broadmark is one of your only options at this point. It reported earnings midway through the Covid-19 crisis and reported that its pipeline continued to be strong. Post 2008 banks moved out of their business as the regulatory framework moved risk to non-banks. Importantly they hold their loans; they don't securitize them.

**Mosaic Inc (MOS):** Mosaic should see some end demand disruption as consumers eat out less and therefore consume less food. However, I believe those concerns pale in comparison to growth due to poor fertilization practices over the past 3 years. Brazil's continued negligent political leadership has resulted in an unfavorable foreign exchange headwind for multiple years now that at one point will cease. Supply chain issues across agriculture may be interfering with deliveries, but that in my mind is unlikely to create a default event. If farmers get crops in the

ground, Mosaic as a company should do fine, and the stock should do very well from these very depressed prices.

**COTY Inc (COTY):** Coty is levered and is currently priced as though it won't make it through the Covid-19 crisis. They manufacture and sell cosmetics and other beauty products for their own brands and for other designer brands. They sell online and in Ulta, Sephora and other make-up counters around the world which have been harmed during the Shutdown. Make-up historically holds up very well in recessions as it's considered an affordable luxury. Within this crisis, interest in cosmetics dropped off considerably in the early days of the crisis, but has rebounded as it drags on and it's still needed for video calls. During the crisis, they have begun providing hand sanitizer for emergency services. I expect that to become a sold product to the general populace as economies open. You can imagine how a sanitizer already provided for emergency services to use that is also enriched can be popular as the economy slowly reopens.

The planned sale of their professional services division, supposedly still on track for a summer sale, received multiple bids which at its previous price would allow it to reduce its debt and it's overall leverage multiple in relation to earnings and buy back nearly all its equity in line with the reduction in earnings from the shut down and buy back all of its equity at current prices. Those bids are likely to be revised lower in the new economic backdrop, but it highlights the significant asset value present and that bankruptcy is a very unlikely outcome as fixed income markets stabilize and the economy tentatively reopens.

As always, feel free to reach out to discuss this or any of your investments at White Brook Capital. I thank you for your support and will strive to continue to earn your trust.

Regards,

Basil Alsikafi

Portfolio Manager

White Brook Capital LLC

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