IDIOSYNCRATIC RISK

Volume 1 / Issue 6 (September 2020)

IN THIS ISSUE:

Idiosyncratic Risk is a monthly investment ideas newsletter published by Antrim Investment Research, LLC.

A Stagecoach, or formerly, a "diligence"

APPRECIATING CAPITAL

OR: TIME TO BACK TRACK ON SPACS, JACK?

On August 28th, 2020, Andreessen Horowitz published a fascinating blog post, "in defense of the IPO," on their website, a16z.com. Fascinating, not only because it served your authors cognitively biased and self-reinforcing selection criteria by arguing *against* "innovations" like direct listings and SPACs, but also because the essay in defense of the traditional IPO process came from a rather unlikely source: an actual denizen of Sand Hill Road.

For some time, industry observers, your author included, have wondered at the IPO roadshow and pricing process, which seems to be little more than a charade designed to line the pockets of financial industry executives and heavy hitters at the expense of actual issuers and shareholders. Interesting and attractive start up companies out of Silicon Valley routinely arrive on Wall Street to pursue an initial public offering, to raise a little capital to help grow the business and to help to provide liquidity to existing, private market shareholders, who may need to sell their shares in the company. These companies go through an underwriting process that includes a "road-show" where company execs sell their story to institutional investors, and a subscription process, through which an investment bank aggregates a bunch of "orders" from its institutional investor clientele in order to "price" the offering at a valuation that's fair to both the company, and its (new) shareholders.

The idea is that the investment bank, with superior access to a broad cross section of institutional investors amongst the ranks of its clients, and an army of junior analysts skilled in the graphical representation of corporate financing in Microsoft Word, PowerPoint, and Excel, are best equipped to find the "market clearing" price, at which both the investors who've purchased the shares and the company who's sold them feel they've been treated fairly. All too often, what happens next is that the stock opens on the floor of the New

York Stock Exchange at a price 40, 50, or 150% above the price at which the deal was struck, leaving the awe struck media to opine that the latest issue is a "hot," or attractive one, and ginning up the animal spirits of amateur day traders and Robin Hood "investors" in whom is created the unmistakable impression that something profitably exciting is going on.

This, presumably, leaves companies feeling hard done. They've just gone through a thorough teeth cleaning, answering investor questions at presentations, breakouts, and 1 on 1 meetings over the course of an actual (formerly) or virtual (presently) "road show." They've endeavored to formulate and articulate their best forward "guidance" on the near-term trends facing the business, and they've filed all this information with the SEC. For their trouble they've received $15, $18 or possibly $20 per share of stock they've sold, and they're forced to watch as those same shares trade hands the very next day for $40, 50, or 60. Long has it been the opinion of this author that Wall Street will need to begin to treat Silicon Valley with more respect during the pricing process, lest the companies they represent start to find an alternative route to the NYSE.

It was no small surprise to find Andreessen Horowitz defending these practices, as their own portfolio companies would, seemingly, be the primary donors to Wall Street's avarice. But they raise interesting points, worth considering here. First of all, they argue that the prices of public stocks quoted on the New York Stock Exchange have little relationship to the value of companies or the actual valuations at which deals are done. I find this argument compelling, but technically lacking. Surely if the market makers at the NYSE can look at an order book and determine that the stock is going to open the following day at $40, or $50, the investment banks need not offer Wall Street such an enormous discount in order to generate "institutional" interest. And while it may be the case that speculators and short term traders make up only a fraction of the demand in the order book, isn't that also a problem, if those same shareholders are the ones willing to pay significantly more for the company's shares? Shouldn't the underwriters simply market more aggressively to those who intend to flip their shares on day 1, if it means that the company can wipe their hands clean after doing a significantly larger capital raise?

Andreessen Horowitz proceeds to argue that such "games" grease the skids for the whole process. They argue that some proportion of "real" investors (who are evidently only willing to pay lower prices, but likely to hold at higher ones) are necessary to attract the "speculators" and "gamblers" who earn profits "flipping" the shares, and that the "flip premium" must exist in order to satisfy that portion of the book. But this is just silly. In a world where industry participants openly embrace "reflexivity" as the rationale for their investment decisions, and inclusion in float weighted passive investment indices is viewed as a "catalyst" for price appreciation, most institutional investors are closer than anyone realizes to pure momentum factor advocates. It would follow, logically, that there would be more institutional demand for higher priced issues than lower priced ones, as patently ridiculous as it sounds.

If it is Andreessen's intent to argue, ultimately, that the quoted prices of public equities don't reflect reality, whereas private market valuations do, then one might be tempted to subscribe to their view that the IPO process is some sort of "reality distortion field," through which a promising issue must travel before it can achieve enough "liquidity" for index inclusion. But I don't think that even Andreessen believes this. Rather, what they believe is that they have no viable alternatives to the IPO process, mismanaged and expensive though it is.

And this author is inclined to agree. The "direct listing," which was much hyped after Spotify and Slack circumvented the bulge bracket banks in 2018 and 2019, respectively, is fine at raising capital for existing shareholders, but useless for companies looking to actually raise additional capital for their business. And the only remaining alternative, lately, seems to be the "Special Purpose Acquisition Corporation" ("SPAC"), alternately known, rather pejoratively, as a "blank check company."

The argument goes, these days, that the cumbersome and inefficient IPO process is less desirable than a direct listing, but that direct listings do not raise capital for the issuing companies. So companies seeking to raise capital should look to raise it from another company that's already public, ideally, a "blank check company," which exists as an empty shell, full of investor cash waiting for the right private company to "acquire" (and thereby bring public, sans scrutiny). Such companies are managed by asset managers, hedge fund managers, or private equity companies theoretically skilled in the evaluation of such investment opportunities, and compensated richly through management fees, incentive fees, and through issuance of warrants in the newly created equity securities of the merged entity. Perhaps it is because the IPO process is so broken that SPACs, which were traditionally associated with penny stock fraud in the 1990s, have become popular again.

As it was formerly understood (and should still be today), and as Andreessen points out, the problem with SPAC's is that their fees are actually higher than IPO fees are, and the incentives are structured all wrong, to boot. The SPAC's themselves exist purely as asset gathering vehicles for investment managers to raise additional funds where existing ones are already capacity constrained. And it is, perhaps, ludicrous to suggest that an individual fund (on average) would pay more dearly for a private offering than the aggregate demand of all the institutional investors amongst the investment banks' clientele.

The proffered solution? Andreessen hopes that the exchanges can successfully lobby the SEC to make it easier for companies to do large secondary offerings in conjunction with direct listings. In a world where companies can quickly come public via direct listing, and offer a substantial float of equity via secondary offering without underwriters and road shows, Silicon Valley will have successfully wrested the capability of separating investors from their capital from Wall Street hands. But this theoretical solution just assumes into existence robust demand for these secondary offerings, sans roadshow. It strikes this author that the issue for Andreessen, in the end, is not the pricing of the issue, but the fees paid the bank. In other words, it's not an attempt to create a more "efficient" market at all, but rather an attempt to keep more of the spoils of the inefficiency in the Valley. Which brings us back to the real question, which is why we have the IPO process in the first place?

That reason doesn't appear once in Andreessen's essay. The word that doesn't appear (even when referring to SPACs) is, "fraud," which was the raison d'etre for the Securities Act of 1933, signed into law by Franklin Roosevelt, with the intention of protecting investors from suspect securities issued pursuant to fraudulent schemes like Ivar Kreuger's "American Certificates."

The idea behind the company filings and the rules about when and how a company can give guidance are meant to protect investors from fraudulent and misleading claims. The filings and the road show are meant to offer institutions (who have a fiduciary duty to their investors) the chance to subject company financials and forecasts to a diligence process and root out suspect assumptions and promises. The "pricing" of the IPO is meant to ensure that the actual investment security is no more suspect than the company profits that secure it, and that reasonable investors can be assured of the safety of their principal after parting with their investment capital.

That these proceedings introduce conservatism and inefficiency is to be expected. It's to be appreciated, in a world where grift is punished rather than rewarded, and investment is recompensed. That we see IPO's so heinously mispriced that serious market participants can argue unironically that the “blank check” company might present a better solution is not evidence that our securities regulations have failed us. It’s evidence that we are witnessing an unprecedented and nearly unfathomable abdication of authority and responsibility by nearly everyone involved in the process of raising and allocating capital. The companies issuing shares would prefer, naturally, to do so without being subject to scrutiny. The investors buying shares would prefer to do so without providing scrutiny. The banks “underwriting” the offering would like to earn higher commission dollars from clients, who, in turn, would like to flip their shares for ever increasing amounts of unearned and undeserved profits. The solution that “greases the skids” for everyone involved in this process is one in which no real scrutiny is applied, in which no diligence is requested or received, and in which “profits,” are actually guaranteed by mispricing, which creates a “flip premium.” But these ills will not be cured by less oversight, rather more is required.

If Silicon Valley would like to access the full and fair value of their equity as they seek to raise capital they will have to share with the world more full transparency into their financial statements, that “real investors” might be willing to pay “real prices” for sound issues. If exchanges and regulators work to actually root out fraud, investors might be willing to begin again to engage in their own due diligence process, secure in the knowledge that the facts and figures they are shown were not conjured into existence from whole cloth. If exchanges actually prevented listings by companies without successfully audited and filed financial statements, or without auditors subject to PCAOB oversight, grifters and thieves might be further dissuaded from attempting to gain access to the El Dorado of investment capital that is the passive allocation in American workers’ 401(k) plans.

The beauty of it is that it is not the “system” that is broken at all. It’s market participants’ staunch refusal to pour sweat equity into valuation work, and the utter abdication of any claims to moral and ethical standards of care that have turned the pricing of public equity (and by extension, the IPO process) into a counterfeit fugazi market devoid of substance. All that is required of us, therefore, is a collective rededication to the policies and procedures that were originally designed to protect the sanctity of the market’s pricing mechanisms from outside influence and malfeasance, and a staunch refusal to acquiesce to the temptation to eliminate bureaucracy under the mistaken assumption that less regulation is always to be recommended.

In their essay, Andreessen Horowitz repurposed a pithy saying in reference to the market for IPOs and the obvious inefficiency of the pricing action we regularly bear witness to: “hate the game, not the player.” In response I can offer only this: the game would look a lot less like a casino if the players would stop gambling. In the long run, there’s no way market confidence is better served by SPACs and direct listings than IPO’s. But it’s time that the underwriters started offering investors rather more than a blank ticket for possible future inclusion in the S&P 500.

USURY AND BACK AGAIN

DESPEGAR RAISES $200M IN EQUITY CAPITAL

Featured in these very pages as recently as April 1st of this year, the leading online travel agency in South America, Despegar.com, finds itself back under the glare of our spotlight for reasons that have everything to do with the discussion of investor capital, and the cost of "raising" it. As we had previously noted, Despegar operates one of the highest quality businesses in the entire world, an online travel agency. It is no small feat that they've become the leading online travel agency in South America, and have outmaneuvered even large peers like Expedia by shifting the majority of their traffic acquisition to their own mobile apps, driving down customer acquisition costs and insulating their brand from changes in Google's search algorithm. Recently, the company has had occasion to report the results of their second quarter of operations for fiscal 2020, a quarter that will surely represent the nadir, globally, for the leisure travel industry as it is buffetted by the coronavirus pandemic and the severity of the international response to it, in the form of travel bans and restrictions.

Indeed, those results were bleak. Without any unnecessary detail, transactions and gross bookings fell 92% and 96%, respectively, on a year over year basis. Business, for all intents and purposes, is closed. The leisure travel industry in South America is in an acute state of distress, as it attempts to cope with lockdowns that were exceptional, globally, in both their severity and longevity. The company has moved quickly to preserve cash. They actually generated nearly $20M in cash from working capital due to disciplined execution in the quarter. Management closed on a $40M committed revolving credit facility to bolster their liquidity position, which remains undrawn today. And they renegotiated the terms of their pending acquisition of Mexican travel agency "Best Day," to push cash outlays into out years.

But not unlike, perhaps, Antrim, who sees value in both the sector and the shares of Despegar, despite the obvious lack of near term earnings power, Despegar sees opportunity as it surveys the competitive landscape for South American leisure travel bookings. And despite that Despegar's balance sheet is undeniably, "safe," it's not immediately clear that Despegar has enough capital both to weather the next four quarters, AND go on the offensive. As a result, they've elected to raise additional funds, and they've chosen to do it by through the issuance of mezzanine equity in the form of preferred shares and warrants, to private equity partners.

DESPEGAR FINANCIALS

Market Capitalization

Price:	**$8.55**
Shares Outstanding:	69.9M
Market Capitalization:	**$598.1M**
Net Debt (Cash):	($214M)
Enterprise Value:	**$384.1M**

Revenue Breakdown

Brazil:	39%
Argentina:	20%
Mexico:	15%
(Pre- Best Day Acquisition)	
Rest of LatAm:	26%

2019 Bookings Growth

F/X Neutral:	+23%
As Reported:	+ 6%

2019 Revenue Growth

F/X Neutral:	+19%
As Reported	- 1%

2019 Income Statement

Revenue:	$524.9M
Gross Profit:	$345.3M
Margin %	65.8%
EBIT:	**($ 8.9M)**
Margin %	-1.7%
Net Income:	($ 20.9M)
EPS:	**($0.30)**
Operating Cash Flow:	**$51.1M**
Free Cash Flow:	**$14.5M**

$50M was raised in a transaction with Waha Capital, who receives Series B convertible preferreds that pay a 4% coupon, and are fully convertible to common equity at a price of $9.25/share, and one board seat. A further $150M was raised in a transaction with L Catterton, who receives a 10% coupon, 11M DESP warrants that exercise at a strike of $0.01, and the right to put the preferreds back to DESP after five years at par. One of these things is not like the other.

At first glance, the terms exacted by L Catterton in exchange for unfettered and immediate access to $150M of investment capital are simply usurious. The warrants already are worth over 60% of the deal price, and the 10% coupon on the preferreds is surely the envy of junk bond afficianados everywhere. But as with the IPO market for fast-growing, but unprofitable start ups, it's unclear exactly what alternatives presented themselves to Despegar.

The company's stock trades a little under $3M/day. It's not immediately clear that a secondary amounting to 50 days' worth of trading volume could be consummated at any price, let alone an "attractive" one. They currently have no revenue, and no EBITDA, so they can't credibly issue debt against even the least restrictive covenants in existence. And they have the audacity (commendable) to state more or less explicitly that they intend to use the capital to acquire other money losing businesses to bolster the market share of their own money losing business, which isn't, at first, the most appetizing pitch this public equity investor has ever heard.

In effect, Despegar is doing a follow on round of venture financing, intended to finance their most recent venture, which is the acquisition of distressed regional competitors. And all indications suggest that endeavor will be a smashing success! But the reality for DESP and their passive public equity shareholders is that rounds of venture financing are expensive. Less expensive, perhaps, than a botched IPO or a failed secondary offering, but they're expensive. That Despegar's M&A hurdle rate can handle preferred equity with a 10% Coupon and $93M in equity dilution should say everything you need to know about the opportunity for attractive acquisitions in the South and Latin American travel end market.

That L Catterton is vanishingly unlikely ever to lose money on their most recent financing transaction is not, in itself, reason to question Despegar's motive for entering into it. It is the curse of the value buyer that frequently portfolio companies labor under the auspicious distinction of little or no institutional interest in their shares. In this case, we bear witness to a real world cost of that relative obscurity. There's no interested parties on the other side of the table when you need to actually raise capital.

It is the official opinion of this publication that some VP at L Catterton is going to become a partner very soon, and that more than one other VC firm will find occasion to wonder why they weren't interested, maybe even at an 8% coupon and for only $85M in equity warrants exerciseable day one.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Long LMND		+0.9%
S&P 500	*August 3rd, 2020*	+7.0%
Short TSLA Short GSX Long AKRXQ	July 1st, 2020 July 1st, 2020 July 1st, 2020	+130.7% +42.4% -89.3%
S&P 500	*July 1st, 2020*	+12.9%
Long MIK Short QSR Long ZMTP	June 1st, 2020 June 1st, 2020 June 1st, 2020	+191.5% +0.2% -4.7%
S&P 500	*June 1st, 2020*	+15.0%
Long NLY Long AGNC Short SWKS	May 1st, 2020 May 1st, 2020 May 1st, 2020	+21.1% +17.5% +40.3%
S&P 500	*May 1st, 2020*	+20.2%
Long DESP Short KNSL	April 1st, 2020 April 1st, 2020	+50.1% +98.2%
S&P 500	*April 1st, 2020*	+35.4%

Who underwrites the underwriters?

A Publication By:

Antrim Investment Research
Eric S. Jensen, Jr., CFA
ejensen@antrimresearch.com
www.antrimresearch.com

DISCLOSURES

Antrim Investment Research is long shares of LMND, MIK, ZMTP, NLY, AGNC, and DESP. Antrim is short shares of GSX and SWKS. Neither does Antrim nor do I, personally, have any business relationship, banking, consulting, or otherwise with any company mentioned in this newsletter.

AS ALWAYS, LIKE, SHARE, AND SUBSCRIBE!

If you are coming across this, the sixth issue of ***Idiosyncratic Risk***, for the first time, welcome. I would always like to make new friends. If you find my views interesting or helpful, and if you'd be so kind, feel free to forward this newsletter along in your network to those who might also make use of its content.

I sincerely appreciate the friendship, support, mentorship, and camraderie I've experienced during my career in Investment Management and I would like to thank my friends and readers for supporting me, whether by forwarding this email and my contact information along in your network, or merely reading these pages and considering what I have to say.

Feel free to reach out with questions, criticisms, suggestions, and investment ideas if you've got any good ones.

Antrim Investment Research