IDIOSYNCRATIC RISK

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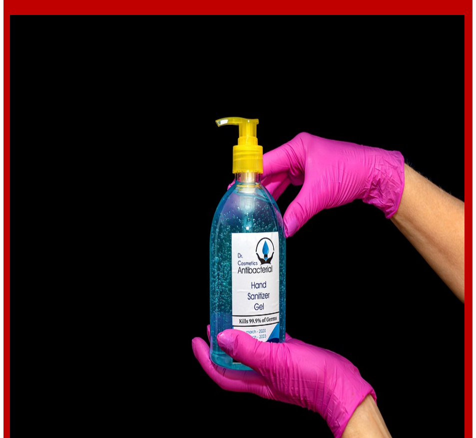


Is hand sanitizer a liquid asset?

WHEREFORE ART THOU, LIQUIDITY?

OR: A BID BY ANY OTHER NAME

I was recently introduced to an investor letter, written in 2018 by Christopher Cole of Artemis Capital Management, entitled: "What is Water in Markets?" which discusses liquidity from the viewpoint of the investor, who is surrounded and molded by it as a fish is by water, and then from the viewpoint of an outsider, who can imagine a world without liquidity that would be wholly unfathomable to an investor who's at once dependent on it, and yet also wholly ignorant of the possibility that an environment could exist without it.

(The letter can be found here: https://www.artemiscm.com/market-views)

Indeed, it is interesting to wonder if it is possible for a fish to conceive of a dry environment (coincidentally - is water wet?). It is certainly possible to imagine that, if you were to ask a fish, "how much water is there?" the answer would be pure confusion. Perhaps the most enlightened amongst the trout could respond, "enough, I hope." And the definition of water, to a fish, must surely be autological. For a fish, the definition of water is an existential question. Water is that without which, there is no is. Similarly, for the investor: How much liquidity is there?

And what does liquidity even mean? It is a word that is generally defined only ostensibly. You can point in the direction of characteristics that are molded by liquidity, but you cannot easily describe what it is. Are average daily shares traded liquidity? Or is free float liquidity? Perhaps liquidity is the spread between bid and ask at the National Best Bid and Offer? In the vernacular, liquidity could also be a mixture, prepared in lab, formulated as an injectable, and administered by the Federal Reserve Board's open market operations desk.

Semantics aside, liquidity is the rather abstract concept of the visibility to market participants of the publicly posted price of an asset, and the ease with which a buyer and seller can transact in that asset at, or near, that price. To that end, a narrow bid/ask spread is indicative of a liquid market, at least in theory. So too, an outstanding bid from the Federal Reserve Board's open market operations desk is liquidity, especially for those looking to sell assets. Paradoxically, though, a liquid market characterized by an overabundance of buyers and a paucity of sellers can feel somewhat undemocratic for its newly prospective participants.

Given that frustrated buyers are no more compatible with the concept of an efficiently functioning market than frustrated sellers are, it is not immediately clear that assets which are competitively bid are demonstrating any greater "liquidity" than those asset classes which aren't. Competitive bidding, rather, begets hoarding of financial assets. Why offer an asset for sale at a fixed price, if the offer serves only to negotiate against oneself? Surely, it would be understood that hoarded assets are not "liquid" (Incidentally, for interested parties – I have a paper copy of Seth Klarman's "Margin of Safety" that was once a .pdf copy, make me an offer I can't refuse).

Established then, that hoarded assets are not obviously, "liquid," one surmises that the liquidity of an asset class is NOT, actually, described by the volume of transactions that occur in that asset class, or by the spread between the bid and offer on the securities in the class, but rather defined by the game theory optimal negotiation posture of the participants in the market for that asset. If the optimal portfolio management strategy is "buy and hold" and it is inherently impractical to differentiate between the individual securities of the asset class, the class will tend towards illiquidity, because any market participant who transacts is either: (a) bidding against the flows or (b) fixing a sale price in a competitive bid situation, and therefore, destined to lose.

The astute reader, of course, will note that these are characteristics of the market for large capitalization equity securities, which are traditionally considered, "liquid." Duly submitted for the reader's consideration: equity investors have mistaken a competitively bid asset for a liquid one. This hypothesis fits the data.

The obvious "bid," is provided by two sources. Inflows to defined contribution pension plans (401(k) plans), which are overwhelmingly allocated to passively managed ETFs and low cost "index" mutual funds, and federal reserve open market operations (asset purchases), which serve to drive bond prices higher and facilitate a rotation from bonds into equities in the "standard" 60/40 asset allocation. These trends are self-evident. If indeed, DC-retirement plans and the federal reserve open market operations are meant to be perceived as a perpetual and inexorable fount of liquidity, through which flows a persistent deluge of "at-the-market" buy orders, then the prevailing sentiment is entirely rational. To whit: the momentum "factor" outperforms quantitative fundamental factors over both the short run and the long run. Reflexivity is the source of intrinsic value, rather than a source of divergences from it.

In the abstract, nobody would argue that outflows from defined contribution plans are impossible. So too – most believe, at least academically, that there must be a practical limit to the power of the Federal Reserve to print money, eventually. As a practical matter, of course, Neel Kashkari would be willing to debate the point. But why does it matter? What evidence do we have to suggest that liquidity dries up when either the fed, or the 401(k)'s stop buying?

In 2013, then-Fed chairman Ben Bernanke suggested that the fed might begin "tapering" back on the fed's implementation of "Quantitative Easing." The fixed income market, which at the time (and to this day), remained illiquid, and driven by the sentiment of active managers, who manage the vast majority of fixed income assets, revolted. In an event now known colloquially as, "the taper tantrum," yields skyrocketed. The 10-year treasury traded at a (relatively) robust yield of 2.81%, up from 1.53% earlier in the year. The equity market hardly registered a disturbance. It is important to note, in our framework, the equity market is not swayed by the attitudes of active managers, who were duly terrified of the taper tantrum. They said so every day on CNBC. It is, however, influenced by the actual flows from the federal reserve (which did not stop) and the actual flows from the defined contribution plans (which did not stop).

In 2015, the fed actually stopped growing its balance sheet, and the equity markets became volatile again for the first time in seven years. On August 24th, 2015, the market experienced a "flash crash" in e-Mini futures, when two straight days of selling pressure caused traders to pull all bids from a sizeable portion of the stocks on the NYSE at the open. The fair value of ETF's couldn't be established at the open, and traders looked to "liquid" e-Mini futures market to hedge outstanding exposures, driving the futures down 5% intraday in a matter of minutes. The market regained most of the losses before selling off again, closing down roughly 3% on the day. And 2015 ended poorly as well, with seasonal weakness in the third and fourth quarters returning to prominence.

In 2018, equity investors were reminded that what DC retirement plans giveth, they may also taketh away. The stock market recorded wretched returns in January and December of 2018, the two months that historically account for a majority of mandatory withdrawals from retirement plans for participants' who've reached retirement age.

There is demographic evidence to suggest that months like January and December of 2018 are set to become the norm. According to global research and consulting firm, Cerulli Associates, gross outflows from 401(k) plans increased at a compound annual growth rate of 8.4% from 2012 to 2017, as baby boomers began to reach retirement age and began making required annual withdrawals from their plans. Over the same time period, inflows to 401(k) plans grew at an annual CAGR of 6.4% as millenials came into their adult earning power. Over the next 9 years, the latter half of the boomer generation (71.6M Americans) will be retiring. Offset only in part by the introduction of zoomers (only 68M Americans) to the workforce. As the gig economy gains steam (no 401(k) plans are offered by "gigs"), and as a smaller number of younger, and more impoverished workers replace a larger number of older, more wealthy savers and investors in the plans, outflows are expected to eclipse in flows.

In 2019, with December 2018 fresh in plan participants' minds, withdrawal activity was spread out. December of 2019 had zero days of above average flows into, or out of index funds.[1] In total, for the full year, inflows numbered in the mere millions. In 2020, in response to the coronavirus pandemic, mandatory withdrawals were suspended. There's unlikely to be a significant impact, as the available data would seem to suggest the full amount of the plans' mandatory withdrawals (and then some) were taken in the latter half of February.

Due to a variety of variables that are insignificant in the long run, but inherently unpredictable in the short run, there's no way to pinpoint with certitude the precise moment that demographics will require equity investors to begin dealing with significant, persistent outflows from defined contribution retirement accounts. The evidence would suggest, however, that the tipping point is closer at hand than not. Were it not for the decision to eliminate required withdrawals for 401(k) plans in 2020, it may have already happened. Of course, it's not illegal to withdraw more than the minimum.

There have never been meaningful net outflows from 401(k) plans. Not in the 40 year history of the plans. The problem with predicting a thing that's never happened before, is that the skeptics hold that fact out as a ready retort, as if it changed

[1] Source: https://www.planadviser.com/401k-participants-less-reactionary-2019-trading/

the logic of the argument. The issue for investors is that they tend to think of an environment that has existed for the last 40 years as, “the environment,” rather than, “an environment.”

When the conditions that have created it disappear, many of those same investors will struggle. Like fish, out of water.

THE DARK SIDE OF GAMING EXPANSION

OR: “I ALWAYS KNEW IT WAS YOU, FREDO”

It has been the practice of this newsletter to offer its readers specific, actionable investment ideas and thought provoking, differentiated analysis. Your author has always had a rather skeptical disposition, and an iconoclastic streak that lends itself to the identification of short ideas, a number of which have appeared in the pages of prior issues of ***Idiosyncratic Risk***. And as a result, institutional interest in Antrim’s research capabilities has grown. With that in mind, Antrim has continued to focus its research efforts on the identification of profitable short ideas, almost exclusively. And in keeping with the needs of Antrim’s core clientele, Antrim has redoubled its efforts to ensure that the ideas under our research coverage have enough free float and average daily trading volume to be practicable, actionable ideas for large institutional managers.

That having been said, it is frequently the case that an idea crops up, fully formed at the outset, more or less, which does not have all of the characteristics that lend it to the practical interest of Antrim’s paying subscribers. In process, then, is a brief description of one of those ideas.

Antrim first came across the discussion of a short idea in Accel Entertainment (NYSE:ACEL) while reading through past issues of Edwin Dorsey’s excellent e-mail newsletter, “The Bear Cave,” which can be found here: (https://thebearcave.substack.com/). In July, Mr. Dorsey discussed the indebted roll-up of video game terminal (slot machines) operations at non-casino properties in Illinois. He believed, at that time, that the lingering effects of the coronavirus pandemic, such as a lack of foot traffic at restaurants and convenience stores, or a reticence among consumers to touch communal game terminals, would negatively impact ACEL’s revenue, even as bars and restaurants re-opened in Illinois during the month of July.

At least in so far as that catalyst was crucial to the ACEL bear case as it was then articulated, it proved to be spectacularly wrong. By the first week of August, “The Bear Cave” put out another issue entitled, “I Was Wrong,” which recognized the Illinois Gaming Board had disclosed the revenue for video game terminals state-wide had set a record over the course of July. And it is true that gaming operators often claim that Video Game Terminal (“VGT”) receipts are recession resistant. But it strikes your author that there’s no compelling reason for July revenues to have set a record statewide, other than government issued stimulus checks, which acutely inflated the demand for non-Casino gambling in the form of lottery ticket sales, video gaming, and Robinhood margin accounts.

Antrim has had occasion to discuss the idea with Mr. Dorsey, and I believe that, for a variety of reasons, ACEL still represents a compelling opportunity. I’ll leave the official opinion of the Bear Cave up to that publication’s author.

ACEL is in the business of operating video game terminals located at bars, restaurants, and convenience stores across the state of Illinois, which legalized the practice in 2009, in an effort to increase tax receipts associated with state regulated gaming revenues and legitimize the historical practice of “gray gaming,” whereby unregulated operators would collect receipts and issue payouts for "legal," token based games at taverns, which ostensibly were required to issue non-monetary payouts.

Propublica.org has devoted an extensive series of investigative journalism to the legalization of coin gambling across Illinois that elucidate a number of drawbacks and unintended consequences of Illinois' uniquely pro-gaming policy stance. Chief among their observations, for example, is the notion that the end consumer demand for coin gaming terminals in Illinois is almost completely saturated. The state has more slot machines than Vegas, and more restaurants, bars, taverns, and convenience stores licensed to operate the machines than any other state. And still, revenue has fallen short of the state's projections, as the expansion of off-premise gaming has eaten into gaming revenues at Illinois' actual licensed casinos, according to the data published by the Illinois Gaming Board.

Second, Propublica notes that statewide tax receipts produced by the gaming expansion have fallen short of the initial projections. In part due to the cannibalization of demand for Illinois' existing casinos, but in part due to the state's disastrous decision to require only a de minimus application fee for restaurant owners and operators to file with the gaming board. Where other states have required several thousand dollars up front in application fees, and hundreds annually for license renewal, Illinois has adopted legislation first crafted by the gaming lobby itself, which requires virtually no application or renewal fees.

ACEL – ISSUER INFORMATION

Price:	$10.71
Shares Outstanding:	91.78M
Float:	41.03M
Market Cap:	$983M
Enterprise Value:	$1,232M
Forward P/E:	18.8x
EV/Adj. EBITDA (2019):	19.1x
Dividend Yield:	n/m
Short Int (% of Float):	6.75%
3mo Avg. Volume ($M):	$4.97M

State legislators and regulators familiar with the arrangement have called that decision, "a mistake" according to Propublica's reporting. Municipalities across Illinois have scrambled to propose their own fees, in order to limit the spread of video game terminals in their localities, and also raise revenue. In 2014, for example, Illinois courts upheld the efforts of the Village at Elmwood Park, who sought to impose a $1,000 annual license fee on operators in their local municipality.

And Propublica's reporting has uncovered a number of unsavory details about ACEL's own business practices as well. A decade after the gaming expansion was adopted, ACEL has become the largest "operator" of gaming terminals hosted by restaurants, bars, and truck stops in the state. They have done so, in part by exercising undue influence over personal connections ACEL management have with members of the Illinois Gaming Board, or so Propublica alleges. In particular, ProPublica obtained emails from the private email accounts of ACEL CEO Andrew Rubinstein and Illinois Gaming Board attorney Bill Bogot, who was a childhood friend of Rubinstein's. In those emails, Bogot answers Rubinstein's questions about the regulatory process, and offers advice about how ACEL might smoothly navigate their restaurant clients through the licensing application process.

Propublica implicitly links those emails to documented and perceived favoritism that ACEL receives from the Illinois Gaming Board. The company experiences shorter delays with regulatory review of its restaurants' applications, and in some cases, appears to benefit from expedited review of its applications. In fairness, the application review process is – byzantine and disorganized, and it appears that nobody knows exactly what order backlogged applications are reviewed in. For his part, Bogot has repeatedly stated that, while he did discuss state business over his personal email, he did not offer ACEL any advice that he would not have offered to any other regulated company who asked. Indeed, there is no evidence to suggest otherwise.

Nevertheless, ACEL continued to grow. The company was founded by Andrew Rubinstein, who formerly worked as a consultant at Arthur Anderssen in the 1990s, before leaving to assist an aunt with the operation of a beauty parlor in Seattle, and then going on to help an uncle run one of Illinois' largest liquor stores. By 2019, ACEL was generating $31M in quarterly revenue from gaming in Illinois, which was over 150% more than its nearest competitor, MJ&J Ventures, and nearly 3x the size of the next largest competitor in the state, "Gold Rush Gaming."

In 2019, ACEL became a public company via SPAC-reverse merger, and operates today under the NYSE ticker: ACEL. The company trades just under $5M of average daily volume, at a market cap of $983M, and with a valuation of 19.1x 2019 EBITDA. That valuation is already rich, to be sure, but it appears even moreso after adding back route acquisition costs to ACEL's "adjusted EBITDA."

The VGT business is structured, operationally, into "routes," which are operated by ACEL and their competitors. Route operaters in ACEL's employ are tasked with cash collections, terminal maintenance, and customer service at a number of restaurants, taverns, and bars along a "route," which has traditionally been established by a local operator, and then acquired by ACEL. Sometimes these "routes," are legitimate licensed routes, which have been acquired by ACEL as they've consolidated the Illinois gaming industry, and other times the routes acquired by ACEL were historically served by "gray gaming" operators, who operated unlicensed cash game terminals prior to legalization, and are subsequently legitimized by ACEL, who assists restaurant owners with the licensing application and regulatory process.

The problem with excluding route acquisition expenses from opex (or capitalizing them), is that there is enormously high churn in the restaurant industry, even during normal times. Each year, as restaurants hosting ACEL go out of business, the company must acquire a certain number of routes just to offset the "churn" within their existing base of licensed operators. By excluding these customer acquisition costs entirely from EBITDA, the company paints a picture of a much higher level of profitability than they could actually sustain, without them. The issue is of particular interest to investors during the coronavirus pandemic, as restaurants across the country have wrestled with the decision as to whether or not they will re-open after temporarily shutting down, or close permanently. When these costs are added back to ACEL's adjusted EBITDA, the company has not yet become profitable.

Oddly, in the company's 2019 10-k filing, ACEL disclosed "a material weakness in the design and implementation of internal controls relating to business combination accounting and route and customer acquisition cost accounting due to the absence of formalized internal controls surrounding the determination of the fair value for assets acquired and liabilities assumed in business combinations, the accounting for initial route and customer acquisition costs and the accounting for such assets." Of course, they also disclosed material weaknesses in internal controls due to a lack of headcount and IT systems necessary to comply with GAAP accounting principles, but it seems particularly important that the company singled out that they do not have adequate controls in place to consistently account for the single largest cost that they incur, and exclude, from reported adjusted EBITDA. Those material weaknesses had not been remedied by year end, nor by the time that the 10-k was actually filed in March. To the best of your author's knowledge, those weaknesses have not yet been remedied, today.

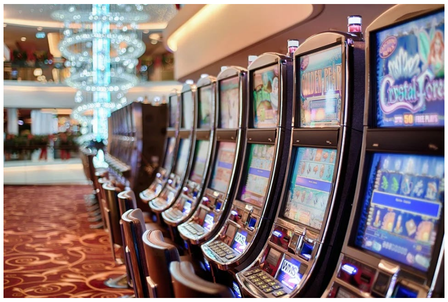
Still, ACEL's valuation is seemingly supported investors' enthusiasm for a significant number of other states to pass various versions of Illinois' gaming legalization and expansion bill. The logic appears to be that, as other states legalize off-premise coin gaming, the largest off-premise coin gaming operator must stand to benefit. But Antrim's analysis can identify no sustainable competitive advantages for ACEL outside of the state of Illinois. In states with existing "gray gaming" operators, ACEL will be required to acquire those routes, just as they have in Illinois. And in those states without, the gaming legalization and expansion framework is unlikely to offer restaurants and bars the same cheap access to gaming licenses that Illinois has.

And then, fundamentals are not as rosy in ACEL's home state as the company's valuation would seemingly imply. Illinois looks set to pass yet another gaming expansion bill, in part to finally recover some of the revenue shortfall from the first gaming expansion. In this bill, the state has raised taxes on ACEL and their restaurant operators, and allowed for construction of two new large casino's in the state, which will siphon business from off-premise game terminals, just as those terminals took market share from the state's existing casinos.

And then there is the issue of fiscal stimulus checks and extended unemployment benefits, which drove record numbers of Illinoisans to the slot machines over the summer, but have since expired. It remains to be seen whether the state's VGT's can sustain their record-breaking revenue pace, or if the expiry of the stimulus benefits will have an outsized impact on demand for Accel's terminals. Indeed, if Illinoisan's enthusiasm for gaming slows, churn within ACEL's base of restaurant owner/operators may begin to materialize in the company financials, should they be able to account for it.

PAST PERFORMANCE IS NOT A RELIABLE PREDICTOR OF FUTURE RESULTS

Recommendation	Date	Performance Since Recommendation
Long LMND	August 3rd, 2020	-14.5%
S&P 500	August 3rd, 2020	+2.8%
Short TSLA	July 1st, 2020	+98.7%
Short GSX	July 1st, 2020	+50.2%
Long AKRXQ	July 1st, 2020	-90.4%
S&P 500	July 1st, 2020	+8.5%
Long MIK	June 1st, 2020	+150.0%
Short QSR	June 1st, 2020	+7.3%
Long ZMTP	June 1st, 2020	-14.0%
S&P 500	June 1st, 2020	+10.5%
Long NLY	May 1st, 2020	+20.8%
Long AGNC	May 1st, 2020	+16.9%
Short SWKS	May 1st, 2020	+41.0%
S&P 500	May 1st, 2020	+15.5%
Long DESP	April 1st, 2020	+18.4%
Short KNSL	April 1st, 2020	+82.0%
S&P 500	April 1st, 2020	+30.1%



Recession proof, pandemic proof, and stimulus approved!

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AS ALWAYS, LIKE, SHARE, AND SUBSCRIBE!

If you are coming across this, the seventh 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