EidelmanVirant
CAPITAL

12th of July, 2019

Dear Clients and Friends,

The S&P 500 Index recorded a 4.5% gain in the second quarter. Such strength is attributed to the Federal Reserve shifting their tone from "gradual tightening" to "patient" regarding interest rates. In other words, investors went from fearing rising rates to excited about lower rates. Low interest rates make stocks more valuable because they 1) entice investors into equities due to their relative attractiveness versus lower-yielding fixed income options, 2) reduce interest payments on company debt thus increasing corporate profits, and 3) increase the valuations of all companies by lowering their cost of capital.

We remain cautiously optimistic for the stock market. On the plus side, the U.S. economy is enjoying modest growth, inflation and interest rates remain low, stock market momentum is robust, investor sentiment is neutral, and valuations in many areas are reasonable. While the median P/E ratio for the overall market is slightly overvalued at 24x earnings, approximately 22% above its 40-year average of 20x, there is value in certain sectors and companies. For example, banks and airlines trade at nearly half the market valuation at 12x and 11x respectively. Conversely, there has been $37B of initial public offerings (IPOs) of companies sporting lofty valuations with more expected later this year. So far, IPO volume is 30% above last year's level.

While the market may be temporarily rewarding such growth companies, history has not been kind to companies with large market valuations and little to no revenues and profitability. In the two years following the dot.com boom ending December 1999, the tech-heavy Nasdaq index fell 58% while the Russell 2000 Value index gained 32%. We will stick to fundamentally sound companies with proven and profitable business models, leading market positions, top management cultures, and low debt ratios, trading at attractive valuations. We are optimistic that a portfolio of such companies gives us the best chance to minimize downside and maximize returns going forward.

If you have any further questions, please give us a call.

Sincerely,

Tom Eidelman, CFA
Managing Director

New Purchases

Renewable Fuel Group – (REGI) – Price $16.

REGI owns refineries that turn vegetable and cooking oil into biodiesel fuel. Such activities benefit the environment by recycling waste products into fuel instead of going to landfills and reducing net carbon dioxode emissions by 78% compared to petroleum diesel gasoline. Because of its environmental benefits and higher cost to produce, the U.S. government subsidizes biodiesel through mandated purchases for refineries and tax credits for producers. While these biodiesel tax credits (BTCs) are supported on a bipartisan basis, the current political divide has delayed past tax credits and put future of the BTC into question. Should the past two years credits be reinstated retroactively as we expect (which has been the case for the past 10 years), REGI would be owed a BTC of $237m or $6 per share. Should congress cancel the BTC, we believe small, high-cost biodiesel producers would go out of business and REGIs large, low-cost competitive position would benefit over the longer term. Should REGI receive the BTC by the end of 2019, we think shares should trade near its estimated tangible book value of $25 per share, a 56% premium to the current price.

Southwest Airlines – (LUV) – Price $52.

Southwest is the third largest airline in the U.S. with an outstanding corporate culture and attractive price. Southwest was ranked #2 on Forbes list of Best employers for 2019. In addition to never having a layoff and allowing employees and dependents to fly free whenever they want, Southwest pays 15% of the profits to employees. Such dedication to their employees translates to the best customer service in the industry. Southwest won the JD Power customer service award two years in a row and has net promotor score (NPS) of 62 vs industry at 44 and least customer complaints in the industry according to DOT (.36 per 100,000) 26 out of 28 years. Lastly, Southwest has always had the lowest debt and highest profitability in the industry.

We believe the recent controversies surrounding the grounding of Boeings 737 Max planes provided an attractive entry point into Southwest shares. Despite the quality of the company as outlined above, Southwest shares trade at just 11x estimated earnings. We think the valuation of such a high quality company should be at least equal to the industrial sector average of 15x earnings, offering a roughly 30% appreciation potential. Southwest is also aggressively buying back 6% of their shares outstanding per year.

MasterCraft Boat – (MCFT) – Price $20.

MasterCraft has leading market share positions in four of the fastest growing segments of the boating industry including the iconic MasterCraft ski and wakeboarding boats. When Terry McNew took over as CEO, financial performance blossomed, and the company transformed into a top manufacturer and was awarded IndustryWeeks Best Plants award. One of the key drivers for the award was its successful employee empowerment program, an ongoing company-wide initiative that encourages factory line workers to suggest improvements to the production process where more than 13,000 employee-generated improvements were implemented over the course of the last fiscal year alone. Despite rapidly growing innovation, sales, and profitability, MCFT shares trade at just 7x earnings. Should MCFT trade at l0x earnings (the valuation of its peers Brunswick & Malibu), shares would be worth $28 per share, a 40% premium to the current price.

Weight Watchers – (WW) – Price $21.

Weight Watchers is the world's leading commercial weight loss business with an effective proprietary calorie counting points methodology and vast network of group support meetings. In 2017, WW hired a new CEO, Mindy Grossman. Prior to WW, Ms. Grossman enjoyed success as a key executive at Ralph Lauren, Nike, and then as CEO of the Home Shopping Network. Ms. Grossman is a talented leader with the rare ability to inspire employees and attract top executive talent. Oprah Winfrey is also an active board member an 11% owner ($158m) committed to the new strategic direction.

WW is expanding beyond its core weight loss business into the broader health and wellness industry, expanding their addressable market opportunity from the $70B U.S. diet market into the $4 trillion global health and wellness market. Leveraging its 4.6mm subscribers, and best-in-class digital app, WW is building a portfolio of health and wellness-based products. We are particularly excited about their new diet program which will be released later this year which we think will grow customers and continue to keep customers on their wellness plans longer.

The market is skeptical that WW can successfully transition beyond weight loss, and the stock has fallen from a high of $100 last summer, to $21 today. We think the share price is so depressed that even if they just recovered their historical profitability around $2 per share, the company should be worth $30 per share, a 43% premium to the current price. Should the broader wellness strategy take off, we could be paying a very low multiple for a market-leading franchise in the early innings of a big transformation.