PRO Weekly Digest: How GAAP Accounting Creates Mispricings With Laughing Water Capital

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SA PRO Editors
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Seeking Alpha PRO

Welcome to the latest issue of the PRO Weekly Digest. Every Saturday for Seeking Alpha PRO subscribers and Sunday for all other Seeking Alpha users, we publish highlights from our PRO coverage as well as feature interviews and other notable goings-on with SA PRO. Comment below or email us at pro-editors at seekingalpha.com to let us know what you think. Find past editions here.

Feature interview

Laughing Water Capital is a long-biased investment partnership with a focus on businesses suffering from temporary problems or misunderstood by the market that have management teams with significant equity ownership. We emailed with Laughing Water Capital about how to exploit a lack of liquidity, why all cash is not created equal and the importance of focusing on the underlying business (and not just the multiple it should receive).

Seeking Alpha: Can you provide examples of how structural impediments or GAAP accounting creates mispricings?

Laughing Water Capital: Winston Churchill said, "democracy is the worst form of government, except for all of the others," and that is how we feel about GAAP accounting. It is a very useful framework, but there are definite flaws that at times fail to capture the true economic power of a business. In our view, understanding these flaws and seeking to exploit the weaknesses of GAAP is an effective way to seek out value in the stock market… especially in a market where so many of the participants are dependent on computer models that take the numbers at face value rather than seeking to understand the numbers as an intelligent businessperson would.

Our favorite archetype of investment is what we call "good co/bad co," where a company has 2 (or more) segments with differing cash flow generating capabilities that are lumped together under GAAP, producing a net number that does not accurately represent what is really going on beneath the surface. For example, if a company has two business lines, and one of them is earning $1.00 and the other is losing $.75, under GAAP accounting the company is net earning $.25, and the market will often value the company based on this net number.

But what happens if the segment that is losing $.75 is shut down? With the stroke of a pen the company is now reporting earnings of $1.00 (absent one-time charges etc.), and in the market's un-informed eyes earnings have quadrupled.

In the real world, it is never quite that easy, and the job of the analyst is to understand the sustainability of earnings at the better business, as well as the likelihood that these earnings will be revealed to the masses within a reasonable time frame. For us, that means spending considerable time and effort to understand the incentives of the management team, as well as the motivations and modus operandi of the largest shareholders.

Another example of the short comings of GAAP would be with software as a service (SAAS) companies. For these businesses, under GAAP they must account for their customer acquisition costs as they are incurred, but the revenue associated with new customers is only recognized as it comes in. In other words, if it costs $100 to acquire a new customer, and that customer will generate $200 in revenue over the next 2 years, an intelligent businessperson would recognize the value in acquiring this customer. However, under GAAP, that $100 would be expensed in the first quarter, while only $25 of revenue would be realized in the first quarter, leading to a loss of $75 in the first quarter.

Again, there is no guarantee that this setup will lead to a mispricing, but we have found it to be a fertile area to search.

SA: You look for management teams at your portfolio companies to have significant equity ownership – is this measured on an absolute dollar basis, percentage of the market cap, etc.? Is some insider buying or selling more equal than others? Can large insider ownership ever be an impediment?

LWC: What we really look for is an alignment of interests with the management teams of our companies. Our portfolio is concentrated, so in order to sleep well at night, we like to know that our management teams are sitting up thinking about their own investment in our companies. Perhaps, the easiest way to confirm alignment of interests is through equity ownership, but it is more art than science – there is not necessarily an absolute dollar amount or a certain percentage of market cap that we set as a minimum amount. Examining the proxy to understand salary, benefits, and bonus is also part of the process, as is understanding management's behavior and capital allocation. We want them to act as if the money is their own.

As for insider buying and selling, clearly insider buying is a good thing – it has been said that people sell for many reasons, but they only buy for one: they are confident in the future of the company. Insider selling is more difficult to interpret, particularly for us as we often have an unusually long time frame in mind when we make an investment, while the sellers may have near-term life events that lead to a sale. Our long time frame allows us to take advantage of large insider ownership stakes, because the market often views large insider ownership stakes as a negative due to reduced float and liquidity. The refrain is often, “the stock will never get a peer multiple due to lack of liquidity.”

In our view, this is an exploitable tendency of the market for those with a capital base that allows for exploiting time arbitrage. We try to invest without thinking about the multiple that the market puts on a stock. Rather, we focus on the ability of the business to increase their earnings power over time through their competitive advantages and skillful capital allocation. We are always somewhat surprised by the emphasis on multiple expansion by many sophisticated investors on sites such as Seeking Alpha or ValueInvestorsClub.com, and in our view base case valuation should not incorporate any multiple expansion because one cannot rely on the market to re-rate shares in any given time frame. Longer term, the market will get it right and put the right multiple on a business, but in the near and intermediate term, investors are better served by focusing on the business’s ability to drive its earnings power, and thus intrinsic value.

An example would be Revlon (NYSE:REV), where Ron Perelman owns ~78% of the shares outstanding. The business is not without problems – in fact, almost the entire industry has suffered lately – but Revlon trades at a severe multiple discount to its peers. Bears often say that the stock will never get a comp multiple due to Perelman’s presence, while we say that the stock doesn’t need a comp multiple to go up significantly due to operational improvements (including the integration of RDEN) that are in the works. Further, we believe that eventually, Revlon will indeed get a comp multiple through a sale. That may take a decade or more, but if the business is able to continue to grow its intrinsic value through intelligent capital allocation, investors will be well rewarded by waiting.

SA: Almost by definition, a relative value thesis requires a multiple re-rating – can you discuss how/why stocks are re-rated higher or lower? Does a re-rating require a catalyst or is the idea that “the market will eventually put this together” enough?

LWC: We do not generally invest in stand-alone relative value theses, and in our view, catalysts are great if you can find them, but they are not necessary for a good investment. Further, if you do find one, you should generally be suspicious. Why is it that you are able to see the catalyst, but the market does not?

Rather than looking for identifiable hard catalysts, we tend to look for situations where common sense is all that is needed. Going back to our earlier commentary on “good co/bad co” setups, in the past we have heard investors say something along the lines of, “but you don’t know when that bad business will be killed off,” as a reason to not invest. If the good business has a defensible position and is growing intrinsic value, we are typically content to not worry about the hard catalyst of “when.” We spend our time understanding the incentives of the management team, and if they are properly incentivized, the answer of “when” typically becomes “eventually,” because it is just common sense that a properly incentivized management team will not let a bad business prevent their good business from seeing the light of day forever. Patience is a key part of the investment.

In our view, more important than any catalyst or re-rating is the quality of the business and the management team, and the unique attributes that will allow intrinsic value to grow over time. This is decidedly NOT a cigar-butt approach. There is nothing wrong with a cigar-butt approach, but with a concentrated portfolio we sleep better knowing that our margin of safety should be growing over time, rather than contracting as is often the case with cigar butts.

SA: ValueAct just announced they are returning capital due to high valuations for the companies it follows – should this impact the behavior of long-only investors? Are there still opportunities out there and if so, where?

LWC: ValueAct has an enviable track record, which has attracted many billions of dollars, which greatly limits their investable universe. Additionally, if you read past the headlines the decision to return capital seems to be as much about having money coming in from other sources as it does about returning capital due to valuations.

There is a ton of evidence that for trying to time the market is a losing proposition because one never knows when the markets will selloff, and actual selloffs are less common than fear of selloffs. That being said, in our view, investors are best served by trying to understand how their investments will perform when something goes wrong before making a purchase because eventually something will go wrong. For us, that means many if not most of our investments have some combination of defensive cash flows and/or a rock solid balance sheet as well as a management team with a history of intelligent capital allocation. In theory these elements will allow our businesses to take advantage of any bad times by taking market share, acquiring competitors, repurchasing stock, or something similar. Having faith that our businesses can actually benefit vs. the competition, or improve their own future during difficult times helps us ignore the volatility.

For smaller investors, we believe there are always pockets of opportunity in the market, but it is impossible to say "where." In our view, it is about picking up a lot of rocks hoping to uncover a situation that is an anomaly. Human nature being what it is, these situations are always out there somewhere.

SA: Your recent write up on Points International (NASDAQ:PCOM) included several hard catalysts – can you discuss from a broader perspective the difference between hard and soft catalysts, how you identify them and which are more impactful?

LWC: In our view, a "hard" catalyst has a date attached to it, while a soft catalyst is something that should or could happen eventually. In the case of PCOM the hard catalyst is that next quarter they are changing the way they present their financial statements. In the case of GAIA, the hard catalyst was that in their next 10-Q their balance sheet was going to be completely changed. Both of these investments were somewhat unusual for us in that we don't typically focus on hard catalysts at all, and we are much more likely to uncover situations that could or should happen based on a common sense understanding of the business and the management team's incentives. In both cases, these hard catalysts were simply identified just by picking up a lot of rocks. Both companies are off the radar microcaps, without a lot of eyes on them, which helps explain why we were able to find them before the market priced them appropriately.

It is hard to say whether hard or soft catalysts are more impactful because this would necessarily include an IRR calculation, which would include a time element. A hard catalyst has a theoretically known timeframe which could lead to higher IRRs, but a soft catalyst could lead to a larger total gain with lower IRRs due to the unknown time sequence. Both offer opportunity, but neither are necessary, and neither precludes the need to do extensive diligence on the business, industry, and management team in question when considering an investment.

SA: Using your excellent call on Gaia (NASDAQ:GAIA) as a starting point, a large cash balance is an obvious attraction for value investors. Going back to the Animal Farm reference, can you discuss why some cash balances may be more equal than others (in terms of how it's used) and the implications for investors?

LWC: Cash as represented by a balance sheet is just a number. When valuing a business, that cash can be worth more or less than its stated value depending on how it is used, which goes back to understanding management's incentives and history of capital allocation. In the case of GAIA, the CEO is the largest shareholder in the company, he is known to be frugal, he has an admirable track record of capital allocation, and he has a well-defined and quantifiable plan to use the cash for customer acquisitions at a rate that will not be more than 50% of the lifetime value of the customer. In other words, he is saying that he will not spend the cash on customer acquisition unless he thinks he will realize a 100% return on the spend. In our view, that makes the cash in his hands more valuable than the balance sheet suggests.

Contrast that with many "net-nets" over the last few years where there may be a lot of cash, but management is draining it by paying themselves high salaries, and there is no real plan of how to productively deploy the cash. It is still possible to make money as an investor in these situations, but frequently the margin of safety is deteriorating as you are waiting.

As with most things, separating these two scenarios is best done by starting with an evaluation of the business and the management team first, and focusing on the price and potential value later.

SA: What's one of your highest conviction ideas right now?

LWC: In our view, EZCORP Inc. (NASDAQ:EZPW) is very attractive. The stock rallied more than 300% from its lows to its highs last year, meaning that it likely became a larger position than intended for many investors. Further, with those kind of gains, many investors were likely eager to push their tax bill out to the next year, leading to heavy selling in early 2017. We believe that both of these factors have contributed to a negative momentum situation where investors have been selling for non-economic factors.

EZPW, which we wrote about extensively in our Q1'16 letter, is in the pawn shop business. Like many of our investments, there are things not to like, such as a controlling shareholder who has not always been friendly to minority investors. However, the company has recently cleaned up its operations, is actively taking share from its largest competitor, has tremendous opportunities to reinvest its cash flow through consolidating existing pawn operations and establishing de novo operations, and is presently trading at less than 8x trailing free cash flow.

Curiously, sell-side analysts have written reports that put a value on the company based on current earnings, while also noting that current earnings are not "normal." In our view this completely fails the common sense test, although as we are fond of saying, "common sense is un-common on Wall Street," so I suppose we shouldn't be surprised.

In any case, looking out a few years the business should be able to earn somewhere between $1-$2 per share, and the company likely deserves a higher multiple now than it has in the past because the regulatory environment is more friendly now than it has been in a long time.

Bears will be quick to say that EZPW should trade at a discount to peer FCFS due to the controlling shareholder, and that may be the case in the near term. However, intrinsic value should continue to grow for years as the company cleans up its operations and continues to grow in the US and Mexico. Further, the controlling shareholder is 67 years old, and thus likely considering an exit eventually. We believe that FCFS would jump at the chance to buy EZPW as EZPW is the largest remaining pawn player, and in a sale, any valuation discount tied to the controlling shareholder would disappear, and a control premium would replace it. Given that FCFS trades at 19x earnings, it is not hard to see EZPW being worth somewhere between $20-40 a share in a takeout situation within a few years.

Perhaps more importantly however, this is a recession proof business, where theoretical liquidation value is not far below current prices. The risk-reward is thus extremely skewed for those willing and able to take a longer-term perspective.

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Thanks to [Laughing Water Capital] for the interview. If you'd like to check out or follow their work, you can find the profile [here].