**Askeladden Capital: Coronavirus Update**

2020-03-09

*Note: this is a slightly edited version of an email I sent to clients last night.*

Dear Clients,

I rarely write to you intra-quarter. However, in light of the rapid and extreme declines in equity valuations over the past several weeks, which have affected the market broadly as well as Askeladden specifically, I thought many of you might appreciate an update on how we're thinking about our investment portfolio. (A PDF is attached, if this is easier for you to read.) To be clear, all of our thoughts here are **probabilistic** in nature - nobody can be certain exactly what will happen.

Nonetheless, it is important to think through the various things that *could* happen, how *likely* they are to happen, and what the *impact* (to our portfolio) would be if they happened. This will not be a comprehensive overview, and I will expound on these thoughts in our quarterly letter to follow in April. In the interests of not taking time away from research, I am also not putting as much time into this as I do into normal quarterly letters, so please forgive me if anything is phrased suboptimally - try to focus on the big picture of what I'm saying here.

We'll start with the topic that is top of mind: coronavirus. From a public health perspective, views on this from experts in the field vary widely. On one end is a group of those who believe that coronavirus is more or less analogous to the seasonal flu, arguing that the severity of the disease is dramatically overstated because of sample bias - i.e., that statistics on hospitalization and mortality rates are overstated because the people most likely to be tested are the people showing up at clinics with severe symptoms (whereas those with mild symptoms, or those who are asymptomatic, are much less likely to be counted.) Thoughtful examples include Dr. Paul Offit (a noted virologist who co-developed the rotavirus vaccine), Dr. Jeremy Faust (an ER physician and instructor at Harvard Medical School), and Prof. Udi Kimron (a Professor of Clinical Microbiology in Tel Aviv - you can use Google Translate to read this.)

At the other end of the spectrum, and much easier to find, are alarmist projections from armchair epidemiologists as well as public health officials like Director-General Tedros Adhanom of the WHO, who have thrown around statistics like a 3-4% mortality rate, and the potential for 40%+ of the global population to be infected by coronavirus. Many people seem to believe, based on data point extrapolation, that it is a foregone conclusion that millions (or tens of millions) will die from COVID-19 and our healthcare systems will be overwhelmed.

We have our own house view, driven by the data and mental models; we are much closer to one side than to the other. We respect that many of you may have different views, and I certainly am not a public health expert myself. However, it is important to note that the public health view is, from an investing standpoint, largely irrelevant. It is not terribly productive to debate whether or not coronavirus is closer to the flu or the Black Death.

Why? Whether or not individuals and governments *should* be responding to coronavirus with such extreme measures, the clear fact is that they are. Depending on how the situation evolves, things could get much worse before they get better - for example, just today, Italy announced that the entire country is essentially on lockdown. Were such measures to be taken (whether voluntarily, by citizens, or involuntarily, by government) for a longer period of time in more geographies, a meaningful slowdown for the global economy would be inevitable.

Specific sectors will be impacted even more dramatically. For example, air travel to and from outbreak hotspots has fallen off a cliff. Many countries and locales have banned large events, and many individuals and companies are voluntarily pulling out of events even when they aren't prohibited.

Such behavior could revert to "normal" in a matter of weeks or months - for example, as the new case count dwindles in China to negligible levels, the country is returning to previous routines. Conversely, it is also possible that such behavior could deepen, worsen, and persist for the balance of 2020, and perhaps into 2021.

From a scenario standpoint, there are of course many possibilities in the longer term. One possibility is that, like H1N1, SARS, or MERS, COVID-19 will do what it will, and then essentially vanish as fast as it appeared, and the world will go back to normal in the long run. Another possibility, highlighted by many public health experts, is that it could also become a recurring annual epidemic, just as influenza is today.

This latter example provides a great deal of hope in the longer-term. A fellow fund manager, Eyal Weitzner, recently quipped that "the flu has bad marketing." Public health organizations such as the CDC and WHO estimate that the flu kills a quarter to a half million people per year, globally, *every single year*. And yet life goes on: masks and hand sanitizer don't fly off shelves. Economy-class travelers are stuffed into narrowbody cabins like so many sardines. Many people fail to wash their hands frequently or thoroughly enough. And about half of American adults don't even bother getting their annual flu shot, because it's "just the flu." (I get mine every year, for what it's worth.)

The flu is part of "background risk." Being alive means being at constant risk of dying. We are at risk of dying every time we do something as mundane as drive to the grocery store, or climb a ladder to change a lightbulb. We are at risk of dying from infectious diseases like the flu, as well as non-infectious diseases like heart disease and cancer. Most of us don't walk around constantly panicking about all these things that could kill us, and rightly so. We could live without ice cream, without any face-to-face interaction with other humans, without going on summer vacations: but what kind of a life would that be?

COVID-19 is scary for many reasons. First of all, it's new (it emerged in late 2019 and nobody had ever heard of it before), it's foreign (it came from China), no vaccines or specific antivirals (like Tamiflu) currently exist for it, and, oh yeah, everyone else is scared about it. Panic has a higher $R_0$ than SARS-CoV-2. Both **salience bias** and **social proof** are at play here. I admit, myself, to having feelings of anxiety, to washing or sanitizing my hands more frequently, even though there is no data-driven reason for me, as a healthy 26-year-old male, to be whatsoever concerned by COVID-19. It is OK to be human - but it is not okay to let these natural human tendencies torpedo our investment returns. Calmer, cooler heads must prevail.

In the long run, this fear will fade. Science will very likely identify effective preventions and treatments for COVID-19. The virus, either by itself or aided by aggressive voluntary and involuntary social distancing, will likely peter out (the way it has in China, and seemingly is on track to do so in South Korea.) And eventually, people will move on. Businesses will grow tired of lost profits; governments will grow uneasy about slowing economies. And people will grow tired of being cooped up at home (there are already several examples of quarantined, asymptomatic potentially infected individuals breaking quarantine to go on with their daily lives).

The extremes in behavior on the part of all of these groups are not sustainable. If the end-state of coronavirus is that it kills half a million people per year - well, we already have that, and it's called the flu. And nobody really does anything about it. We all go on as normal. Borders and businesses aren't shut down.

For these reasons, it seems highly probable that in most cases, the long-term outlook for most industries will be more or less unchanged from pre-COVID-19 expectations. There may be some behavioral changes that become **habit** and "stick" - for example, hopefully, more people will wash their hands more frequently and more thoroughly. Similarly, it is possible that when CFOs observe how well their businesses function after cutting back on "non-essential" travel, that some of this "non-essential" travel will be cut to fund more valuable business endeavors.

This is where we get to our portfolio. As a result of all of the above - i.e., the near-term uncertainty as well as the likelihood of, *more or less*, long-term reversion to "normal" - we have not really changed our longer-term views on any companies, whether in our portfolio or in our watchlist. We don't believe we have any informed basis on which to make such conclusions.

What we have spent more time thinking through is shorter-term, **path-dependency** issues. What do I mean by path dependency? Sometimes, the long-term view doesn't matter, if you aren't going to make it to the long-term. For example, for a patient today with severe pre-existing respiratory issues and a "critical" case of COVID-19, it is of little comfort that COVID-19 may disappear in 3 months, or, if not, be more easily preventable or treatable if suitable vaccines or antivirals are developed. Such a patient doesn't have the luxury of waiting for that long-term outcome.

And so it is with some businesses. I mentioned earlier, for example, that large events are essentially either being canceled or seeing attendees self-elect to drop out. One of the companies on our watchlist (but, thankfully, not in our portfolio) is Emerald Expositions (EEX), an operator of trade shows. Most of these trade shows are unique, hard-to-replace venues for industry participants to exchange knowledge and conduct business. In the long term, it seems very highly likely that Emerald's shows will thrive.

However, in the short term, Emerald has a highly leveraged balance sheet (over 4, probably closer to 5x EBITDA). It is not immediately clear what percentage of Emerald's EBITDA would be covered by non-refundable payments by attendees, or business interruption insurance. What is clear, however, is that if the current situation persists, there is a non-zero risk that even if Emerald's *shows* do fine in the long term, Emerald *shareholders* might be wiped out or significantly diluted before the long-term ever gets here.

The primary area where we believe such short-term risk could exist in our portfolio is in positions which have exposure to travel demand or oil prices, both of which have imploded (the latter, of course, being only partially the result of coronavirus, partially also the result of the recent OPEC decision.) This is thus the area we've spent the most time thinking about - specifically, AerCap (AER) and *[redacted]*, which are exposed to travel demand. As you are aware, we try very hard to avoid **sunk costs**, and have a general policy of trying to position the portfolio based on what we think is the best balance of return and risk.

We move on from positions, even if at a loss, when we believe the rewards no longer justify the risks. Had we not done so with names like Lydall (LDL) and Emerald Expositions (EEX), we would have sustained significant additional losses. In the case of AerCap and *[redacted]*, we don't believe there is any justification to sell at this time or price, as both companies seem positioned to withstand even a substantial multi-year downturn in travel demand, with a strong value case beyond (and even during) such a scenario.

We don't want to be overly conservative and *never* take *any* risks; on the other hand, there are certain kinds of risks we're very cautious around. As has been discussed in previous portfolio commentaries, chief among these is leverage - and a close second is commodity price risk (as well as business-durability / secular decline risk). We have consistently avoided taking on positions - even at very attractive valuations - with substantial leverage risk, which led us, for example, to forego, over the past year, investing in the popular thesis Garrett Motion (GTX), a company that could be in real trouble if auto demand continues to weaken.

Many of our portfolio companies have *net cash* balance sheets; most of the others have a modest (<1.5x net debt to EBITDA) amount of debt that would be serviceable even in a severe earnings-contraction scenario, and only a handful have more significant leverage that that - and in these cases, we remain confident that management has plenty of liquidity even in meaningful downside scenarios, and will make the appropriate decisions to ensure shareholder returns. Moreover, many of these companies have streams of high-margin recurring revenue that should remain resilient - if not continue to grow - even in an uncertain economic environment.

Similarly, despite what we viewed as an extremely attractive valuation in ProFire (PFIE), we've kept the position size modest because of its direct exposure to energy (cumulatively with other indirect energy exposure in our portfolio.) The company has a history of strong cash flows (even through the last energy crisis) and a ton of net cash on the balance sheet, so there is no solvency risk here - nonetheless, we didn't want to expose our portfolio to an outsized loss if oil were to make the sort of move that it has so far. Even in such an environment, we believe ProFire is worth more than our cost basis in it, let alone current valuations; this is the point of investing with a substantial margin of safety.

We built the portfolio with scenarios such as the current one in mind. While we obviously had no specific plan for COVID-19, we know from history that plenty of terrible things can happen. We hope, for the sake of humanity, that such events are relatively infrequent and minor in scope. But hope is not a sound investment strategy, which is why we keep risks such as these top of mind. (Remember that my family and I have more of our net worth, as a percentage, invested in our strategy than any client.)

Although we are not overly concerned by what we see today, we will of course continue to update our **priors** based on new data. And, as discussed in many letters previously, we are also always looking to "highgrade" the portfolio by improving returns at the same level of risk, or maintaining returns at a lower level of risk.

We have not had many opportunities to do so in recent weeks, since *everything* has been hammered with no attention paid whatsoever to fundamentals. To this end, I want to talk to you about performance. I was hopeful, as of last week, that upcoming earnings reports would serve as positive "catalysts" for some of our beaten-down stocks. As of right now, this does not seem like it will be the case.

Let me provide you with a tangible example. As many of you remember, Magic Software (MGIC) is an Israel-based software / IT consultancy company that operates globally, but particularly in North America and Israel, with an emphasis on improving customers' IT environments through in-demand offerings in rapidly growing market segments like integration and low-code development. The company has a strong track record of growth through a mixture of organic growth and M&A, and 2019 was no exception: the company generated mid to high single digit organic growth.

I initially (last week) had some concerns that the company might face near-term disruption. After all, many of their offerings include on-site delivery, and with Israel quarantining incoming arrivals, many other geographies severely restricting travel, and many businesses having white-collar employees work from home as much as possible, one can see how their business model might be impacted until things return to normal.

Magic appears to be seeing immaterial impact so far, however, which is actually consistent with the comments I have seen from many other companies (both on and off our watchlist) over the past several weeks. Indeed, management once again guided to mid to high single digit organic growth, and while they did note that the coronavirus is a rapidly-evolving situation that could impact those expectations, so far they aren't seeing any effects. They are taking steps to prepare their own employees to be able to work productively remotely (relative to both Magic facilities as well as client sites). While the macro situation could certainly worsen, it was extremely reassuring - *to me, a shareholder* - that they have seen no material impacts so far, despite doomsday headlines and actions by governments and businesses alike.

Generally, one would expect Magic to bounce on such an earnings report. Prior to today, since the middle of February, the stock had sold off 20% on no news other than the general news (i.e., coronavirus). The company has over $70 million in net cash on the balance sheet (vs. a ~$400MM market cap, ~$325MM in trailing revenues, and ~$58MM in trailing EBITDA). They generated over

$40 million of free cash flow in 2019 and $20 million in 2018 (apparently driven by working capital timing differences; I believe true economic earnings are right in the middle of those two at about $30 million per year). The company has strong margins, much of which is driven by recurring maintenance software revenue and services on mission-critical business IT infrastructure, and the majority of its cost base (personnel) is variable.

This is, then, a business with a Fort Knox balance sheet, with a long-term track record of strong results, that reported an exceptionally strong 2019, guided to an equally strong 2020, stated categorically that they have seen *no* material impact *so far* from coronavirus (despite all the scary headlines), and it was trading at an extremely attractive ~12 - ~13x earnings (ex-cash) prior to reporting earnings today. It is frankly quite difficult to envision a scenario in which Magic has any near-term existential risk whatsoever (unlike the aforementioned example of EEX).

In my experience, generally, such a positive earnings report would send the stock *up*, as it should put to rest much of the (previously reasonable) speculation by market participants as to how Magic might be affected by current circumstances. Instead, Magic closed today *down* another 8-9%, *on top of* the substantial sell-off since February.

This is not a complaint: it is simply a factual statement of what occurred. The company reported essentially the best that could be expected of any company reporting at this time (strong finish to 2019, strong guidance for 2020, no impact seen yet from coronavirus), and apparently that wasn't good enough for the market. While there is always a possibility that my analysis is incomplete or in some way incorrect, it is difficult to conceive of any rational explanation for why this earnings report fundamentally merited another nearly double digit percentage selloff.

My guess is that several other of our businesses fall into similar categories to MGIC. For example, Franklin Covey (FC), which all of you likely know extensively at this point, reported in January that they had so far been entirely immune to the trade-tension-related slowdown that had impacted other generally strongly-executing companies on our watchlist and in our portfolio. Franklin Covey's on-site presentations to clients may well take a hit if large events are being avoided, telecommuting is prioritized, travel is restricted, etc.

On the other hand, this is a lower-margin revenue stream for them. The majority of the company's profitability is generated by contractual annual (or *multi-year*) subscriptions and licenses. Franklin Covey's variety of delivery modalities, ranging from videos to podcasts to micro-learning, will allow it to continue to serve client needs, whereas competitors who rely extensively on on-site presentations or events/conferences may lose even further share. In fact, one can visualize scenarios in which Franklin Covey actually *benefits*, as managers might view the slack time created by cancellation of in-person events, meetings, and travel to provide a great opportunity to accelerate corporate learning and development goals, to keep employees engaged and motivated while they're out of the office. If anything, improving employee productivity and changing organizational behavior at scale becomes an even more important task when everybody is working remotely and managers have less ability to monitor or interact with their employees face-to-face.

What will actually happen? Who knows. However, we do know that Franklin Covey, by virtue of its strong business model and stellar customer value proposition, is less likely to be meaningfully affected in the short term than many businesses, and the long-term story is clearly unchanged (even if some buying decisions are pushed to the right due to coronavirus uncertainty, although this doesn't seem to be happening among MGIC's customer base right now.) That said, while Franklin Covey's strong cash flow, unlevered balance sheet, and sticky recurring revenue are clearly *fundamental* protectors, that hasn't done anything to stop the company from selling off along with the rest of the market over the past several weeks.

This observation extends to many companies that aren't in our portfolio, and even many companies that aren't on our watchlist (such as JPMorgan). While there are undoubtedly still plenty of stocks that are overvalued, there are also plenty of stocks that were previously reasonably valued or undervalued that have sold off equally dramatically, vastly in excess of any reasonably-calculated fundamental adjustment to fair value that might be necessitated by current events. Is coronavirus going to cause a real economic impact, whether temporary (Q1/Q2) or more extended? Yes, absolutely. Does it justify the kinds of sell-offs we've seen in many fundamentally sound companies? No.

I don't have any better idea than anyone else when the market will stop panicking and start paying attention to fundamentals again. Maybe this email marks the bottom, and it's all green from tomorrow. Maybe the market selloff deepens.

Here's what we do know: our strategy of generally focusing on durable businesses with equally durable balance sheets, trading at extremely attractive valuations, was designed with situations like the current one in mind. In the long-term, protracted distress may even be positive for many of our companies. Companies with strong balance sheets are in position to either buy back their own stock at extremely accretive levels, or acquire competitors or complementary players at extremely attractive multiples. Along with scenarios where a coronavirus-driven global recession materially lowers earnings, there are actually scenarios where our portfolio companies' long-term intrinsic values actually end up *higher* because of such opportunities that would not have otherwise existed. We believe that many of our portfolio companies will take advantage of such opportunities over the coming weeks and months.

Note as well: the prices which we have paid for most of our portfolio companies represents an attractive discount to even a significantly reduced estimate of future results. As such, I don't view it as particularly meaningful that Askeladden is down several hundred basis points more than our benchmark on a YTD basis. I know what we own, and I'm confident that, while we might be more or less correct on our evaluations of any individual situation, long-term results will reflect the quality and value of our portfolio holdings.

As always, I'm putting my money where my mouth is. Notwithstanding that I have other conflicting personal financial goals (such as saving cash for a down payment on a house), current valuations are simply too attractive for me to not want to deploy my own capital into our ideas. I am in the process of opening a personal account at Interactive Brokers to participate, pro rata, in aggregated trades that I am placing for all clients. This is in addition to my substantial existing investment in Askeladden

Capital Partners LP, and I plan to continue adding capital to this account as I am able to, over the course of the year, as long as such attractive valuations continue to persist.

Finally, I want to express my sincere gratitude for your collective support. Many managers would have frazzled, distraught clients ringing them off the hook, demanding explanations (more like rationalizations) for near-term performance of the market and the strategy. Askeladden clients have behaved exactly the opposite: you have left me in peace to spend my time on what it is best spent on, i.e. managing the portfolio and conducting research. In the few cases that you have reached out to me, it has been with a supportive, helpful intent;a couple of clients provided information that I found useful in evaluating ongoing events.

Although we continue to prioritize monitoring any developments that might impact our portfolio, we simultaneously continue to work on longer-term research, and expect that, even with the massive distraction of COVID-19, Q1 2020 will be one of our most productive new-research quarters in a long time. We look forward to providing you with more detailed thoughts sometime in April, once we have additional results from portfolio companies (and other companies) that will give us a clearer view of what's going on in real time.

Best,

Samir