HEIJIN CAPITAL

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

April 5th – April 19th, 2020

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Commentary Overview

Market Snapshot

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	24,242	+6.89%	-16.03%
S&P 500 Index	2,874	+7.92%	-11.77%
NASDAQ	8,650	+9.31%	-4.86%
10-yr Treasury Yield (% yield)	0.65%	-0.02%	-1.23%
WTI Oil ($/bbl)	$18.27	-29.95%	-70.8%
Bonds	$117.25	+1.48%	+4.06%

*bonds are represented by the iShares Core U.S. Aggregate Bond ETF (NYSEARCA:AGG)

Global Macro

Corporate Socialism

From an economic standpoint, the past 4 four weeks in the US were staggering: 22 million initial unemployment applications, about 15% of the total labor force, while stock markets bounced back by almost 30%. This extremely unnatural behavior of public markets is the result of governments and central banks proving that they stand with their "whatever it takes" stance. In the US, for instance, the government passed the $2.2 trillion CARES Act to provide fiscal stimulus, while the fed slashed interest rates to almost zero and pledged to inject another $2.3 trillion into the economy; And this is likely just the beginning, as some politicians on Capitol Hill are already working on a second fiscal stimulus package. However, in our opinion, the "whatever it takes " stance amounts to an economic absurdity.

Already in the Great Recession of 2008, governments around the world demonstrated they would do anything to save the economy. What has this led to? Well, it led, amongst others, to the longest bull market in history, unprecedented amounts of share buybacks, and immense compensation packages for CEOs. Obviously, after more than a decade of good business and high profits, you would expect companies having enough money to withstand a couple of months drought, right? Wrong! Even after so many years of low-interest rates, unprecedented earnings, and Trump's tax cuts in 2017, companies are not at all prepared to face economic turbulences. For instance, the airline industry spent over the last decade 96% of its free cash flow on share buybacks, and now after just three months of economic turbulence, they are at the brink of bankruptcy. One might argue that a pandemic is a black swan, and it's almost impossible to predict it. And indeed, I have to admit that even in January, I did not expect COVID-19 to be a significant problem on a global scale; however, I'm also not the CEO of a multi-billion-dollar company with an annual paycheck of $15 million such as Delta Airlines' CEO for instance. Shouldn't a person who earns $15 million a year be able to prepare a company for a couple of months of economic pressure? Even the organizers of the US Open and Wimbledon, who earn a fraction of Fortune 500 CEOs, were smart enough to buy pandemic insurance; They paid $2 million a year in insurance and now received a $141 million pay-out. The problems that corporations face right now is in most cases, by no means caused by COVID-19 but by gross mismanagement; COVID-19 was just a trigger that revealed mismanagement.

Capitalism has a solution for gross mismanagement: Bankruptcy! The "whatever it takes" stance is extremely irrational because it goes against the foundations of capitalism, the system by which we live. Bankruptcy is natural selection in the economy, and it is essential because it filters out lousy management and companies to allow good companies to prosper. Moreover, the "whatever it takes" stance of the government in 2008 is the very reason why companies risk to fail in the first place. In 2008, companies saw that in the case of an economic downturn, the government would do everything to save them, and now they rely on it. The reason why corporations are currently unprepared for financial pressure is that they knew the government would protect them in case of turbulence, so they spend all the money to enrich shareholders. It's not stupidity; it's intelligence and greed.

The only way to prevent this fraudulent behavior is to allow companies to go bankrupt since then next time they will be prepared during the next economic cycle, and they won't have to rely on the government. The main argument people use against this idea is the employees.

If a company goes bankrupt, then all the employees would lose their jobs; thus, we cannot let them fail, right? Wrong, this is not how bankruptcies work in most cases. In many cases, parts of a company are sold off to save core operations, or the entire company is sold to an outside investor. And as laid out in the investment commentary a month ago, at the moment, there are so many PE firms sitting on piles cash and waiting to buy companies for cheap, that bankruptcy wouldn't be that big of a problem. Nearly the only ones who would lose are equity investors and investors of unsecured tranches of debt; however, these are the rules of capital markets; these are the rules of the game. Investors earn returns because they take on risk, and sometimes they have to accept that these investments fail.

The implications of this corporate socialism culture governments and central banks are currently running is nearly impossible, because it never happened in history in such an extensive and global scale; however, if economic history has taught humanity one thing than it is that printing money is not the solution to economic problems. Somewhere in the future, countries will have to pay back their liabilities, and the more they take on, the worse it will be when it happens. Moreover, corporate socialism is making society worse off because it hinders good companies from prospering by keeping bad companies alive.

So what should governments do? Analyzing history demonstrates that the best way to solve economic problems is through investments in infrastructure and education. Giving out money to companies so they can buy back shares and issue dividends does not return anything to the country; however, better infrastructure and talented people do, they result in higher economic growth and thus more taxes for the government. Obviously, this is a solution that works in the long-term. In the short-term, the government should only focus on giving financial aid to humans, because lack of money results in death for humans, while it only results in bankruptcy for companies.

Obviously, writing about something won't change the situation; people have to deal with reality. So how can people deal with the current reality? From an investing perspective, the current situation seems to make hedges almost superfluous, because the US, for instance, is currently in the midst of an economic disaster, but stock markets are only down 15%, that's about 1.5 years worth of S&P 500 returns. Beyond this, investors might want to look a bit more into private markets, where valuations are less distorted by central banks and governments, For instance, Airbnb, a private company issued $1 billion debt on April 9 at 11-12% interest rates, while on the same day, Slack issued $750 million debt at 0.5% interest rate. The current situation is indeed favorable for Slack and dangerous for Airbnb, but in our opinion, this does not justify the profound disparity. In times, where money printers and ETFs distort public markets, we think private markets are more attractive and less risky.

Investment Analysis

How The Contrarian Investor Can Navigate COVID-19

We realize that it is currently hard to imagine life again 'un-masked', being able to go out to a restaurant or even not wait in line at the local grocery store for toilet paper. However, the day will come sooner rather than later what the human race does what it does best... adapt and survive. Wall Street rarely acts rationally on the best of days, let alone in times of economic hardship. The market tends to be very short-sighted and only believes that what is happening now will continue indefinitely, otherwise known as the hot (or in this case cold) hand fallacy, which is the notion that because one has had a string of successes, an individual or entity is more likely to have continued success.

So, what can the intelligent investor, with a long term vision do whilst confidence is low and markets are in disarray? Well in the well-used phrase by Baron Rothschild, "Buy when there's blood in the streets, *even if the blood is your own.*" No matter how well hedged you were pre-Covid, the majority of portfolios have likely taken a sizeable slide in performance. But we can see this in two ways: one could panic sell, then hoard onto their money in their respective fiat currencies, however as we well now in this day and age; cash is trash. Or, more intelligently, the contrarian investor realizes that the market is usually wrong at both its extreme highs and lows. And that these extremes are fertile ground to position one's self into the future as one can buy strong value stocks, that have been dragged down by market sentiment rather than their own doing. Moreover, in our own experience in Real Estate through our Strategic Financing Advisory, it truly is a buyer's market right now and those with long-term vision are currently picking up exceptional properties both residential and commercial at substantial discounts. So, for those who can see the opportunity in this crisis, what equities, products and other investment vehicles are attractive?

Travel has of course borne the brunt of the virus, with enforced curfews and self-quarantine all around the world halting travel plans. The doomsday preachers and various sensationalising tabloids have stated that the way we travel will "never be the same". As a realist I am far from convinced, after all even after the sink of the titanic in, people still booked cruises by the tens of thousands. Our first choice is **Expedia Group (NASDAQ:EXPE)** . It is a solid pick for myriad of reasons. Firstly, just by very basic logic it is a travel site that compares flights, hotels and package holiday bookings from other websites on one easy to use interface. When people's pockets are hit by the virus, it is price comparison sites such as these that will be the first port of call for many consumers eager to book their summer holiday. The company itself is in brilliant financial health and its substantially undervalued. Expedia is currently trading at $63.22, 57.1% below its fair value of $147.35. The stock is a classic value play with rather exceptional, PE and PB ratios as well as an enviable future ROE of 39.5%, beating the industry average by almost 30%. Their earnings have been very high and their debts, both long term and short term is well covered by their cash flow. Expedia also has a fair dividend yield of 2.15%. Heijin believes that should one invest, it would be a medium to long term play with a holding period of well over 12-18 months.

Our next beaten down product is **CareTrust REIT (NASDAQ:CTRE)**. CareTrust has done an exceptional job of filling the gap in the market for affordable, well run care homes as the baby boomer generation begins to retire and become in need of assisted living facilities.

Covid-19 has done a brilliant job of scaring away investors from care-home/elderly living investment such as CareTrust due to the large number of deaths in this age category. This has left a financialy robust firm considerably undervalued. CareTrust has one of the lowest debt to equity ratios in the REIT market at 0.25. Moreover, it also has a strong debt to EBITDA ratio of 4.8. CareTrust has enough dry-power to keep its self afloat it these troubling times, and its debt is well covered by operating cash flow (22.8%). Furthermore, their debt to equity ratio has reduced from 309.3% to 59.8% over the past 5 years. And on average over the last three years, CareTrust REIT has seen earnings per share increase by 9.4% each year with revenue up 4.1% in the past year. This strong financial profile is bolstered by its attractive dividend of 5.80%, which is expected to grow to 7% by 2024.

It is clear that however bleak and dismal the current climate may be, an intelligent investor can see opportunities in the same places others find panic and dismay. This is a brilliant time to buy a range of investment vehicles at a substantial discount. And in the eternal words of arguably the best investor of all time, Warren Buffet," Whether we're talking socks or stocks, I like buying quality merchandise when it's marked down."

Real Estate

Covid-19 & The UK Real Estate Industry

First, it was Brexit, now - a global pandemic. To say the least, the UK real estate industry has not had the smoothest run over the last year. According to Begbies Traynor, one of the largest corporate restructuring firms in the UK, the real estate industry is the hardest hit industry in the UK amidst the coronavirus crisis. The number of firms in the RE (real estate) and property sector encountering significant financial risk increased 6% in the first three months of 2020. That puts the total number of RE firms at risk of default or bankruptcy to almost 60,000 nationwide. Across all business sectors, the number of firms experiencing financial distress sits at around 509,000, meaning that RE and property firms account for just over 10% of these businesses.

Despite all the negative news and uncertainty, the coronavirus crisis has created a vast opportunity for distressed debt & discount investors to be entering into the industry. In 2019, asset managers around the world raised more than €200bn to invest in real estate – up almost 25% on the amount raised in 2018. Out of this amount, roughly €75bn went to investment into the UK and neighboring European countries such as France, Germany, and Spain. Pension funds continued to be the most significant source of equity, making up 30% of contributions, but their share has declined each year since 2015 when they accounted for just under 50%. Insurance companies have been growing the amount of equity raised each year, contributing 22.5% of capital raised in 2019. However, only 60% of the total capital was invested before the end of the year, leaving €80bn still to be deployed. This may cause problems for managers and investors as they adapt their approaches to cope with the global economic shutdown.

This has an even more substantial impact on specific sectors, such as retail and hospitality, which will likely experience more turbulent times ahead. In fact, we are currently facing a new macro-economic reality that will unquestionably inspire a period of strategic reappraisal and asset revaluation. In some way, this will be beneficial to the sector, as sky-high runaway valuations will be brought down to their realistic levels, meaning investors will be more interested in allocating into the market.

Although it is still too early to fully assess the impact of coronavirus on the UK real estate market (as this will depend on the duration and severity of the current outbreak), we can identify several short-term implications related to pricing and rental-growth. In general, real estate investment volumes are anticipated to decrease as investors adopt a "wait-and-see" approach against a backdrop of intensified uncertainty. Volatility in other asset classes will also have impacted portfolio weightings, and these will need to be rebalanced. Any slowdown in activity is likely to be compounded in markets that are reliant on overseas capital (such as hospitality & tourism-heavy industries), due to travel restrictions. Consequently, the competitive pressure seen at the start of the year may diminish, and yield compression that we expected in some segments at the beginning of the year looks less likely. That said, any outward yield movement is suspected to be constrained by the lower interest rate environment. Against a 10-year gilt rate of around 0.7%, the income characteristics of RE mean the case for investment based on relative pricing remains quite strong & lucrative.

Moreover, around £118m was withdrawn from RE funds in March, compared to £20m in February and £83m in January, according to Calastone, a global fund connector & introducer. Several open-ended

institutional funds closed last month due to concerns that they were unable to value their portfolios accurately.

There was a considerable disparity between passive and active fund outflows and inflows in March. Passive funds saw healthy inflows, totaling £1.4bn last month, with UK equities also seeing more investment flowing in, attracting £508m. On the other hand, European equity funds didn't fare so well, experiencing their second-worst month on record, posting £500m in outflows. Active equity funds saw record outflows as well, with nearly £1.7bn of capital being redeemed in March, down from £1.2bn in February. In short, investor sentiment has played its role again in as with any crisis, allowing passive funds to prosper and active funds to hinder. It seems investors attempting to catch market troughs may merely be focusing on timing and just relying on the index as a whole to do the rest - in short; they are playing the long waiting game. But in fact, active managers tend to do rather well in difficult times for stock markets, so the significant outflows from that segment at a time of such big inflows to passive funds are a little surprising.

Moving onto our outlook on short-term rental growths. Short-term rental growth expectations for 2020 will need to be revised. Weaker economic growth will harm occupier business activity, increasing the risk of more significant tenant failures and, therefore, loss of income. Faced with the current levels of ambiguity, occupiers are likely to delay real estate decisions, reducing activity in the leasing market. However, the underlying real estate fundamentals remain healthy. Good quality supply remains lower, particularly in the office and industrial sectors, and should be supportive of a return to rental growth once the virus is contained.

The industrial sector may be weakened in the short term, given the disruption to global supply chains. For many occupiers, this will have a negative financial impact resulting in rent levies and an increased default rate. Many industrial occupiers may look to reassess their supply chain designs in the medium-term. There is potential that this results in more demand for UK storage space and a transformation towards the re-shoring of some manufacturing. This driver is likely to be intensified by Brexit, depending on the final deal agreed.

We will continue to monitor the developments in these sectors and will keep you updated with any new advancements concerning containing the effect of the virus on the RE industry. In the meantime, our position remains relatively optimistic, with hopes that the industry will recover from the slump that we are experiencing.

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