Snog

Marry

Avoid?

Snog Marry Avoid?

In the BBC 3 television series 'Snog Marry Avoid?', contestants with an 'addiction to slap' were given a 'make-under' that involved removing layers of make-up and switching out flamboyant clothing choices. In this, the *Cape Wrath Capital* version, we peel back the layers to see what lies behind some recent investments.

During October we exited our position in *Flybe* (FLYB) on which we lost 64% over our 15 month holding period, and also sold *Safestyle* (SFES) on which we made 76% over our two month holding period. These investments illustrate a few key aspects of our investment approach.

- You can make great returns from mediocre businesses. This seems to be a kind of open secret. If you ask an investment manager for their thesis on a stock they will most likely talk with enthusiasm about what a great business it is. Our view is that this has very little to do with whether the company is a good investment or not, although we understand that it makes for an easier conversation. An erstwhile colleague of mine had the challenging task of cold calling institutional investors to arrange introductory meetings. Sometimes the call would go on for long enough for the prospective investor to ask what was in the portfolio, and after groaning audibly through the top five holdings the call would often be brought to an abrupt end. On one occasion my colleague successfully arranged a meeting only to have it cancelled later that day after the prospective investor studied our holdings list. Being contrarian for the sake of it will make you poor, quickly. But buying stocks that prompt a visceral reaction in other professional investors can lead to excellent returns.
- Our best investments typically have holding periods of less than six months. This is because our approach is primarily focused on capturing 'behavioural alpha'. Where we invest in an operational turnaround, we calculate an 'Approximate value' (AV) based on certain assumptions about the turnaround succeeding. However, while an operational turnaround may take several years to execute, the share price will often capture the markets expectation of success within a much shorter period.
- Our work with *Essentia Analytics*, a company specialising in behavioural analytics for portfolio managers, identified something called 'alpha decay' in our portfolio. Beyond a twelve-month holding period the likelihood of our achieving good returns on an investment diminish significantly. A bias common to value investors is to under-price the structural challenges facing a business.

We live in a world characterised by a broad range of possible outcomes with unknown probability distributions and many 'unknown unknowns'. This means that investment returns do not always correlate with skill. Sometimes you make a bad decision and get lucky. Sometimes you make a good decision but lose money because you are unlucky. Sometimes you make a good decision and then get so bogged down in your own emotional biases that you mess the whole thing up. I am reminded of this last point whenever I see the ticker FXPO. Over 21 months through 2015 - 2017 you could have made 2,246% on an investment in the Ukrainian iron-ore mining company, *Ferrexpo*. We managed to lose 19%.

Our SFES investment is a good illustration of the kind of returns that are available when buying a business that is priced for Armageddon. Although we achieved a good return, the post-match analysis showed that we captured only a 36% 'Share of Potential Returns' (SoPR). Some of these potential returns were lost simply due to our valuation-focused investment process; these are returns that we cannot reasonably hope to capture. But better execution of our process could have added a further 230 basis points to the Fund's performance.

Our FLYB investment demonstrates what can happen when a good strategy comes into contact with weak industry economics at the wrong point in the cycle. While FLYB's strategy combined with its unique market position may ultimately deliver an acceptable and sustainable return on capital, the growing likelihood that it will need an equity raise along the way convinced us to cut our losses. Investing in FLYB was a bad decision, but we could have significantly reduced our losses if we had better managed our biases.

Bad decisions, and potential returns lost despite good decisions, provide cause for reflection but also for optimism. **They represent the opportunity to get better.**

Snog

In August 2018, we initiated on SFES, a double-glazing business which had issued six profit warnings over the previous 12-months. While our model implied that we should open with a 5% position, we had concerns around input cost inflation (glass and plastic) and the impact of BREXIT on consumer sentiment and therefore purchased a 2.5% position at 31.9p, believing that the newsflow would create an opportunity to buy further tranches on weakness. While SFES is not a high-quality business, our analysis found no evidence of the existential threat that the 90% peak-to-trough share price decline seemed to imply. Rather, SFES simply appeared to be a business that it had become very easy to hate. In so far as our focus is on identifying behavioural opportunities, SFES is a good example of what we look for.

The UK uPVC double glazing industry is fragmented, with thousands of fitters and fabricators, however the 'Big Three' – Anglian, Safestyle and Everest (in size order) together account for around a third of the market. In recent years the industry has suffered from shrinking volumes, overcapacity and a battle for market share. AIM listed Entu PLC, owner of three mid-tier brands, went into administration in 2017. Until recently SFES had been growing, with a UK share of 10.7% in February 2018 up from around 8.0% at the time of its IPO in 2013.

While uPVC double glazing sales have declined significantly over the last 15 years, we do not believe that the market is in structural decline, rather we see the industry as categorised by a long replacement cycle of 20-30 years, and a short cycle driven by consumer confidence. Unlike FLYB, SFES is a highly cash generative business, having returned £38m in dividends since its IPO in 2013 (at a market cap of £77m), while also undergoing a capex expansion cycle (£19.1m capex since IPO), and maintaining a net cash balance sheet of around £11m at FY17. We believe that SFES would also have been profitable and cash generative in FY18, were it not for issues relating to the 'copycat' business 'SafeGlaze', which is based a few miles from SFES in Bradford and became #4 uPVC brand in the UK from a standing start 18 months ago. SafeGlaze is backed by Mitu Misra, the founder of SFES, who left the SFES management team at IPO.

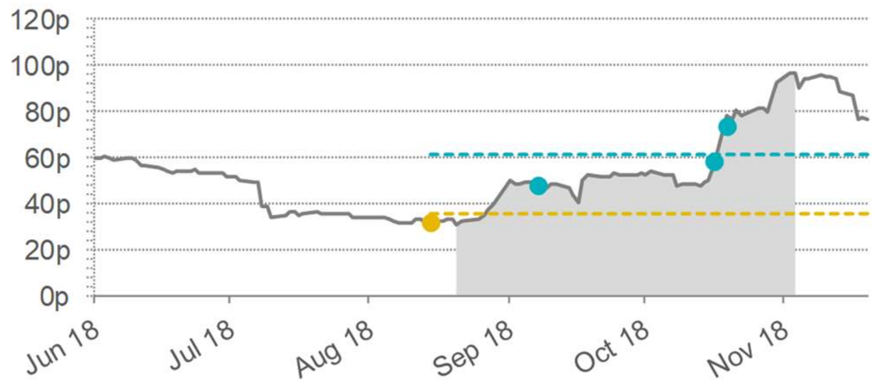
On 21 May 2018, SFES issued a legal claim against SafeGlaze, 'and a number of named individuals', for 'misuse of confidential information, unlawful means, conspiracy and malicious falsehood'. In 2017 and 2018, SFES was itself also subject to legal action and fines relating to unsafe working practices and aggressive sales tactics.

We found SFES' balance sheet and accounting to be robust, but the business was at significant risk from consumer weakness and a turn in the credit cycle, along with rising uPVC and glass costs. We did not pick up anything material from records of short interest in the company, and found that the main institutional shareholders had generally been averaging down through the share price decline. Between May and July 2018 there was wholesale management change at SFES with a new CEO, CFO and Chairman.

We calculated a 61.4p Approximate Value (AV), which put SFES on 8.7x discounted recovery earnings, versus 7.0x at IPO and a 2016 peak at 14.6x. Based on a significant risk of competitive disruption, and its operating in a highly cyclical industry, our High Margin of Safety (MoS) implied an initial entry at 36.1p, second entry at 32.3p and third entry at 29.2p. With the shares trading at 31.8p, the model implied that we should buy two tranches. A cost-cutting plan and a successful conclusion of legal action against SafeGlaze provided potential share price catalysts, but given the extreme negative sentiment around the stock, we believed that any evidence that things were not getting worse would be sufficient for a significant re-rating.

Our single tranche purchase of SFES stock at 31.9p was 2.3% off the episode low price, and while we appeared to have bought well, in buying one tranche rather than two we exercised Judgement versus Model (JvM). This was a mistake that cost the fund at least 190 basis points.

Safestyle UK PLC		**SoPR**	**36%**
Optimal episode (months)	2.5	Episode (months)	2.2
Optimal purchase	31.2	Average purchase	31.9
Date	*23/08/2018*	*Off low*	*2%*
Optimal sale	96.5	Average sale	56.2
Date	*06/11/2018*	*Off high*	*-42%*
Potential price return	209%	Actual price return	76%



	Exit points
	Entry points
	Approximate Value, which changes over time as we update our valuation model
	Target Entry Price 1, which is calculated at a discount to the Approximate Value

We exited our SFES position in three tranches at an average price of 56.2p, delivering a 76% return. Our average exit was 31% off the episode high, largely because we again exercised JvM in selling our first tranche at 48p, 22% below our AV of 61.4p. This was a mistake that cost the fund around 40 basis points. We have a soft rule that irrespective of our AV, we should take some profits where we see a return of >60% within <8 weeks, on the basis that the short-term risk is to the downside after a significant up-tick. It is also psychologically easier to buy on weakness when you have sold on strength. In the case of SFES we cut half the position after achieving a 50% return, rather than the 60% in our soft rule. On reflection there was an element of loss aversion in this action.

Over 5 trading days from 18 – 24 November SFES returned 73% trough to peak as they announced an agreement with Mitu Misra (against whom they had previously initiated legal action), including 'a five year non-compete agreement and the provision of services by Mr Misra in support of the continued recovery of Safestyle'. In essence, SFES were paying Mr Misra to shut down SafeGlaze. We were quick to act, selling 2/3rds of our remaining holding at 58p (after SFES responded to rumours of a deal, but before the deal terms were announced), and the balance the following day at 73p (after the deal was announced). The shares averaged around 80p through the week following our final sale. We'll return to consider this final selling episode at the end of this Broadside. But for now, it's worth highlighting some of the things that made our investment in SFES a good illustration of our style.

- Having suffered six profit warnings in twelve months, there was a lot of bad news in the price. We study company newsflow and share price charts through the lens of the cycle of investor emotions. We often find that shares which have suffered a period of extreme negative news are less risky than those that are riding high on positive newflow.
- SFES' share price implied that the company was either facing rapid structural decline, or in need of financial restructuring. It seemed to us that neither of these was true.
- Prior to our investment there had been wholesale management change. Where a fresh pair of eyes has studied the business and, if necessary, had the chance to do a 'kitchen sink' exercise, we see the situation as being significantly de-risked.
- We found the accounting and balance sheet to be generally robust. We found no evidence of shenanigans or working capital issues that would need to be unwound.

Marry

At Cape Wrath Capital we practice polygamy.

We try not to get comfortable in an investment, and typically target a six-month holding period, although in practice our average is closer to a year. This is because behavioural arbitrage plays out over much shorter periods than either operational turnarounds, or traditional value investments which often lack distinct catalysts.

Complete honesty is rarely an effective marketing tool, but we think that it leads to more resilient relationships in the long-term. Telling potential investors that we typically invest in average quality business and are working hard to increase the turnover in our portfolio, elicits a range of responses. Sometimes the allocator 'gets it', and can see that this is consistent with our philosophy and process, and we find that our relationship becomes deeper as result. At other times the response is much as you might imagine if we had lobbed a rotten egg over the table – somewhere between shock and disgust.

Avoid

> 'When Richard Branson, the wealthy owner of Virgin Atlantic Airways, was asked how to become a millionaire, he had a quick answer: 'There's really nothing to it. Start as a billionaire and then buy an airline.' Unwilling to accept Branson's proposition on faith, your Chairman decided in 1989 to test it by investing $358 million in a 9.25% preferred stock of USAir.'
>
> Warren Buffett

Over its lifetime the airline industry has delivered a negative return on capital. Airlines are capital intensive, low margin and plagued by overcapacity and price competition. Sensitivity to fuel costs and high operational leverage means that from the perspective of an individual operator, the logical strategy is to invest in more efficient aircraft and to fill them to capacity. However, when everyone is following the same strategy, the result is a race to the bottom that destroys industry economics. It's a good illustration of the Prisoner's Dilemma. Buffett highlights the issue nicely in his description of the original Berkshire Hathaway textile business.

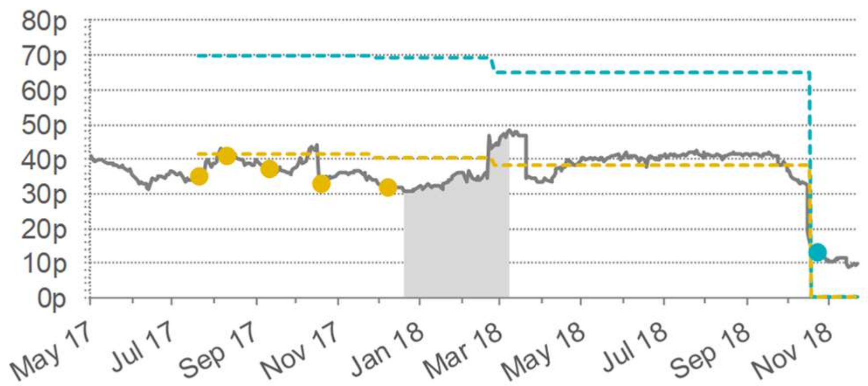
> 'Many of our competitors, both domestic and foreign, were stepping up to the same kind of expenditures and, once enough companies did so, their reduced costs became the baseline for reduced prices industry wide. Viewed individually, each company's capital investment decision appeared cost-effective and rational; viewed collectively, the decisions neutralized each other and were irrational. After each round of investment, all the players had more money in the game and returns remained anaemic.'
>
> Warren Buffett

A few years after making his USAir preference stock investment, Buffett tried to sell them at a 50% loss. He couldn't find a buyer. In the end it took him 24 years to exit the investment.

Against this background of unattractive industry economics, why invest in an airline? Looking at FLYB we saw an airline with atypical competitive dynamics. FLYB operates regional aircraft, such as the 78 seat Q400, on low volume, primarily domestic, routes. By contrast the A320 and 737-800 aircraft that are the staple of most low-cost carriers typically have 180 - 190 seats and operate on higher volume, primarily international, routes. Thus, on 80% of its routes FLYB has no competition from other airlines and, under a new management team, the strategy was to reduce capacity to drive utilisation and operating efficiency. The previous management team's strategy had been titled 'Growth and Profitability', but under the new management team all references to 'Growth' were dropped. FLYB has a clear roadmap to reduce capacity by returning aircraft as their leases expire. In particular, returning seven out of nine E195s, which is a larger aircraft with 118 seats which FLYB cannot operate profitably, will significantly improve group profitability. In buying an airline we seemed to be in good company. Through 2016 - 2017, Warren Buffett surprised many people by investing around $9bn across American Airlines, United Continental Holdings, Delta Air Lines and Southwest Airlines.

Our thesis on FLYB was simply that if management executed their stated strategy then, mathematically, the company would start to turn a healthy profit. Indeed, from a load factor of 69.6% when we invested, FLYB reported a load factor of 86.6% at the October 2018 update that prompted us to exit the investment. Given that the capacity reduction programme was only part-way through, this load factor was ahead of our expectations, and not far off the short-haul industry average of around 91%. In essence, our core thesis was playing out. The problem was that nothing else was going well for FLYB.

Flybe Group PLC		**SoPR**	**N/A**
Optimal episode (months)	2.6	Episode (months)	15.1
Optimal purchase	30.8	Average purchase	36.3
Date	*20/12/2017*	*Off low*	*18%*
Optimal sale	48.3	Average sale	13.1
Date	*09/03/2018*	*Off high*	*-73%*
Potential price return	57%	Actual price return	-64%



●	Exit points
●	Entry points
- - -	Approximate Value, which changes over time as we update our valuation model
- - -	Target Entry Price 1, which is calculated at a discount to the Approximate Value

The first sign of trouble was at the first half trading update in October 2017, about three months after our initial investment. Increasing maintenance costs meant that FLYB would be loss-making in FY18e, while we had expected them to make a small profit. The shares fell 18% on the day, however a subsequent meeting with management satisfied us that the profit warning had led to a shake-up of priorities, and put cost control front and centre. As a consequence, there was very little impact on our AV, which showed around 100% upside. Following the meeting with management we increased our position.

With the full-year results in June 2018, the shares fell around 5% to 39p, but remained a little ahead of our average purchase price of 36.3p. During the period they had seen a brief rally to 46p on the back of an offer from Stobbart Group which was rejected. At this point we were starting to have concerns about rising fuel prices and also about the balance sheet. Again, dialogue with management gave us comfort on these issues and increased our conviction in our thesis, although by this point we had a full weight in the stock and were not in a position to add to it. In my conclusion on the results I wrote, 'There have been a number of occasions when I have regretted not selling FLYB'. I would have done well at this point to have reflected on a Buffett quote, which is now stuck on my wall.

> 'If you buy a stock and it goes down and that upsets you, it obviously means you think the market knows more about the company than you do. In that case you're the patsy. If you want to buy more because you know the business is worth just as much as when you bought it, perhaps a little more, so you buy more, it's the patsy.'
>
> Warren Buffett

Incidentally, our struggles with FLYB put us in good company - by this point Buffett was nursing a $1bn loss on his recent airline investments.

Three months before the recent profit warning, FLYB issued a 1Q trading update. Passenger numbers were up 3.3%, despite capacity falling by 7.9%, leading to an 880bp jump in the load factor to 81.3%. While the capacity utilisation strategy continued to play out ahead of expectations, costs were now rising ahead of the increase in yields. This was an early sign that the business was going to struggle to make the forecasts of breakeven for the year, which should have rung alarm bells.

The shares drifted down 22% to 32.2p over the four weeks prior to the October update, which we put down to some combination of BREXIT and fuel price concerns. On the morning of 17 October 2018, after reading the profit warning, we conducted a review of the investment case and sent a list of questions to the CFO. Our analysis was that, given FLYB was now unlikely to be profitable again during this cycle, the level of debt on the balance sheet made the risk of an equity raise too high to justify continuing to hold the investment. The shares closed down 41% on the day at 18.9p. In hindsight this would have been a good exit price. But rather than sell immediately we waited the rest of the week for management's response to our questions. We finally exited on 24 October at 13.1p.

During October the investment took around 400 basis points off the fund's performance. If we had sold on the day, the impact would have been reduced by almost 100 basis points. On reflection, our delay in selling FLYB was another example of loss aversion, which we will look at in more detail shortly.

When faced with large paper losses, our strategy is typically to increase the position, and under those circumstances we usually exit the investment profitably (AA Group), or at least with a much-reduced loss (Capita). But we did not believe that this was appropriate with FLYB because of the risk of an equity raise. It's worth reflecting on some of the red flags that could have prevented us from investing in FLYB in the first place.

- It was the wrong point in the cycle to be investing in an airline. At the time of our investment the consumer environment was fairly benign and jet fuel prices, which are equivalent to around 16% of revenues, were at cyclical lows, supported by hedging contracts. Spot prices for jet fuel today are around 50% higher than the hedged cost of the fuel that FLYB was burning when we made our investment.
- The mathematical 'certainty' of improving economics via capacity reduction was at odds with the anxiety I felt at various times at not having exited the investment and the constant need for reassurance from management.
- The airline industry has notoriously bad economics, being capital intensive, low margin and subject to overcapacity and price competition, with high fixed costs and cyclical demand. Management had the right strategy, but they were swimming against the tide.

Being a (Better) Behavioural Investor

We believe that the best investors are behavioural investors, in that they are effective at understanding their own emotions as well as those that drive short-term market behaviour.

Being a behavioural investor is not about overriding gut instinct with rational calculation, but rather involves synthesising reason and instinct to maximise your decision-making potential. The subconscious is able to make decisions based on greater volume and complexity of information than the conscious mind. Studies have shown that we subconsciously spot patterns in data long before we become consciously aware of those patterns. The challenge is recognising when our emotions are guiding us to make good decisions, and when they simply reflect anxiety-avoiding behaviours like loss aversion.

In our worst investments we tend to spend more time and energy in dialogue with management and other shareholders (DX Group, Premier Foods). In the case of FLYB, as well as meeting management one-on-one, we had regular phone and email exchanges with the CFO and Financial Controller. This increased need for 'comfort' was based on a subconscious lack of conviction in the investment case. Engaging with stakeholders can also create an illusion of control. While the FLYB thesis was simple and based on a clear set of modelling assumptions, something didn't 'feel' right. Increased interactions with management, building up a more detailed picture of the business, fine-tuning financial models, all help to increase confidence, but this need for comfort should itself have been a red flag.

Being quick to take profits (as we were with SFES) and slow to realise losses (FLYB) are classic manifestations of loss aversion. Many studies have shown that the market does not respond to new information immediately, but that prices continue to adjust for at least several days after the news has been made public. With this in mind we are implementing a soft rule to sell early when a piece of bad news breaks our thesis, and to sell late when a positive piece of 'new' news pushes a holding through our AV (here we distinguish between 'new' news, and news which has been well flagged and which the market has already priced-in – with the latter, 'buy on the rumour, sell on the news' is probably better advice).

The rule is also applicable to buying situations. This month we purchased one tranche of WPP when it fell through our initial entry point. We bought on the morning of the profit warning at 888p, but would have achieve a better entry price if we had waited a few days for the market to digest the news.

Applying these soft rules retrospectively to our SFES and FLYB sales in October would have added 210 basis points to the month's performance. Following the model on our SFES purchase by adding two tranches, rather than applying JvM and buying only one tranche would, when combined with an exit based on these soft rules, have added a further 310 basis points to performance over two months.

So across two holdings over two months, we can identify 520 basis points of alpha which was lost through the execution of our decisions, rather than through the decisions themselves. In other words, great analysis can be undermined by weak execution, and the bad analysis can be mitigated to some degree by good execution. Of course, the best outcome in the case of FLYB would have been to have avoided the stock in the first place.

It's easy to make better decisions with the benefit of hindsight, and there will be some situations where the best outcome is achieved by applying JvM, which is why we give ourselves this flexibility. Applying a single set of decision rules in all circumstances will rarely produce optimal outcomes. The challenge is to understand how to adapt the rules as circumstances require. The numbers make it clear that the incremental alpha available to investors who know when to trust their gut is significant.

Adam Rackley

Cape Wrath Capital

November 2018

Postscript

After finishing the first draft of this document I sent it to a few friends for comments, and then went on holiday. While I was on holiday FLYB announced that they were putting themselves up for sale. The shares jumped 40% on the announcement, before closing the day at 11.3p, a few percent below where they opened. The next day, FLYB announced the sale and leaseback of their hanger at Exeter Airport, netting £5m to fund operations, while locking them into a 10.3% rental yield. Effectively they had gone to the pawnbrokers for a high interest loan. The market took badly to this, and the shares fell to a low of 8.6p the following day. Sitting on the beach I did a rough calculation: (1) depending on currency movements and their cash burn rate, the company will probably have a liquidation value of around 32p by their March 2019 year-end (there is no other way really to value a structurally loss-making business); (2) if I believe there is a 50% chance of takeover and 50% chance of a large rights issue that effectively renders the current equity worthless, the shares should be worth 16p; (3) that gives around an 80% upside from their current price of 9p; (4) in terms of short-term market behaviour, the shares will probably bounce when Aberforth finishes selling down their 16% stake.

But this was just idle thinking, because I have a rule that the possibility of a takeover is not a sufficient reason to hold an investment, all the more so if the downside risk is 100%. I was also aware that if I lost money on this investment a second time, it would have a negative effect on my ability to make good decisions about the position.

As I write these words on Monday 26 November, FLYB is up 151% over a little under two trading days to 22.6p, as it has emerged that Virgin and British Airways may be in a bidding war for the business. Of course, it's painful to get whipsawed, and it might seem a cruel and unusual punishment to then write about and publicise it. But in this job, and particularly with this strategy, it's important to build emotional resilience. Ultimately my purpose is to shape the very best process that a concentrated, deep value strategy can offer, and to execute that process in a disciplined and behaviourally aware fashion. And in so far as it's possible, that's what I try and spend my emotional energy on.