



MASSIFCAPITAL

Friday, April 10, 2020

Dear Friends and Investors,

The core portfolio for Massif Capital was up 3.1% during the first quarter of 2020. A detailed report on individual account performance will be provided to investors in the coming days.

Attribution¹

Performance for the quarter was driven by a combination of our short book and our tail risk hedge. Our tail risk strategy is designed as an insurance product for the portfolio. We choose to execute this hedge through S&P 500 ETF Put contracts that we purchase 30% out of the money with a strike date that is 90 days out. Options are rolled every 30 days and sized such that the expected cost of carrying the insurance every year is roughly 1.5% to 2% of the portfolio's value. With volatility at historic lows for much of 2017-2019, the cost of this insurance product relative to the notional value of protection it afforded was an attractive investment for us. The options have historically responded favorably to both falling stock prices and increasing volatility. We have frequently utilized large swings in volatility to limit the cost of the hedge to the portfolio. This quarter, the tail risk hedge contributed a positive 13.1% to the core portfolio return.

Our short positions, inclusive of both short option and short equity positions, contributed 9.8% to the quarterly return. The most significant contribution came from Norwegian Cruise Lines (NCLH), which generated a gain of 77.8%, contributing 3.6% to the overall portfolio for the quarter. We have exited our position in NCLH after a two-year holding period. Our original research on the firm was highlighted by Barrons in 2018 and can be found [here](#). Other notable shorts include Sunrun (RUN), Bloom Energy (BE), and Union Pacific (UNP), each of which contributed roughly 1% each to the portfolio's return.

Our long book fell roughly 18% for the quarter. We were very aggressive in deploying capital, particularly in January and February, adding 13 new positions to the portfolio (an additional 50% gross exposure), with over three-quarters of our additions coming on the long side. In almost every case, we choose to initiate positions at about half of our typical portfolio weighting, leaving ample room to build into these positions at prices that have grown increasingly attractive.

An Historic Quarter

The fragility of our current lifestyles, and the systems that support them, has been on display during much of the quarter as a result of the evolving COVID19 pandemic. Over the last ten years, we have seen the proliferation of increasingly complex supply chains operating on diminishing margins and inventories. Economist Tyler Cowen aptly pointed out recently that complex international supply chains are fragile for

¹ Attribution of the core portfolio, gross of fees. Results in individual managed accounts will vary.

the same reasons they are valuable. Namely, they are hard to construct and maintain as they involve so many interdependencies.² Late-stage capitalism is optimized for efficiency, not resiliency. Tightly coupled systems can fail suddenly and without much warning. From our perspective, the popular lean manufacturing and just-in-time inventory practices look very similar to individuals that have little in the way of savings. In both circumstances, fewer assets and resources sitting on the sidelines results in increased exposure to adverse shocks.

From an investing perspective, this issue has been with us since before 2008, and frankly, the events of 2008 were caused in part by a lean risk management approach on the part of banks and borrowers. Large safety buffers against the unknown were abandoned in favor of thin safety nets. This was made possible by the perception of control, which was proved, as it always does, illusory. Risk cannot be diminished or destroyed, only transmuted, a reality many need to be consistently reminded of. Operating without a safety net is often a state that a person or a business can get away with for a time but is not a permanent state one can survive in.

We are not the first to observe this, we will not be the last, and the current crisis will not prevent the reoccurrence of such threadbare approaches to life and business in the future. It is not unreasonable to suggest that the current pandemic is adding to the kindling that will form the basis of a future crisis in sovereign debt.

Market Events

The year began with major indices picking up where they left off in 2019. Between January 1st and February 19th, the S&P 500 was up 4.9%, the NASDAQ was up 11.3%, and the Russell 2000 was up a comparably pedestrian 1.65% (although it is worth noting on an annualized basis that would still produce a greater than 12% return). From February 19th to March 23rd the S&P 500 fell 33.9%, the NASDAQ, 27.9%, the Dow 36.6%, and the Russell 40.6%. Over the last three weeks³, all four major indices reflat between 17% and 27%.

We were admittedly anxious through much of February and March, often glued for inappropriate amounts of time to the news and daily movements in equity and credit markets. Upon reflection, the pace of change and the increasing uncertainty of future outcomes likely contributed to this behavior far more than the weight and implications of any one event. We are mindful that fear and uncertainty can shrink the time horizons by which we make decisions, a tide we will continually try and swim against.

The unprecedented move in markets was accompanied by the US economy moving from record low unemployment to a recession in a matter of days. The Federal Reserve dropped overnight lending rates to zero and unleashed trillions in liquidity and lending programs. The tripping of circuit breakers in the equity markets seemed to occur daily, and investment-grade credit spreads quadrupled to 400 bps. Companies began drawing on credit lines aggressively while grocery store shelves emptied. Hoarding, lack of inventory, and disjointed messages from policymakers was the status quo for most of March.

Rating agency downgrades have followed with the cumulative change in investment-grade credit ratings (to something below investment grade) occurring at their fastest pace on record. Research from Bank of America highlights that we are still far above the level of downgrades we experienced in previous shocks.

² [“How robust are supply chains?”](#), Tyler Cown, February 2020.

³ Through April 9th, 2020.

With companies as large and geographically diversified as McDonald's reporting that sales were down a stunning 22% globally in March, we expect more downgrades to come.⁴

We are unsure of the historical truth of the following idea, but we have noticed that many prognosticators have begun saying that markets tend to stop panicking when policymakers start panicking. This is to say, normalization of market activity during a crisis occurs coincident with the panic necessary to generate collective action amongst politicians who usually are too busy with their soap opera to pay attention to the real world. If that is the case, then perhaps we have reached the end of the market panic. We are unsure. The effects of the pandemic appear far-reaching. As such, the complexity of the impact of the pandemic grows exponentially with the growth of the economic linkages touched by the virus. It's difficult to see how the market could have yet discounted a future that can only be described as highly uncertain and not open to probabilistic analysis.

We are looking at a world with parameters bounded by pure imagination; where we go from here is anyone's guess.⁵

The pandemic has renewed debates over the costs and benefits of physical and economic boundaries. It is not clear that the movement towards inter-dependence that has defined the past 30+ years is sustainable (either economically or politically). We remind readers that ongoing trade wars were escalating between countries before the outbreak. We are left to wonder what the implications of large-scale supply chain disruptions coupled with large scale, coordinated, global fiscal stimulus programs will be? In October of last year, we presented to several investors in the Gulf region our long-term view for real assets; our principal thesis at the time was that possible coordination between fiscal and monetary policy would unfold during the next global shock leading to widespread inflation. We believe this is already starting and expect that continued coordinated efforts by policymakers will have significant implications for future inflation expectations and the supply/demand dynamics of the energy and basic materials.

Looking ahead, it will be essential to try and untangle how much demand is being deferred vs. how much demand is being destroyed. The second question is how much production is being placed on hold vs. how much production is being permanently shut down. Production capacity can often be quite inelastic given cost implications and time-to-build issues that we have discussed at length through the lens of capital cycle analysis. The most significant impact of COVID19 is the combination of short term demand destruction, created by efforts to contain the spread of the virus, and long-term conditions of undersupply created by stunted corporate investment. This pull and tug, between demand destruction in the short-term and supply contraction in the long-term, will frame the remainder of our portfolio discussion.

Oil & Gas Markets

In March, an unprecedented combination of demand destruction and supply expansion produced a historic selloff in the price of crude oil. On the demand side, with Goldman Sachs estimating that stay-at-home orders are impacting 95% of global GDP, some analysts expect as much as 26 million b/d (or

⁴ Credit ratings will be very important to keep an eye on this year. The size of the BBB market is far too large for the junk bond market to absorb even a modest fraction of downgrades. Holders of institutional grade debt may become forced sellers having cascading implications.

⁵ Please note that we have carefully articulated the world going forward as one of pure imagination rather than suggesting we are, as some might do, looking into the abyss. We do this because we believe we are currently confronted with uncertainty; this is distinct from risk.

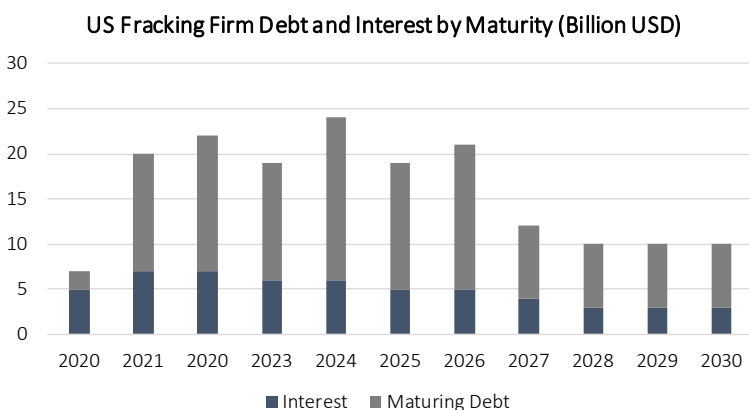
roughly 25% of total global demand) to have evaporated. On the supply side, estimates are that oil markets will overproduce by approximately ~10 million b/d for the year.

We believe the foundation for a significant inflationary supply shock is being laid. It does not seem plausible that a reduction of demand of this magnitude will not create substantial and persistent implications for supply. Once the capital stock in oil is damaged, it is an expensive and lengthy process to re-build (assuming it gets re-built). This contrasts with other parts of the economy where capital stock can often sit idle, ready to re-start. Oil and gas fields are not like other manufacturing plants. They are organic deposits with decline rates. For older wells that are turned off, it may never be economical to bring them back online.

We anticipate an acceleration of production declines in April as producers are forced to evaluate a shut-in. Only the leanest of producers can continue operations with sustained prices below ~\$30 per bbl. Less efficient producers with higher operating costs will have to shut in production to reduce the losses incurred from producing. Of equal concern is the long-term impact of revised CAPEX budgets by oil producers. As of the end of March, we have seen average CAPEX cuts of the following:

- **European Oil Majors** (RDS, Total, Equinor, OMV, ENI, Repsol): 22%
- **US Oil Majors** (COP, CVX, HES, APA, XOM, etc.): 31%
- **US Small and Mid-Cap E&P Shale Firms** (WLL, QEP, MTDR): 35%

The CAPEX budget and asset rationalization for US shale are likely just starting. The balance sheet optionality of shale operators, and thus their resilience in the face of uncertainty, can only charitably be described as weak.



Source: Company reporting, Massif Capital

where we are heading with this analysis. If all marginal barrels of oil over the last ten years have come from US shale plays, a mostly accurate characterization of what has happened, and those incremental barrels add up to roughly 10 million barrels a day, and oil must trade at around \$50 a barrel for shale producers to achieve a 10% full cycle return, we can expect future supply to plummet in North America. This won't happen immediately, but by the second and third quarters of this year, we will begin to see the potential depths that North American production will sink. Alongside the decrease in North America, there are/will be delayed final investment decisions by oil majors and similar CAPEX cuts by overseas

We tried to put the 2019 free cash flow for the group on the chart to contextualize balance sheet flexibility, but it was hardly visible on the graph. Unfortunately, even after adjusting for a few onetime items (such as OXY's acquisition of Anadarko), the groups FY2019 total FCF was \$200 million, and their market capitalization-weighted EBITDA less CAPEX over interest rate coverage ratio was only 1.5x.⁶

Our long-time readers can guess

⁶ We believe that EBITDA less CapEx over Interest Rate is the most relevant coverage ratio for the group given the need for continues investment needed to maintain production from shale wells.

E&P's. Taken together, this sets the stage for a significant supply shortage sometime in the next few years. For businesses with robust balance sheets, we are a buyer at these prices.

Our portfolio has three oil and gas positions at the current time, representing about 12% of the net liquidation value of the portfolio. All three were added this year.

- Arc Resources (ARX) is a Canadian exploration and development company focused on natural gas production in Western Canada. ARX was initially conceived of as a steady income earning position with a dividend of 11.4% in the last twelve months. This has changed with the fall in the price of oil, but we continue to believe the management team has a solid asset base, a smart hedging strategy, and the capability to survive the downturn and return the dividend to its previous levels with a modest rebound in oil prices. We also like the fact that ARX is very gassy. Most of the growth in North American natural gas supplies in recent years has come from gas associated with the production of oil. As crude production declines, associated gas production will also fall. In such a situation, to meet demand, gas prices must rise to a level that economically justifies a growth in dry gas production to make up the difference. We think ARX will be a beneficiary of this trend.
- Africa Oil (AOI) is an African focused E&P with a working interest in producing offshore fields in Nigeria and developmental fields onshore in Kenya. AOI is a fascinating asymmetric play, with a working interest in 10% of all of Nigeria's oil production and multiple substantial development opportunities that are either in conventional plays or offshore. Going forward, we believe that the significant capital loss investors have experienced via investments in shale and fracking firms in the US will make access to capital by US domestic E&P more difficult. The result is that investors will pay more attention to large conventional and offshore fields that can profitably operate in a variety of price environments. Africa Oil should benefit from this transition.
- Equinor (EQNX) serves as a strong ballast position with a large resource base, strong balance sheet, and the added benefit of an appealing dividend that will almost certainly be reconsidered by management, but is generally secure. Equinor is also driving its business towards a more sustainable and less carbon-intensive model. Equinor is developing and operating some of the lowest carbon-intensive oil reserves in the world. This significantly reduces their risk of future stranded assets. Meeting the terms of the UN Paris Agreement would leave 29% of oil reserves stranded and eliminate roughly \$360 billion in the value of the top 13 international oil companies by reserves. Equivalent to greater than 1/6th of their total enterprise value. We believe that EQNR has limited downside risk in this regard and will play an essential role in the evolving energy landscape as it burnishes its green credentials with interests in offshore wind.

With this slate of oil and gas investments in place, we do not think we are likely to add any additional oil and gas exposure on the long side.

Alternative Energy

A survey of businesses in the alternative energy industry can best be described as disheartening. There are exceptions, but our review finds a critical reliance on capital markets and valuations that reflect improbable growth paths even in a rapid transition to a low carbon energy economy. Worse, many firms are taking extraordinary liberties with how they articulate their financial health.

Early in the year, we established short positions in Sunrun (RUN), Bloom Energy, (BE), and Plug Power (PLUG). We have taken a long position in the European wind turbine manufacturer, Vestas (VWS).

RUN is a good example of our concerns. The firm sells, or more commonly leases, residential solar systems. Revenue earned is mostly in the form of operating leases and loans to consumers. Operating leases provide RUN roughly 20 years of predictable cash flow from customers who have locked in their electricity rate for the same period.⁷ Unfortunately, the underlying business is not profitable, by which we mean selling or leasing solar systems to residential customers does not make money for the firm. Financial engineering, on the other hand, is sometimes profitable: combining a mix federal incentives and accounting maneuvers (modified accelerated cost recovery) allows RUN to sell tax equity packages to investment funds and corporates looking to lower their own tax rates.

While the tax equity investments run through consolidated financial statements, the benefits are primarily stripped out by outside tax equity investors. They have priority on the cash flow. In most cases, even if the underlying asset does not perform and RUN has to absorb customer defaults, etc., RUN still needs to pay those investors. Arrangements hold for about seven years before the ownership of underlying assets flips back to RUN, and they begin accruing the benefit. Equity investors in RUN are left with leveraged risk where the outcome is dependent on the long-term performance of solar panels. The firm is cash flow negative and is increasingly levered. Sunrun is a roofing company with a finance arm focused on complex structured products. In our humble opinion, these are not things that go well together.

A key operating metric for RUN is there 'net earning assets', or the difference between the total lifetime value of a project and the upfront cash costs to service that project. Or as RUN may say, "how we turn customer contracts into cash". We take issue with how the firm calculates the lifetime value of a project.

For instance, the company assumes that *all* lessees will choose to renew their lease in 20 years and that there will be zero defaults. A Better Business Bureau score of less than two stars out of a possible five stars suggests that a 100% renewal rate in 20 years might be a stretch. A slight dip in renewal rates or defaults causes large swings in the present value of their assets.

Growth in the near-term likely rests with the rate of change in installations in California (about 40% of their current customer base). The recent Californian mandate that requires new properties under three stories to have a PV system may not be as accretive as originally anticipated. Sacramento builders recently petitioned the California Energy Commission for cost relief and won. Instead of adding the price of solar panels to an already steep home price, builders may now take credit for offsite solar power produced by the municipal utility district. Homebuyers thus save the installation costs.⁸ We would assume that other contractors may follow suit.

RUN fell ~50% during March. We feel comfortable continuing to hold the position. The company has guided that a 'reasonable downside scenario' entails a 50% decline in revenue for the next two quarters. Under this environment, the firm believes they could limit consumption of cash to \$30M or less without any capital market activity. We're not sure how this is possible, quarterly interest payments alone exceed

⁷ Customer agreements can look very different depending on the state, utility and solar irradiance characterizations.

⁸ This is to say nothing of the efficacy of the program more broadly. It's not clear that this mandate actually solves the concerns it is looking to address and in fact increasing intermittent resources behind-the-meter will continue to place strain on a state electric grid.

\$30M. We take issue with the firm stating that they are cash-flow positive and we don't think cash arising from the issuance of debt should be included in a cash flow calculation. Sunrun management does.

How long can an unprofitable enterprise stay alive? We suspect this will largely depend on how long the Federal Reserve keeps the printing press turning; nevertheless, RUN is a zombie firm in the making, if it's not already one.

The wind power industry is maturing into a commercially viable, unsubsidized industry with significant promise for offshore development. We have initiated a long position in the European turbine manufacturer Vestas (VWS). Growth estimates suggest that total wind capacity will increase by ~50 GW per year through 2025. This will add about 8-10% to total installed capacity every year. Limitations are emerging in the onshore wind market as available land is making suitable project development sites scarce. As such, offshore wind is gaining notable traction as installation costs decline making the resource competitive even on a merchant basis in European auctions.

Vestas is in an excellent position to capitalize on this growing industry. It's a market leader, or close second, in both onshore and offshore production. Revenue has grown by 44% over the last four years with a return on capital employed averaging just over 20%. The firm sits on a cash balance of \$3B EUR with roughly \$600M EUR of long-term debt to manage. Assuming 8% long term EBIT margins, normalized operating income looks to be about a billion EUR's per year. We believe the firm is worth at least \$20B EUR with a legitimate growth path ahead.

Basic Materials

The basic materials component of our portfolio is invested exclusively in mining firms at the moment and represents the largest industry exposure in the portfolio. Through our investments we have exposure to gold, uranium, diamonds, copper, and lithium as well as nickel, potash, and iron-ore through an investment in a base metal streaming business. Our portfolio construction within mining continues to be a mix of high-quality juniors and Tier 1 producers.

The next several months will likely be very volatile for mining companies as market participants try to ascertain forward supply/demand equilibriums. Akin to our commentary on oil and gas, we believe this sets up for a highly inflationary price environment for select commodities. Copper provides an interesting case study:

- About 15% of the world's copper mines are now offline or operating at reduced capacity.
- The response function to the pandemic is highly dependent on geography. Mexico accounts for 3% of global copper production and has not deemed mining an essential service, so all of that supply is now offline. Other countries such as Argentina have changed their tune on this issue, deeming the industry necessary as of early April – a reprieve for numerous precious and base metal miners, as well as lithium brine operators.
- The current 15-day mandatory quarantine in Peru and Chile could see 1.5% of annual global copper supply lost, and should that quarantine extend to 45 days, the disruption would be equal to nearly 5% of global demand. Meanwhile, no projects are likely to be sanctioned at current price levels, which could lead to falling global mine output ~4-5 years from now.

The copper producers we follow generally have an operating cash cost of between \$1.20-1.50 per lb of copper produced. Inclusive of sustaining capital expenditures, few companies are cash flow positive at current prices. Jeffries estimates that the marginal unit of supply costs about \$2.30 per lb. to bring to

market. Firms can cut sustaining capital expenditures for a short period of time, but copper prices cannot fall far below today's price without substantial supply becoming uneconomic.

We have initiated two positions in copper that we are looking to build to a total of 12% of the portfolio over time. Our positions in Ivanhoe Mining and Turquoise Hill give us exposure to two of the largest and cheapest copper mines in the world. Both firms are operating/developing mines with lives over 50 years, and both, when fully operational, will produce copper at a cost at the bottom of the lowest quartile of the copper cost curve.

Our capital allocation to junior miners has been characterized by companies that have world-class volume production potential, bottom quartile cost of production, limited capital market needs, and significant operational leverage. The risk/reward asymmetry in junior mining is unique. Evaluating operational risk and a management team to determine whether a mine turns on or not is far more tenable in our opinion than creating conviction around an appreciating commodity price. That said, 2020 will be a tough year for junior miners as they are regular users of the capital markets. It seems unlikely that a management team with control over a reasonable mineral prospect wants to fund their exploration and development program further without a clear view towards how they raise money. The talk amongst producers is now focused on people management (how to get staff into and out of mine sites without spreading COVID19) and on any high-quality early-stage assets that might be available for M&A targets at incredibly low prices.

The M&A potential makes capital deployment tricky; we want our portfolio to benefit from any burst of M&A activity, and the accompanying rerates in value of the assets being purchased but want to avoid investing in juniors that might not be desirable targets for majors. This is a challenge in the best of times, let alone in the current environment. Thus far, we have a good track record of picking mid-tier or junior miners that are buyout targets:

- **Nevsun:** We realized a return of 73% on the buyout by Zijin Mining over a holding period of 2 years.
- **Cobalt 27:** We realized a return of 9% on the buyout by Private Equity firm Pala over a holding period of six months.
- **Continental Gold:** We realized a return of 41% on the buyout by Zijin Mining over a holding period of three quarters.

We have our eyes on a few assets we believe may be prime targets but are remaining patient in the interim. One area that we may be quicker to deploy capital to right now is precious metals streaming companies. With the selloff in the first quarter, there appears to be a newfound desire to monetize any precious metal byproducts that base metal producers might have. As CEO Randy Smallwood of Wheaton Precious Metals noted in a recent discussion with the Mining Journal:

"We were knocking on doors for most of last year, but towards the end of the year, we suddenly had companies approaching us for capital. There is a strong need for support with the capital in that space [base metals], and so we have seen a change in the last four-to-six months in terms of the quality and scale of opportunities out there."

We expect the trend Mr. Smallwood noticed towards the end of last year has picked up and that needy sellers are offering up precious metal streams at potentially favorable terms.

Elsewhere in the mining world, the foundations for potential supply constraints are building at a rapid pace. Uranium, which we have long viewed as a possible supply-constrained metal in the near term, is down to just a few operating mines globally. The majority of which are owned and operated by Kazatomprom, our preferred investment in the uranium mining world. Demand for uranium is very distributed, but primary supply and processing is very concentrated. Concentration grew recently as Cameco announced that would close their Cigar Lake mine, a mine responsible for 13% of global uranium supply, for at least a month. Namibia, a key supplier to China, has also halted all mining activity nationwide to help curb the spread of COVID19. Finally, just this week, Kazatomprom has announced it would reduce operational actives across all of its uranium mines for three months due to COVID19 risks.

In total, our back of the envelope math indicates that roughly half of global uranium production has come offline in the last four weeks. As always, the risk of some mines never coming back online is significant. Namibia, for example, has shut down production at individual mines expected to have less than two years of mine life left. Will those be turned back on?

Growing pains in the lithium industry provide a similar trajectory, and we reaffirm our bullish outlook with the acknowledgment that the time horizon has become increasingly unclear given the lack of clarity around how the virus impacts government decision making. Three key points are worth considering:

- Suspension of Argentine lithium production during March will remove around 17.5kt LCE (Lithium Carbonate Equivalent) of capacity from 2020 annual production via direct disruption and delays to capacity expansions. Delays to the development of greenfield projects are also expected to push back growth in lithium supply during 2021, with Lithium Americas stating that commissioning of its Salar de Cauchari-Olaroz project will likely be delayed because of the national shutdown.⁹ If a similar level of disruption is considered, Chilean refining capacity could be reduced by roughly 42.kt LCE in 2020.
- Meanwhile, China and the EU have implemented measures to accelerate the electrification of transport regardless of oil prices. China has extended rebates for EV purchases as of the end of March. We believe these have to the potential to accelerate as governments look for avenues to stimulate growth.
- Lastly, supply chain dependencies and recognition of political/economic vulnerability will accelerate a transition to chemical investment outside of China. The concern of China controlling disproportionate shares of a battery metals supply chain has been a growing concern (U.S. Executive Order 13817 called for a federal strategy to ensure secure and reliable supplies of critical metals. More on this topic can be found in our 2019 white paper). This will accelerate that conversation.

We are currently invested in Lithium Americas and expect the firm to benefit from this backdrop in the medium-term even as it endures some pain in the present.

Industrial Firms

Our portfolio is currently net short industrials. Our broad thesis for industrial shorts in the United States was laid out in our third quarter 2019 letter. We remain short the US freight transportation industry

⁹ We have yet to hear from the company on an updated timeline following Argentina declaring mining an essential service.

though UNP and CSX and continue to hold our short position in John Deere (DE). We have initiated a small long position in the dry bulk shipping industry through Start Bulk (SBLK), which we anticipate growing should the market provide the opportunity. Finally, we remain long global graphite electrode production through the vertically integrated producer EAF.

We began digging into the IMO 2020 marine sulfur emission rules back in 2017 while evaluating Norwegian Cruise Lines. Fast forward to 2019, and we found ourselves studying the global shipping industry to get a better grasp of the economic impact of retrofitting 200,000-ton vessels with environmental scrubbing equipment. The dry bulk industry became particularly interesting both through the lens of the dry commodity market and how capital allocation decisions by management teams provided insight into how they believed the sulfur emission limits would impact the market. Furthermore, companies were responding to market changes at very different speeds suggesting that in ~1-2 years, we may see a divergence in industry financial performance.

SBLK is the largest publicly traded dry bulk shipping company, controlling 118 vessels with 13 million tons of combined cargo capacity. Following an aggressive capital spending program to retrofit close to 100% of the firm's fleet by 2020, SBLK entered the year in a strategically advantageous position. Before the COVID19 crisis took root, debt levels were manageable, and we projected earnings could comfortably cover interest expenses. We anticipated SBLK could generate ~\$320 million a year in operating cash flow. With no CAPEX, the firm's stated dividend policy (absent any share-buybacks and early debt pre-payments) had them potentially paying out \$140-\$150 million in 2020 and 2021, respectively. Margins are excellent compared to industry comparables, with an EBIT margin of ~20%, primarily driven by an industry floor OPEX of ~\$4,000 per ship per day. Forward projections give the firm about an 8-9% ROIC and a 10% return on equity over time.

To be clear, recent events have thrown our early 2020 projections out the window. Index data by S&P Global Platts, through the middle of March, showed that the day rate decline visibly pre-dated the coronavirus. Base spot rates have bounced during the outbreak. If there is a negative effect from coronavirus on rates, it isn't showing up yet in the index data — a potentially ominous sign, given that data from CargoMetrics implies a sharp decline in China's bulk import appetite. Due to the drop in oil, the benefit associated with investing in scrubbers is not as significant.¹⁰

A bottoming in Chinese imports and exports appears to have occurred on February 15. Cargo flows (measured in terms of mass transferred on/off ships) seems to have reverted to historical norms following the Chinese New Year. Clarksons Securities confirms a similar trend, charting a sharp uptick in Chinese port calls and characterizing it as a "remarkable recovery." It's unclear how sustainable these trends are. While the IMO has issued reminders that seafarers are essential to the movement of goods and services, ships are having trouble rotating and supply enough crew onboard to actually execute these journeys.

We don't have a perspective on the price level at which time-charter rates may normalize, nor what the near-term spread between high sulfur and low sulfur fuel blends might be. We do know that SBLK is well-capitalized and enters the year having finished a major CAPEX program and maintenance cycle to retrofit their fleet. The firm has the lowest industry operating expenses and has a clear plan to return capital to

¹⁰ The daily savings that come from burning high sulfur fuel oil instead of low sulfur fuel oil have shrunk as the price of oil has fallen.

shareholders.¹¹ Taking the Bull case off the table (which reflects their earnings power under heightened fuel spread differentials and healthy trade flow), the value of their operating assets less net debt looks to be worth about \$1.4 billion vs. a current market cap of \$530 million.

John Deere continues to excel at setting and surpassing their own quarterly expectations. The market rewards them for doing so; their stock appreciated ~7% on the day they announced earnings, even as their underlying financials paint a rather bleak picture. Messaging from senior management focused on the stabilization of the U.S. agriculture industry. The passing of the USMCA and the Phase I trade deal last fall certainly put some life back into their sails, even if it's not at all clear how accretive this is for the U.S. farmer, let alone DE's income statement. Compared to 2018, DE's first quarter 2020 net sales (which concluded on January 31 and did not incorporate any of the COVID19 effects) fell 6%, led by their agriculture & turf division falling 4%, construction & forestry falling 10% all balanced out by their financial services division gaining 9%. Total operating profit for the firm fell 16% year-over-year, primarily driven by a sharp 59% drop in the operating profit from construction & forestry.

Deere's headline acquisition of Wirtigen in 2018 seems to be causing more headwinds than tailwinds thus far. The firm's 2020 outlook does not provide much relief. Prior to the knowledge that the pandemic would effectively press pause on economic activity for an unknown period of time, both their agriculture and construction divisions were expecting sales to contract 10-15%.

US freight carriers' are having a similar experience, with both CSX and UNP shipping volumes contracting for 15 straight months leading into this March. As experienced practitioners of share buybacks, it will be interesting to see how their respective management teams can continue to coax an EPS narrative without being able to manipulate "S" as frequently. Ironically, the prioritizing of efficiency over resiliency, which appears to be a central risk in the structure of the economy highlighted by the pandemic, is the exact business model that major railroads have pursued for the last decade. We have discussed our thoughts at length on Precision Railroad Scheduling (PSR) in previous letters, but remind leaders that outgoing CEO of Berkshire Hathaway's BNSF stated recently: "it's in the public's best interest to move more tons to the railroad network, not to move tons off the railroad network."

As always, we appreciate the trust and confidence you have shown in Massif Capital by investing with us. We hope that you and your families stay healthy over the coming months. Should you have any questions or concerns, please don't hesitate to reach out.

Best Regards,



Will Thomson



Chip Russell

¹¹ We forecast that under a 2019-time charter rate environment, the firm could deliver a 10%+ dividend yield. We believe the firm will likely reduce their debt and return capital to shareholders simultaneously should they get the opportunity.

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