Value Investor INSIGHT
The Leading Authority on Value Investing
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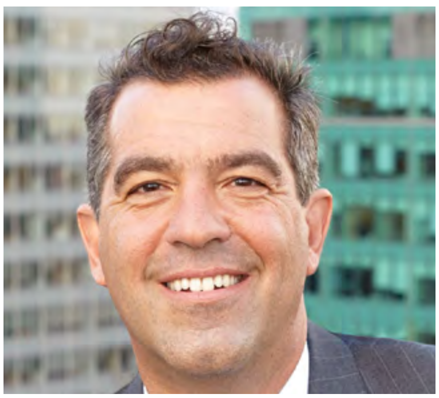
Staying the Course

ValueWorks' Charles Lemonides explains why his economic outlook remains relatively positive, why the stocks of some already beaten down high-fliers could still have much further to fall, why the nascent recovery in energy markets has room to run, and what he thinks the market is missing – good or bad – in Air Lease, Mesabi Trust and Beyond Meat.

INVESTOR INSIGHT



Charles Lemonides
ValueWorks

Charles Lemonides has a stellar long-term record – his ValueWorks long/short strategy since inception in 1999 has earned a net annualized 15.1%, vs. 7.8% for the S&P 500 – but it's come with its fair share of ups and downs. "Sometimes your discipline is in sync with the market and sometimes it's not," he says. "I think the ability to stay the course through volatility is what separates successful investors from not-successful ones."

With volatility certainly at hand, Lemonides today is finding long opportunity in economically sensitive areas like aircraft leasing, energy and industrial commodities. On the short side, he expects some high-fliers whose stocks have been in free-fall to continue down that path.

When we spoke three years ago [VII, **March 31, 2019] you were finding a lot to do on both the long and short sides given that, as you put it, "things that are cheap are really cheap, and things that are expensive are really expensive." How would you update that general view today?**

Charles Lemonides: The stocks that were really expensive three years ago got quite a bit more expensive for a period and then really started to unwind. That's sort of how these things work. I wouldn't say it's over, but a lot of the air has been taken out of various bubbles over the past nine months and there's been a rotation into areas that were really cheap. Our outperformance on the long side over the last two years has been in names that had been absolutely tossed out – related particularly to energy and commodities, but also in areas like financials – that have now come back to more realistic levels.

What I'd say today is that valuations are less extreme than they were. That's a good thing. But we're still finding broad sectors of the market that are quite reasonably priced and should do very well if the economy continues to do well. That's becoming a bigger "if" to a lot of people today, but our general expectation is that economic growth over the next year or two is still set up to be positive.

Describe why you're optimistic about the economy.

CL: There's a lot going on, obviously. Interest rates and the cost of money matter, but interest rates should not be restrictive when real rates are negative, as they may be for some time. We expect negative real rates to be stimulative. Pandemic-related fiscal spending is still finding its way into the economy, in a big way. Individual and corporate balance sheets are healthy and there is a lot of pent-up demand in a number of cases. People can't buy cars because there aren't any in showrooms. They're spending more and more on real estate. Businesses want and need to invest in technology, and unclogging bottlenecks means not only spending money to do so, but more throughput once you have. All of that we think continues to drive economic growth.

There's the matter of the war in Ukraine, which understandably gives anyone pause. If it continues to worsen, that would be bad. But we don't think the base case is that it severely affects the global economy over the next year or two. One impact we do expect to have legs, however, is that commodity prices broadly – and energy prices in particular – are likely to stay elevated. Unless Russia miraculously shifts course and democracy breaks out in Moscow, sanctions should stay in effect and the resource supply issues exposed by the war aren't going away quickly.

You've been very active in energy, which has served you well of late. Describe where you still see opportunity today.

CL: The energy sector, broadly speaking, is likely to be dynamic for a while. We expect oil prices to stay relatively high for a reasonable period of time, as solid demand growth from a healthy economy coincides with persistent supply pressures. Oil prices are only back to where they were around 20 years ago, and at $100 per barrel it's now very profitable to explore and drill for oil, which should result in a lot of activity. Beyond that there will be continued political and social pressure to expand capacity for alternative sources of energy, another big growth driver for the sector.

Where do we see opportunity? We got into Whiting Petroleum [WLL], the big U.S. shale producer, by buying its debt in bankruptcy in 2020. In rough figures, it had $3 billion worth of debt that was trading at 30 cents on the dollar, valuing the company at $1 billion at a time when we thought its net assets were worth closer to $3 billion. There was a lot of pain from there and the debt got exchanged for equity, which we were happy to own because we still thought the assets were worth at least $3 billion. And that was with oil prices of $50 per barrel. Today the market cap is around $3 billion, but we think the assets at today's oil prices are worth closer to $10 billion. The history and the math is quite similar with Oasis Petroleum [OAS], which in March agreed to merge with Whiting. We own shares in both and expect to keep a position once the firms combine.

Another example would be Valaris [VAL], one of the biggest offshore-drilling contractors. It also went bankrupt in 2020, exchanged all its debt for equity, and at the current share price [of around $50.75] has a market cap of $3.9 billion, with no debt. Even though the stock has done well, we estimate the current market cap is only maybe 25% of the replacement cost of its assets, which consist primarily of giant rigs that generally cost $800 million to $1 billion each. That doesn't make sense in a $100-per-barrel oil environment, where there's extremely high demand to drill offshore. On the free cash we believe the company can earn with its existing assets in two to three years, the free-cash-flow yield on the shares today is more than 30%.

I should point out that while energy has been very good to us over the past year, it has not been an easy sector to own for most of the last several years. A few years ago we bought into Tidewater [TDW], which owns and operates a large fleet of vessels that support the offshore oil and gas industry. We bought the stock at around $30, which we considered an extraordinary price relative to asset value of roughly 3x that. As oil prices fell – on their way to turning negative in April 2020 – offshore drilling literally dried up and Tidewater felt that more than almost anyone, taking the stock below $5. Even now the shares trade at around $20 and we think the assets are worth $90. With demand and pricing for offshore service vessels at the early stages of recovery and not really showing up yet in the company's results, we think there's plenty of room for the stock to run.

ON ENERGY:

It's not easy to maintain conviction when investments go against you. But I think it's hard to outperform otherwise.

It's not easy to maintain conviction when you have investments go against you like this. We bought Whiting debt at 30 cents on the dollar and it went to 5 cents. Tidewater stock went from $30 to $5. But as an investor you have to be able to stick to your guns when you believe your long-term thesis is still intact. I think it's very hard to outperform otherwise. This also speaks to the importance of not putting all your eggs in a similar basket. When something goes from 30 to 5, it helps if you hopefully own some things that are going from 5 to 30 at the same time.

Would Eneti [NETI] be an example of an alternative-energy idea that interests you?

CL: It is, although it's also rather controversial. This was a dry-bulk shipping company until it sold everything off in order to purchase a fleet of vessels that are used to install offshore wind farms. We think net asset value is on the order of $20 per share, but the stock trades at around $6. One big problem is that the company in the fourth quarter of last year had a big equity raise to expand its fleet – with a related company and some insiders participating – at $9 per share. This at a time when the stock was in the mid-teens.

That's obviously concerning, but we think the asset value is there in a company positioned to benefit long term from increasing utilization of wind power. If governance is a risk, we think for the time being at least that we're being well compensated for it.

You've described the "holy grail" of value investing as finding growth that's priced like value. Does airplane-lessor Air Lease [AL] fall in that category today?

CL: I'm talking here about legitimate long-term growth companies trading at legitimate single-digit multiples. Air Lease is definitely one of those.

You couldn't ask to be in a worse place than in support of airlines during a worldwide pandemic. Air Lease clearly felt that pain and its earnings came down, but the company never came close to losing money. Earnings per share that had been at a run rate of about $5 pre-Covid bottomed at around $3.50. They had to renegotiate some lease contracts and some of their planes were put back to them, but the fact that earnings were so resilient is a testament to what we think is the power of the business.

It's not an overly complicated business. The company has to be smart about the planes it buys, the lease terms it offers, and how frequently and well it turns over its fleet of aircraft. Airlines for a variety of reasons don't want to own all of their planes all of the time, so Air Lease provides a valuable service with consistent demand. Growth is tied to global demand for air travel, which took a short-term hit from the pandemic but we believe on the evidence is still on the same positive long-term trajectory, driven by rising populations and rising incomes.

How exposed is Air Lease to Russia?

CL: The customer base is mostly outside the U.S., balanced fairly well geographically with what we consider a favorable tilt toward Asia. They have some planes in Russia, but less exposure than their biggest competitors and as long as they at least get any planes there back, the financial impact from the war as it stands now should be minimal.

How inexpensive do you consider the shares at today's $40.25 price?

CL: As a simple intermediary buying long-term assets and renting them out, it makes sense that the stock doesn't trade at a big premium to book value or at a super-high P/E. That said, the stock today is at only 80% of tangible book value, and we'd argue that value is understated. The company consistently earns gains on selling its aircraft, which would indicate they're conservative in depreciating their planes. Given the state of supply and demand for commercial jetliners and the current worries about inflation, you could also argue that older planes are depreciating more slowly than they have in years, if at all.

If Air Lease just delivers on its contracted order book, earnings next year should come in at around $6 per share, going above $7 in 2024. So the stock on forward earnings trades at less than a 7x P/E. That for a company that just from a steady-as-she-goes cadence in its industry can grow at a 10%-plus rate over at least the next few years. That's what we mean by finding growth at a value price. We'd argue this should trade at closer to 15x earnings, which on next year's EPS estimate would put the share price at $90.

The stock is priced as if there are fundamental problems in the business that we don't see. If customers just meet their obligations – not an unreasonable expectation in a benign economic environment – earnings shouldn't vary much from that $6 estimate next year and $7-plus the year after. We also can't see the multiple going much lower than it is. So over the next 18 months or so we think the potential downside is very limited and we could very well see the stock double. That works for us in terms of risk/reward.

What do you think the market is missing in U.S. iron-ore royalty company Mesabi Trust [MSB]?

CL: The company owns the royalty rights to iron ore taken from a large mine in Minnesota on the Great Lakes. The mine is operated by Northshore Mining, a subsidiary of Cleveland-Cliffs, which crushes it, separates out the iron particles and makes them into pellets that primarily Cleveland-Cliffs itself then uses to produce blast-furnace steel. Northshore pays royalties to Mesabi based primarily on the selling price of the pellets as well as on the volume of ore extracted from the mine. It's a very long-lived resource and has been producing roughly four million tons of ore per year for decades.

As in a lot of commodity businesses, demand for iron ore has continued to grow but there's been little investment in supply for some time and the result has been increasing prices. So part of the appeal here is that that supply/demand dynamic could work in the favor of iron-

INVESTMENT SNAPSHOT

Air Lease
(NYSE: AL)

Business: Purchases jet airplanes directly from manufacturers and then leases its fleet of planes to a range of global commercial airlines, the largest share of which are in Asia.

Share Information (@4/29/22):

Price	**40.28**
52-Week Range	33.41 – 50.99
Dividend Yield	1.8%
Market Cap	$4.76 billion

Financials (TTM):

Revenue	$2.09 billion
Operating Profit Margin	50.5%
Net Profit Margin	20.9%

Valuation Metrics (@4/29/22):

	AL	S&P 500
P/E (TTM)	11.3	24.1
Forward P/E (Est.)	6.7	18.6

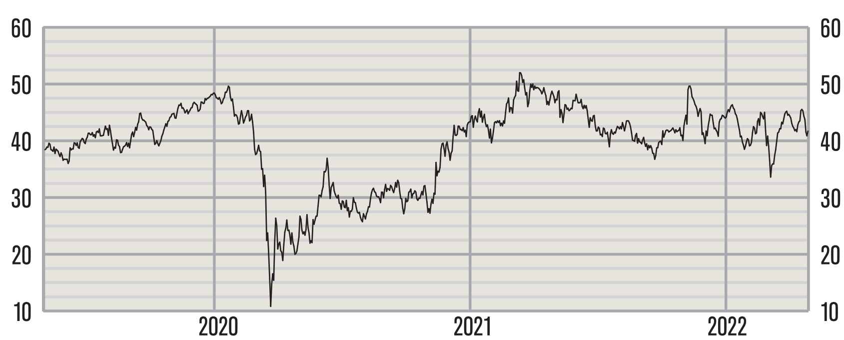
Largest Institutional Owners (@12/31/2021 or latest filing):

Company	% Owned
Capital Research & Mgmt	11.5%
Vanguard Group	8.4%
Dimensional Fund Adv	5.1%
BlackRock	5.0%
Artisan Partners	3.8%

Short Interest (as of 4/15/22):

Shares Short/Float	3.5%

AL PRICE HISTORY



THE BOTTOM LINE

Charles Lemonides believes on the evidence that the long-term growth trajectory of the company's business tied to global air-travel demand is intact. If it delivers on its contracted order book, he expects EPS to hit $6 next year and at least $7 in 2024. At what he would consider a reasonable 15x forward P/E, the stock would trade at closer to $90.

Sources: Company reports, other publicly available information

ore producers, who today are generating relatively fat profits, through a prolonged economic cycle. Increased spending on infrastructure in the U.S. means more steel demand. Car production coming back to historic norms means more steel demand. Economic growth in general means more steel demand. All of those things we think give us a lot of risk to the upside for steel and iron-ore prices, and ultimately the royalty revenues of Mesabi.

A specific issue for the company, however, is its relationship with Cleveland-Cliffs. There was a dispute primarily about the price Cliffs was using to calculate royalties. It all went to arbitration and the arbitrators ruled last fall that Cliffs was short-changing Mesabi Trust. But they went a step further and mandated that rather than using an average pellet price, Cliffs should pay Mesabi based on the highest price it received for any shipment of any grade over a 12-month period. It was a huge win for Mesabi.

Cliffs has continued to make its royalty payments, but in response notified Mesabi that starting in May of this year it was shifting production to a similar operation in Minorca and planned to use the Minnesota mine only for swing production. It also announced it planned to limit the tonnage of iron-ore pellets it sold to third parties in coming years, keeping its supply for its own steel-manufacturing plants. Shares of Mesabi Trust sold off pretty dramatically, from the mid-$30s to the low-$20s. The stock is now around $23.30.

Our basic view is that this is a bargaining tactic to get Mesabi to renegotiate its contract and we don't think Mesabi has to or even should. It doesn't make economic sense for Cliffs to stop mining this asset, which it has spent $100 million on in recent years to upgrade so it can produce the quality and makeup of pellets that work best in its most-efficient and productive steel plants. The Minorca operation they have has been producing only 25% of what the Minnesota property does, so they can't quickly make up the supply. Finally, iron ore today goes for $120 a ton, vs. $40 at the trough. That's a very profitable level, so not to produce and sell to third parties just to save some money on royalty payments to Mesabi just doesn't make financial sense. I don't fault Cliffs for trying this, I just think it's a bad economic decision to ultimately go through with it.

What upside do you see in the shares if you're right?

CL: In the latest quarter Cliffs made $20 million in royalty payments, which comes to around $1.70 per Mesabi share, an annual rate of $6.80 per share. Mesabi didn't pay the full amount out to shareholders, as it decided to hold some in reserve due to the dispute.

If Cliffs backs down and iron-ore prices stay high – not even as high as they are today – we think a base-case dividend expectation for Mesabi shareholders would be on the order of $5 per share. That compares with about $4 per share prior to the latest increase in ore prices and before Cliffs had to increase its royalty rates. At a base-case yield of 10%, that would result in a share price of $50. There's likely to be variability around that due to iron-ore prices, but as much to the upside as the downside.

INVESTMENT SNAPSHOT

Mesabi Trust
(NYSE: MSB)

Business: Royalty trust deriving income from iron ore mining and pellet-production facilities that are located in Minnesota and operated by a subsidiary of Cleveland-Cliffs.

Share Information (@4/29/22):

Price	**23.35**
52-Week Range	20.02 – 39.61
Dividend Yield	18.4%
Market Cap	$322.0 million

Financials (TTM):

Revenue	$53.7 million
Operating Profit Margin	94.1%
Net Profit Margin	93.9%

Valuation Metrics
(@4/29/22):

	MSB	S&P 500
P/E (TTM)	5.0	24.1
Forward P/E (Est.)	n/a	18.6

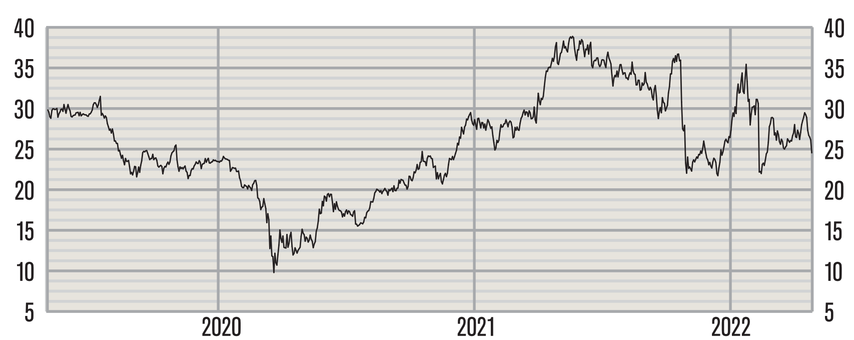
Largest Institutional Owners
(@12/31/2021 or latest filing):

Company	% Owned
Horizon Kinetics	16.2%
ValueWorks	3.9%
Beddow Capital Mgmt	3.1%
BlackRock	1.6%
SFE Inv Counsel	1.5%

Short Interest (as of 4/15/22):

Shares Short/Float	1.3%

MSB PRICE HISTORY



THE BOTTOM LINE

While a dispute with Cleveland-Cliffs, the operator of the iron-ore mine on which the company earns royalties, is calling into question the future royalty stream, Charles Lemonides believes Cliffs' position is untenable and won't hold. At a 10% yield on his base-case annual dividend estimate of $5 per share, the stock would trade at around $50.

Sources: Company reports, other publicly available information

You're still finding opportunity on the short side. Can you generalize about where that tends to be?

CL: We actually have a pretty eclectic universe of short names today, but one theme would probably be super-loved companies that had exciting stories and traded for extremely high valuations – which we didn't short then, by the way, because it's very dangerous to short great stories based on valuation – but where the growth has started to be questioned and we think the news is going to get even worse. Quite a few of these types of high-fliers have come down fantastically in price and some may even be rather interesting now. But others we think have challenged business models and mediocre prospects, and relative to that their stocks still strike us as really expensive.

Peloton [PTON] would be one example. It was selling bikes for $1,500 each while other people were selling them for $800, and it was losing money. There was crazy demand and supply couldn't keep up, and it was losing money. Now demand has gone down, the competition is still there, and it's hard for us to see how they make money now. The idea is awesome and they have a non-trivial subscription-revenue base, but if they couldn't generate a profit when there was unlimited demand, I don't see how they do it when demand is challenged. We think it's going to be tough to grow the subscriber base from here and even though the shares [at a recent $17.50] have been decimated, they're going to have to grow users quite a bit to justify the stock price today.

We're assuming you have a similar take on Beyond Meat [BYND]?

CL: When Beyond Meat first came on the scene it seemed really exciting. Selling plant-based protein strikes me as a positive thing, for the environment and for people's nutrition. Underlying consumer demand, in general, is likely to be there.

But as the business has grown and matured, the actual products, competitive position and performance against even the current valuation we don't think make for a positive investment case today. There has been a steady stream of exciting new product and partnership announcements – last month it was the launch of a meatless jerky in a joint venture with PepsiCo – but what tends to happen after an initial spurt is that revenue growth kind of stalls out and none of those new sales channels become profitable. What growth there has been comes mostly from investing in new sales channels, not from strong organic growth once they're in them.

We also don't see the competitive environment getting any easier. There are something like 6,000 recipes for plant-based protein out there and barriers to entry – especially for food companies that already have brands and distribution – are not high. What Beyond Meat has to establish is its name recognition and brand value, which is a function in the end of how much people like their products. There is clearly some brand value here, but based on the performance so far, the jury is still very much out on how high or sustainable that is. It also doesn't help that the health benefits from these products, given things like their calorie counts and fat content, may not be what was originally expected.

INVESTMENT SNAPSHOT

Beyond Meat
(Nasdaq: BYND)

Business: Producer of ready-to-cook and frozen plant-based food products under such brand names as The Beyond Burger, Beyond Sausage and Beyond Chicken Strips.

Share Information (@4/29/22):

Price	**36.88**
52-Week Range	35.41 – 160.28
Dividend Yield	0.0%
Market Cap	$2.34 billion

Financials (TTM):

Revenue	$464.7 million
Operating Profit Margin	(-34.2%)
Net Profit Margin	(-39.2%)

Valuation Metrics
(@4/29/22):

	BYND	S&P 500
P/E (TTM)	n/a	24.1
Forward P/E (Est.)	n/a	18.6

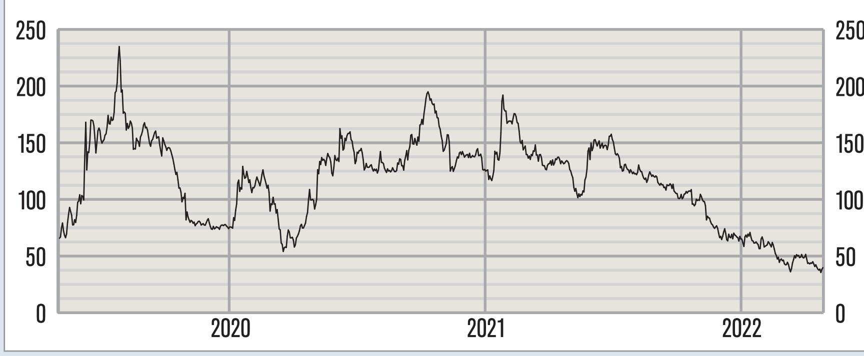
Largest Institutional Owners
(@12/31/2021 or latest filing):

Company	% Owned
Baillie Gifford	13.3%
Vanguard Group	7.9%
BlackRock	3.8%
Spyglass Capital	3.2%
Susquehanna Intl	3.1%

Short Interest (as of 4/15/22):

Shares Short/Float	38.1%

BYND PRICE HISTORY



THE BOTTOM LINE

As the company has grown and matured, the reception of its products, its competitive position and its performance don't make for a positive investment case today, says Charles Lemonides. If the business continues to show stagnant organic growth and persistent losses, he thinks the stock could trade at 1x annual sales, vs. closer to 4x today.

Sources: Company reports, other publicly available information

How do you handicap the risk of Beyond Meat being bought out?

CL: That's clearly a risk, that someone decides that what Beyond Meat is today is worth a material premium to the current market value. I would argue that risk is quite a bit lower than it was and is still relatively contained. The brand and distribution could help a company jump-start or accelerate its business in the space, but given that the business is still losing a lot of money, is that something you pay a big premium for? I've been wrong before on this type of thing, but there's a reason nothing has happened yet and without positive momentum in the numbers, we think it's unlikely to happen soon.

As you mentioned, the stock is a shadow of its former self, down more than 75% over the past ten months to just under $37. How much worse can it get?

CL: Management's guidance for 2022 is for revenues of $560 to $620 million, against what is today a $2.3 billion market cap. If the business continues on the path it's on – stagnant organic growth, persistent losses – that's not sustainable and they're going to have to do something different, although I don't know what that could be. If investors lose all enthusiasm for the story, it would not at all be unreasonable for the stock to trade at 1x sales. That's still a long way down from here.

You still hear people holding out that all it's going to take is for one big company to hit it big with a Beyond Meat product and then the money's going to start pouring in. That's not an investment thesis in my mind. Yes, if McDonald's decides to make them rich, it could happen. But companies like McDonald's don't usually decide to do that, and there's no evidence they or anyone else is likely to do that in the near future.

We spoke about retailer Five Below [FIVE] as a short idea in November of 2020, when the stock was at $158. It's been well above that since, before coming down more recently. How did that play out for you?

CL: Not well. The stock had bounced back quickly from the onset of the pandemic and our thesis was that as the economy reopened Five Below's store traffic would not snap back that quickly. We expected parents to be very reticent to send their kids back into Five Below to hang out and fill up their shopping carts with candy, gift items and beauty products. We didn't handle the position well from a trading perspective because the stock eventually ended up coming down again, but as the business prospects started looking much better, we pulled the plug on it at a loss.

We made the same type of mistake in exiting our long position in Brunswick Corp. [BC] relatively soon after the pandemic hit. It sells boats and we were in it because it was a dominant player in its markets, we thought there was an excellent secular demand story, and the stock was trading cheaply relative to history. After the stock fell apart in March of 2020, I wasn't sure of a lot at the time, but with unemployment going higher at record speed and whole industries shutting down, I was pretty sure that six months from then people were not going to be buying boats and that demand was likely to go away for at least two years. Six months later, people (myself included) were desperate to buy boats and couldn't find one. I don't think we were alone in missing something like that, but we got that one wrong too.

ON ADAPTING:

If you're counting on single-decision investing coming back any time soon I think you're asking for trouble.

If it turns out you're overestimating the health of the economy over the next year or two, why would that most likely be?

CL: If the Fed raises interest rates enough to create a deep recession, then we'll have a deep recession. We don't think they want to do that, or that they need to do that to combat inflation, but getting that all right won't be easy. We generally think the Fed is pretty good at what they do, but our eyes are open to the risk they don't get it right this time.

Whatever your outlook for the economy or interest rates or inflation, one thing I don't think investors fully appreciate is that the fundamental investing environment has changed. People got used to identifying companies with enticing long-term potential and owning them at any price. That worked fabulously well for four or five years, stalled out in 2021, and has been a disaster over the past six months. If you're counting on such single-decision investing coming back any time soon, I think you're asking for trouble. VII

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