Seeking Alpha Interview

Author Bio

Greystone Capital is a long only, equity focused Registered Investment Adviser located in West Chester, PA. The firm utilizes a fundamental research process focused on identifying mispriced small and microcap securities in order to build a concentrated portfolio of high conviction investments.

Walk us through your investment decision making process. What area of the market do you focus on and what strategies do you employ?

My firm invests money in individual securities on the back of deep fundamental research that is designed to help me gain a high level of conviction about a business and determine whether or not there is a mispricing between the current trading price and the potential value of the business. As a result, I spend most of my time conducting research in order to learn more about specific businesses, industries and the competitive landscape surrounding those two things. Most of each week is made up of managing existing positions within client portfolios (basically always trying to figure out what I might be missing or if my thesis is still relevant), and then attempting to find new investments. Because I typically invest in the small cap and microcap spaces, I focus on those two areas the most and spend a lot of time sifting through the universe of those businesses, usually filtered out by my investment criteria as well as what I am capable of understanding. From the standpoint of looking for new investment ideas, I say 'no' to a lot of things, with the idea being that what I'm looking for is very specific and infrequent. I'm lucky if I can find a solid new investment idea per quarter, or 1-2 very good ideas per year. When I think I've identified one, I will run it through my intensive research process consisting of reading, studying the industry and most importantly finding people to talk to in order to backup the insights or conclusions I've come to on my own. I have taken small positions in things before completing my research process in its entirety, and I've also ended up making those small positions larger ones, as well as cutting them completely if I discover I was wrong about part of my research conclusions. My aim during the research process is to get very familiar with a company's competitive positioning, and understand how likely it is that my view of things will actually happen. In other words I want to identify how wide the range of outcomes is and how precise I have to be in order to make money, where I'm looking for situations that require limited preciseness or a wide mispricing.

Because I invest in a concentrated way, try not to turnover the portfolio much, and have a high bar set for new investments, I'd say the actual making of decisions doesn't happen too often (other than saying no to a lot of things). I'm not buying and selling frequently, but rather view what I'm doing as constant information gathering and information verifying to try and manage risk, among other things.

Where do you find the greatest mispricings and why do they exist? Will any of them ever go away - why or why not?

Mispricings can occur anywhere, but for my purposes, the greatest mispricings I've seen on the long side are a combination of trading activity, a tired shareholder base, over-extrapolating bad information – all taking place within a small market cap business. Over the years, I've come to appreciate – and pay attention to – more and more who owns a stock and how that ownership can drive inflows and outflows or interest. I've also found that large mispricings can occur within a business that nobody wants to own (or knows to own) that becomes a business that everyone wants to own. This can happen quickly in the microcap space, and The Joint Corp. (JYNT) would be a good example of this dynamic. There, you had all the elements of a mispricing including a frustrated shareholder base, management change, business strategy pivot, turnaround, underfollowed, small size and very good unit economics not yet visible to the world. Following a strategy pivot and a few good quarters of performance including some very good future guidance, the stock all of a sudden became a high flier that everyone wanted to own.

I've said before many times that the greatest mispricings can occur in the microcap space given the often wide disparities between price and value due to the underfollowed and/or under-owned nature of these businesses. While I will never have a real analytical or informational advantage as compared to a larger shop with greater resources, I have absolutely been able to identify mispricings in this area before a company is large enough to be owned by institutions or larger firms. A good situation to come across in the microcap space can be a business that dominates their niche and is growing, with a solid management team yet trades at a cheap valuation because there is zero institutional ownership, no analyst coverage and the shares are illiquid.

In terms of whether I think mispricings will ever go away? I'm not sure. I can speak to the fact that I have seen at least more interest in the microcap space from some larger firms – whether its Mario Gabelli dedicating a portion of his assets to covering microcaps, or Renaissance Technologies sifting through the momentum names – but until there is a way for large pools of money to both purchase microcaps in a way that will move the needle for them, and dedicate the time and resources to analyzing them (difficult without the investment banking fees that come with sell side coverage), I think this will still be a good area for finding mispriced opportunities.

For someone like myself, I'm not sure if there is such a thing as having a real 'edge', but what I do have are structural advantages that will allow me to do things that larger funds can't do such as invest in smaller securities or move in and out of a particular stock quickly. In other words, I don't ever want to be competing with the Druckenmillers or the Ackmans or the Loebs of the world. I want to stay as far away as possible from areas where you need talent, resources and information to compete. The microcap space is a great place to look for interesting opportunities among less competition.

You run a concentrated portfolio of high conviction investments – how do you manage risk on an individual security and portfolio level? Can you discuss how "killing the idea" is used here?

My risk management process has both fixed elements or rules and variable elements that are subject to change and depend on the individual situation. An example of a fixed element might be that I usually never enter into a position size greater than 15% of a client's portfolio at cost. An example of a variable element that could be subject to change is selling that same security. If the position doubles and becomes a large percentage of the portfolio, I wont necessarily sell for that reason, but rather continue to analyze the risk/reward, whether the business is getting stronger and examine the potential forward return profile. From a portfolio standpoint, I do like having at least some cash available to add to current positions or buy something new without selling a current holding, but the percentage of cash varies based on the investment opportunities available, where we are in the market and again the future return profiles of current investments. I rarely use potential volatility at the portfolio level as a reason to make decisions given that I am very comfortable with it (I didn't say I liked it, just comfortable) and I make it clear to express that to current and potential clients. Since Greystone does not hedge, use derivatives or option strategies, my philosophy has been that there will be times when client portfolios are down a good amount, and times when individual securities are down a lot, but when things are going well we should more than make up for any negative short term price action. The period during March and April was a good example of that. Some client portfolios drew down quite a bit as the world grappled with the

COVID-19 pandemic – and although I didn't expect it to happen this quickly – we have more than made up for that nasty volatility this year as the market has recovered.

The concept of killing the idea is something I shamelessly stole from Bruce Berkowitz of Fairholme Funds. He talks often about running new investment ideas through his funnel and research process with the aim of 'killing the idea' or figuring out the strongest possible reason why he won't be able to make any money. If he isn't able to kill the company then often times he may have found a good investment opportunity. Running a concentrated portfolio means that new investment ideas have to clear a high hurdle for inclusion in the portfolio as a core position, because current ideas are made up of thoroughly vetted, high conviction, well-known businesses that sometimes I have owned for years. To reduce or eliminate one of those would mean that I've found something better that I like even more. Most of the time I don't reach that point and I've 'killed off' the idea before it enters the portfolio. Sometimes it can be as simple as the industry its in, other times I can get as far as going through my entire research process and discovering that I like the name, only to remember that I don't like it as much as something I already own. Its very unscientific.

What are some of the highest value-add activities an investor can do? What are some of the lowest value-add (or destructive) ones?

I think context is definitely important here, as a high value activity for me might look a lot different than a high value activity for another investor or firm. Right now, my time is basically spent doing three things: managing client portfolios, researching potential new investments, and running my investment management business. With that said, I've broadly shifted my thinking in this area over the years as it relates to where I spend most of my time during the week. As it relates to Greystone, low-value add activities would be reading multiple newspapers, reading new investment related books, spending time in areas of the market that don't add value to our strategy or client portfolios. I used to think I had to be like Buffett and sit in an office all day reading 500 pages consisting of newspapers, magazines and 10ks until I developed some investment insight and was able to build a portfolio that way. There's nothing wrong with spending your day doing that, but I found it those things added little to what I was trying to do. My time is better spent studying various business models, understanding the competitive dynamics of a certain industry, or researching businesses to add to my watchlist. I also have added talking to other investors, trying to build relationships with people and exchanging notes/ideas as often as I can. Having a group or network of smart people that invest in similar ways that can push back on ideas or tell me what I might be missing is an invaluable resource. In addition, outside of investment specific research, an incredibly high value add activity for me has been to talk to people within a certain industry about a specific business or about the competitive dynamics of that industry. Company filings only get you so far – sort of lay down a base of what you need to know – but speaking with people – employees, customers, ex-managers, consultants, bankers etc. – adds an incredible amount of depth and insight to our research. I've also learned that people can be incredibly generous most of the time, and I try to frame every conversation as if I'm just trying to learn more, which is true. In line with that, an extremely helpful technique I picked up over the past few years is to be focusing on or learning things that wouldn't be considered expiring knowledge. For example, it may be less relevant to know how many acquisitions were made in the podcast space in 2019, but more helpful to understand why the industry is consolidating. A small shift in my thinking this way has helped open up more opportunities for longer team learning and understanding about the business world.

Outside of managing portfolios and keeping an eye on our current investments, I spend most of my time reading investment writeups, speaking to other investors, or reading about businesses in the small and microcap space that I find interesting. Very little of my time is spent in Excel, or on Bloomberg (probably because I don't have one yet) or screening through stocks based on certain metrics. I have a very strict set of investment criteria for new positions, and I know exactly what I'm looking for when researching businesses, so mostly every activity or business that doesn't hit on those criteria is an easy pass.

How do you tell if a sharp decline in a stock is due to fundamental or non-fundamental reasons, or said another way, how do you tell when it's time to move on from a thesis?

This is a great question, and something I have to deal with a lot in the microcap space! I've owned businesses that have traded 15-20% higher in a day or two on no news, and businesses that have done the opposite, traded downward on seemingly no negative news. I would say as a general rule most of the time, price action is the last thing that tells you when its time to move on. The stock market is an interesting place as an area where shares of businesses are bought and sold because often times the selling (buying usually only happens for one reason) can occur for reasons that have nothing to do with the fundamentals or economics of the business. I've heard the phrase that in the private business world, the seller is often times the smartest person in the room. Well in the public markets, businesses can be sold down to crazy levels for plenty of reasons outside of how a smart and informed seller would act in a private or less liquid situation. Obviously momentum shifts in both directions so a stock that has declined 30% is probably not due for a sharp reversal, but again the price action alone doesn't tell you much about the actual business. To use COVID19 as an example, at the onset of the pandemic, nearly every publicly traded business saw sharp price declines as estimates about the future had to immediately be revised downward given the state of the world and the economic shutdown. This included businesses that are seen as recession proof or recession resistant, and would continue to operate in a shutdown or remote working / living world. Looking across client portfolios, we had several businesses that grew revenues and continued to take market share in 2020 (not off of a low base, but from YoY), so the price action just provided us with an opportunity to buy a lot more of each. Contrast that with businesses like airlines, commercial real estate and restaurants, where anyone owning these types of businesses would probably have to seriously consider whether the original pre-COVID theses were broken and whether or not their competitive positioning (or ability to even continue as going concerns) was/will be harmed permanently.

Setting aside for a second that prices decline usually based on revised estimates about future cash flows / terminal values most likely on the back of some negative occurrence, and I would say that the primary time to move on from a thesis would be when your analysis of the businesses competitive positioning has changed in a way that is likely to impair your ability to earn a rate of return above whatever your hurdle or expectations were. When I'm making decisions for Greystone Capital, I usually sell for three reasons: one, the investment was a success and reached my estimate of value within a certain time frame (for special situations) or the valuation has swung too far to the extreme where expectations are now much higher and the risk/reward has changed for the negative, two, I find something better to put client capital in, whether it be a better business, cheaper opportunity, higher rated stock based on my criteria etc., and three, when the thesis has changed or my analysis and underwriting of the risks/rewards turns out to be wrong. The fourth reason by the way would be that a position becomes too large a percentage of the portfolio and needs to be trimmed for risk management purposes as discussed earlier. Of the four reasons, number three – when the thesis has changed – is the most difficult to recognize and implement given the speed of change in the business world and the fact that it might only take a few quarters for a company's competitive positioning to be eroded, depending on the industry.

To give a few brief examples, a thesis may be broken when a previously high growth business segment begins to show declines and/or market share losses, when a small company management team completely and out of nowhere diverts from their core business to chase an exciting (but less measurable and higher risk) new business segment, when a business starts paying too much for acquisitions (or buys non-complementary things that don't provide cost or profit synergies), or when you've underwritten the recovery of a business in secular decline (and it doesn't happen). Examples of when a thesis is not broken include insider stock sales, negative price action, or issuing equity (to an extent).

In the past it was very difficult for me to move on from a broken thesis – especially when holding a mark to market loss – but I've improved my thinking in this area over time and have become much less emotional as a result. I try to utilize an investment journal which helps me keep a real time log of buying and selling activity and tracks decision making (and the emotions associated with those decisions) over time so that I can try to eliminate how I *feel* about a specific security when making a decision and just deal with the facts and reality of each situation.

How do you use an investment journal? What specific improvements have you made or lessons learned from it?

Over the years, I've benefitted from recording decisions in real time and documenting the reasons for making (or not making) certain investments. Being able to re-visit the decision-making process that led to a good or bad investment outcome can be a helpful way to eliminate the emotions associated with buying and selling securities. In addition, as time passes I have been known to develop a selective memory especially when it comes to research and making investment decisions, so keeping track in real time of what I've done or what I'm doing helps eliminate the guesswork of what I think I was doing at a particular point in time.

I use a journal in two specific ways. One, I write down investment decisions as I make them and the reasons why. I also write down how I felt about making the decisions and why I felt that way. Two, following the passage of time or a specific outcome, I revisit the journal to try and determine whether a correct decision was made at the time. Since what I'm doing involves sticking to a specific process throughout each year, my hope is that the use of a journal provides an opportunity for me to evaluate why and *how* a decision was made independent of the outcome.

I also keep a 'company research log' that I fill with notes on both current positions and potential investments. I use the company research log to take and keep track of notes from quarterly earnings, presentations, acquisitions, or conversations with other investors. I've found using a research log has been helpful to track a company's progress over time combined with my thoughts on that progress and how it matches up with my original projections. For new idea research, I want to make sure when I am looking at something I have a tangible record of what initially brought me to the opportunity and what I saw. I want to know why I'm doing more work on it, why I passed, or why I might want to revisit something later.

Using a journal over the past few years has allowed me to learn a lot about my portfolio management process as well as prepare me with more intelligent and thoughtful questions for both management teams and other investors when researching a business. I've made some improvements to my process in terms of portfolio management process as well with things like position sizing, sell discipline and portfolio construction after making some mistakes in those areas. I find it incredibly useful to openly document mistakes while being intellectually honest with myself and then be able to refer back to those mistakes (which are powerful teachers) to help tweak or refine my process.

What are some items on your investment checklist? Is there anything that can't be included on a checklist?

Taking you through my investment checklist would without a doubt drag this interview on for way longer than you'd want to talk to me haha. Instead I can talk about some of the categories on the list and why they might be important to an investment thesis. First, the concept of an investment checklist has become well known in most investment circles but probably isn't used by most in the way you would think. For example the items on my checklist have been addressed *before* I get to the end of my research process and way before I make a buy/sell decision. The checklist I use has become incredibly long but that's because it serves as more of the foundation of my research process and as sort of a research cataloguing / organization tool. In addition, lately I've added many more competitive dynamics/analysis items to the checklist than things such as 'does the company have a clean balance sheet'. I'd argue that thinking about things like 'can private equity or venture capital money enter this space and change the competitive landscape' is a much more important item than 'is valuation reasonable' etc. With that said, I have many of the standard things on the checklist that cover questions I have relating to the business and fundamentals, the industry in which the business operates, the management team and their background, and items about valuation and future projections. I also have some behavioral and psychological items on the list that I like to work through which can include things like 'is this investment better than what is currently in the portfolio from a conviction / risk/reward standpoint' and 'are you holding too much cash and are bored as a result which is causing you to lower your quality hurdles?'.

Checklist items differ for every business, and some take much longer than others. There are items on my list that can be answered in my head, and items that take a long time to figure out or verify. That's one of the other benefits of using a checklist. It can help you determine your actual understanding of the business and investment case. If every item takes a long time to confirm or there are many unknowns as you move through the list, maybe you want to think twice about owning that particular company or maybe you don't know it as well as you thought. I don't think any items on the list are make or break, nor do I believe any of them lead to specific buy or sell decisions, but as a collective I think I should be able to back up a one-page thesis by going more in depth with these items and verifying what I need to.

There's probably not much than can't be included on a checklist. Management motivations and character strike me as one. That's always very difficult to determine even with reference checks, former employees industry insider conversations etc. I don't have too much to add here as I'm sure other investors optimize this part of their process better than I do. I'll finish by saying I derive a lot of value from organizing my research process and using a checklist to help with that.

A recurring question in this interview series is about the mispricings created by the coronavirus and its short and long-term impact – can you weigh in on this?

While I believe there are smarter and more experienced people to ask about this particular topic, at a high level I think we all saw firsthand how the market reacted to news of the pandemic – swiftly and aggressively – and what market prices for certain assets were implying about the future if not at least the remainder of 2020. No matter what you thought about the remainder of the year, or what a two week economic shutdown would imply, there were a lot of babies thrown out with the bathwater so to speak. I'm still in the camp that believes we haven't yet seen the full impact of the pandemic in many areas, so it would be smart to remain cautious and keep my eyes open as new information rolls in, but there were certainly mispricings among all types of businesses including the ones my clients own. From an investment standpoint, most client portfolios hold decent cash positions should we experience another market decline, but among the group of businesses clients own, things have been very good from an operational and execution standpoint. I've actually been surprised with the performance of a few of the companies we own, and even more surprised with the share price response in such a short period of time. To that point, that was part of the reason I was very active in March and April. While I had no idea how the world would look (and will still look) post pandemic, nearly all of the companies we own continued to operate during the pandemic, grew revenues, grew their customer bases, continued to take market share, and only two raised capital (for reasons that had nothing to do with COVID). Pre-COVID, if you did the correct analysis of our businesses, you would see that we own some cheap quality stuff that only got cheaper at the beginning of the year. The mispricings were off the charts following the market selloff, and I figured a simple return to pre-COVID prices would result in material returns for many clients, so I was an active buyer. Having said that, hindsight is always 20/20 so take what I just said with a grain of salt. I figured the world and market would rebound somewhat, just not this quickly.

And while I'm never one to offer an opinion on the market as a whole, you could maybe at least imagine that things would get better heading toward the back half of the year. Government stimulus measures, a large amount of money on the sidelines waiting for distressed situations, and ever positive news flow could point to at least a partial recovery. With that said, it was very difficult to feel good about buying stocks in March and April. Adding to that was the fact that you had to move quickly to capture many of the bargains available, as the market turned right around and ripped higher following the governments intervention. Investors can say what they want about historical valuations, tech bubbles 2.0 and frothy market activity, but there is clear momentum toward the bull side and I think it would be very difficult to be bearish until that momentum breaks. Famous last words I guess.

What's one of your highest conviction ideas right now?

I've owned RCI Hospitality (RICK) since the beginning of this year, and despite significant price appreciation I still believe there remains material upside to the share price over the next 12-24 months. In fact, I'd argue that the company is in a stronger position today than they were pre-COVID, with an interesting new business segment (which is their Bombshells restaurant concept) that is growing fast and generating very good cash on cash returns for newly opened units. I think RICK exceeded nearly everyone's expectations this year in terms of their operating performance during the pandemic, and showed the resiliency of their operating model as well as the cash generative ability of their nightclubs even with over 2/3rds of them shuttered for a period of two months.

During the third quarter, I increased client positions in the name following positive announcements coupled with better than expected Q2 performance by the company. While the possibility of reducing the position from a risk management standpoint occasionally weighs on my mind, I haven't sold a single share as I believe material upside still exists as mentioned above. During 2021, RICK could exceed $200mm in revenues and generate somewhere in the neighborhood of $30-40mm in free cash flow. The current market cap is under $200mm. We are also invested alongside a CEO who has spent his entire career building this business and has a maniacal focus on delivering value to shareholders including himself as the second largest owner of the company. In addition, management has shown the willingness and desire to repurchase large amounts of shares when the opportunity presents itself as well as undergo strategic acquisitions at high cash on cash returns which have to date resulted in material value creation. Both of the aforementioned capital allocation moves were put on hold as the company was focused on moving through the pandemic. Now that it seems the worst is hopefully behind us, I would expect to see buybacks and eventual acquisitions taking place at favorable prices.

As mentioned previously, while RCI spent the majority of the past three to five months operating with a fraction of their venues open at reduced capacity, the business is now fully operational as of September 30^{th}, and should see very positive operating results from key markets and locations in New York City, Florida and Texas. It's my belief that locations in New York City and Florida alone are capable of producing company wide EBITDA of $20-30mm on a potentially reduced operating expense run rate and the potential for increased prices from bottle service and cover charges.

Shifting gears back to Bombshells, their performance has been stellar. This performance also comes during a period of time when nearly $1/3^{rd}$ of US restaurants may not recover from the coronavirus impact. While Bombshells is capable of generating material EBIT as it stands right now, there exists significant option value in the future of this business segment. As of now, the concept has been expanded slowly as RCI tests their core markets, but moving forward there remains the potential for concept/market expansion, franchising, joint venture opportunities with a larger restaurant business, or the potential licensing of the brand name for high margin royalty income. I become even more optimistic about Bombshells when looking at their current comps (even adjusting for pent-up demand and higher than normal COVID traffic) and remembering that their current footprint is 10 restaurants. Ten. This compares to nearly 100 Twin Peaks locations and over 400 Hooters around the country. The potential runway for Bombshells growth is incredibly long. To summarize, the risk reward remains favorable at these prices and I think investors should continue to do well over time.