Tiburon Capital Management

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Wide Moats and Castles, Tornadoes and Trailer Parks

Disrupted Industries in Secular Change with Diminished Moats as Fertile Ground for Shorts

Of Wide Moats, Adherence to Doctrine and Dynamism

We are advocates of a *Bottom-Up*, classic deep value approach to identifying companies that are cheap (or rich) on an intrinsic basis. Trained (1990-98) by Marty Whitman of *Third Avenue Funds*, the rigors of discerning cheap from rich always made sense to me. The "B" of our five-pronged *B-R-A-C-E* investment methodology[1] – prong one – is *Bottom-Up* analysis. As mentioned in some of our recent investor letters, heightened weighting to "B" is called for in these range/earnings-bound markets. Interestingly, as/when/if others pick up on value as a flavor of the moment, they may also note the importance of *Wide Moats* to the discipline of Deep Value. Just as you might imagine, companies that appear to have a *Wide Moat* are those that seem to have a sustainable competitive advantage - pricing power, high barriers to entry, etc. Deep Value advocates are a particularly doctrinaire crew. New zealots to anything formulaic tend to be too (assuming the market moves toward value). Don't get me wrong - I love the doctrine, rules, and textbooks - the academia around a value discipline. But to us, it is a starting point, tends to be static and calls for dynamism to be practicable in modern markets. As simply one component of *BRACE*, *Bottom-Up* becomes, de facto, more dynamic. Moats matter. We want to be long companies that have wide moats, trade cheap and have a plausible catalyst. *We also want to be short those with no moat*.

Deep Value Advocates Reflexive Dismissal of Value Short Investments

Hey, I resemble that remark! – Curly of the Three Stooges

Self-selecting deep value proponents and luminaries eschew the short side. Some of the reasoning goes that when you are right, positions get smaller, and are somehow, de-stabilizing. Others simply call it "too hard" – it is contra a market that tends to inexorably rise over time. Those more honest (in our view) say there are human biases (which they fear they share) associated with shorts that can create dysfunction in decision-making. Let's say for the moment, that we do not share this dysfunction. Securities we are long or short are not Mr. or Ms. Right – they are Mr. or Ms. Right Now. All positions are disembodied line items meant to produce profit and loss, and not anthropomorphic. Assuming our "B" *Bottom-Up* research can offer up company securities that are rich on an intrinsic basis and have an "R" *Revaluation Catalyst* that can re-price the security down in step-function change, why would we not go short?

If Wide Moats afford protections to value-based longs, the lack thereof leaves richly priced securities vulnerable, providing similar protection. We are finding fertile ground for shorts in sectors undergoing secular change. With the growth of directional shorts in the portfolio with secular industry sea-change working against them – an "E" *Externality* – we can also moderate down portfolio hedges as volatility can be damped by the directional shorts and a cash position earmarked for use when/if we see our buy target prices on high conviction names breached.

It's You and Me Against the World - It is Much Harder to Make Money with Shorts

The speaker of truth has no friends – African Proverb

There are many aspects of being short securities that make it a more difficult way to make money than outright longs. The upside is limited while the downside is not. One competes against the market's long-term positive slope, other investors, and the companies' management teams, all trying to prove a short thesis wrong. To reiterate a key point here: *virtually every market participant and observer - shareholders, brokers, analysts, company employees, business media - have a vested interest in believing broadly in company securities' prices increasing*. *Choosing to short a security places you, the discerning investor, at odds with plausibly the biased and/or less informed multitudes needing/wishing/wanting or favoring a positive outcome*

[1] See a brief discussion of Tiburon's *BRACE* methodology on our web page, here (contact us directly for a more thorough discussion): http://www.tiburonholdings.net/brace-investment-methodology.html

for company securities. A short strategy needs to take into account these factors as well as your own psychological limits. Those open to shorting overvalued companies (for us, also with a plausible *Revaluation Catalyst*) need to decide: (1) What kinds of targets to pursue; (2) how to screen for potential candidates; (3) how to vet them; and most importantly, (4) how to live with them.

Fundamental Valuation Work and the Benefits of Directional Agnosticism

I have read a description of short selling in the public domain, *as the opposite of a typical investment process*. First, let's clarify that the investment process is the hard work of determining if a company's securities are rich or cheap. What this erroneous quote describes is not the investment process but the transaction or trading process. So then, again, assuming dispassion in your temperament, we can clinically use our investment process to determine cheap (potential longs) and rich (potential shorts).

Directional agnosticism as part of your approach or mandate affords the investor the luxury of a broader investment universe – company securities needn't be bought long as they are simply cheap on an intrinsic basis, to be an alpha-generating position, they can be the shorted if they are rich. For us, in either case, with some plausible *Revaluation Catalyst* that can re-price the longs or shorts to fair value.

Further, just as there are difficult market dynamics impacting those choosing to short securities, short sellers do have some markets advantages too (presuming again, a bias-free and reasoned and correct short thesis):

- The largest holders of the targeted short securities are likely and most often passive, long only mutual funds, that by design and practice, do less detailed analysis regarding the companies' securities in the portfolio, are compensated based on long only positions and then relative to an index (versus absolute returns).
- Sell-side research and mutual fund buy-side analysts tend to break down by industry coverage. Assuming an industry is undergoing a secular change, it not only threatens the companies, but the analysts too, as their livelihoods are tied to access to management, understanding the sector and, in these analyst's view, an ability to earn a reasonably stable living. These biases can lend to company management needing to believe in a story of turnaround or recovery, drinking that *Kool-Aide* and then serving it up to the companies' analysts (who mostly gladly consume if it confirms the status quo).
- Passive mutual funds, then, can be easy to trade against. That is, shorting into them as they buy to approximate their index, capitalizing on their collective herd-like capitulation when bad news and/or the short thesis catalysts are – surprise - realized.

Moats and the Lack Thereof – Perceived Sustainable Value versus Secular Damage

"In business, I look for economic castles protected by unbreachable 'moats'." – Warren Buffett

Deep Value proponents appreciate and seek sustainable value creation in investment prospects. Sustainable value creation has two dimensions - how much economic profit a company earns and how long it can earn excess returns. The sustainability of these advantages finds its way into valuation and when present, is described as a “Wide Moat”. We incorporate this assessment in the “B” *Bottom-up* component of our methodology. However, what may differ (on the long side) between a classical Deep Value approach and our *BRACE* methodology, is that a plausible “R” *Revaluation Catalyst* - could/should unlock value, re-pricing securities up to fair price in the shorter term. Therefore, while desirable to have a Wide Moat as part of our assessed *margin of safety* - the sustainability of earnings suggesting long term value, is less important to us on the long side, than say, that a company’s securities are cheap to fair value assuming a high probability-weighted near-term event.

Interestingly, however, *the lack of a competitive advantage - a diminishing moat - can be of paramount importance in the success of our event-driven shorts*. While there is little Deep Value advocacy of shorts as an investment approach, and none (that I can find) on the absence of, or diminishing moats, such limitations to sustained value creation, particularly when secular in nature, can create enormous headwinds for companies and portend possibly a rich landscape of value-based short ideas.

With secular-based shorts, I look for economic trailer parks in tornado territory – The Author

Just as moats helped defend and protect the fortresses and castles of old, economic moats tend to protect a company from competition that may eat into its business. The strength and durability of a company’s economic moat go a long way in the company’s ability to fend off its rivals and protect its earnings. If Wide Moats are a critical component of longer-term deep value longs, arguably a diminishing moat or total lack thereof can provide a pivotal clue to overvalued companies too, as prospective shorts. To the extent the lack of, or a diminishing moat impact a sector, such an “E” *Externality* can suggest a secular change creating a large headwind to any such sector company’s share performance.

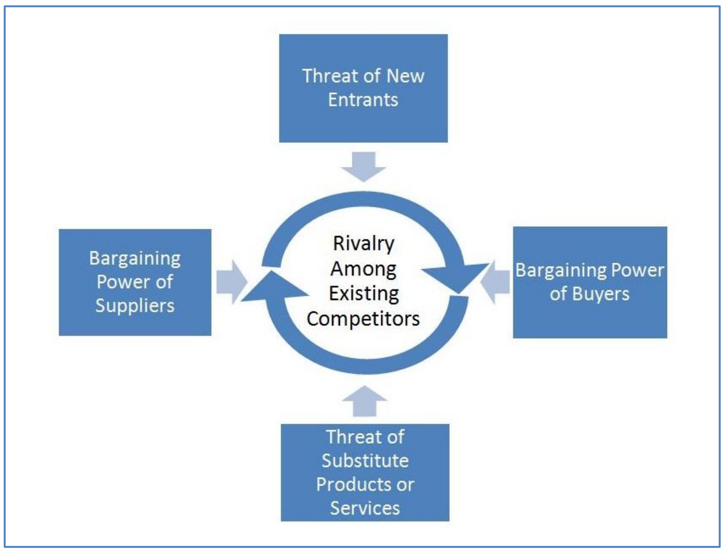
Porter’s Five Forces – Gleaning Castles from Trailer Parks

In 1979, Michael Porter, then an associate professor at Harvard Business School published his first article for HBR, *How Competitive Forces Shape Strategy*.[2] In the years that followed, Professor Porter’s explication of the five forces that determine the long-run profitability of any industry has shaped a generation of academic research and business practice. Some (we included) consider these factors when thinking of the sustainability of excess earnings suggesting a Wide Moat or, given our directional agnosticism, the lack thereof suggesting prospective shorts:

[2] *How Competitive Forces Shape Strategy*, Porter, Harvard Business Review 1979
http://ecaths1.s3.amazonaws.com/fernandoserra/Porter%20(1979).pdf

1. Supplier Bargaining Power: How easy it is for suppliers to drive up prices. This is driven by the number of suppliers of each key input, the uniqueness of their product or service, their strength and control over the company, the cost of switching from one to another, and so on. The fewer the supplier choices a company has, and the more they need suppliers' help, the more powerful their suppliers are.
2. Buyer Bargaining Power: How easy it is for buyers to drive prices down. Again, this is impacted by the number of buyers, the importance of each individual buyer to the company's business, the cost and ease to them of switching from the company's products and services to those of someone else.
3. Threat of Substitute Products or Services: This is affected by the ability of the company's customers to find a different way of doing what the company does - for example, if the company supplies a unique software product that automates an important process, people may substitute by doing the process manually or by outsourcing it. If substitution is easy and substitution is viable, then this weakens the company's power.
4. Threat of New Entrants: Power is also affected by the ability of competitors to enter the company's market. If it costs little in time or money to enter the market and compete effectively, if there are few economies of scale in place, or if the company has little protection for its key technologies, then new competitors can quickly enter the market and weaken the company's position. If they have strong and durable barriers to entry, then the company can preserve a favorable position and take fair advantage of it.
5. Competitive Rivalry: What is important here is the number and capability of a company's competitors. If they have many competitors, and competitors offer equally attractive products and services, then they'll most likely have little power in the situation, because suppliers and buyers will go elsewhere if they don't get a good deal from the company. On the other hand, if no one else can do what the company does, then they can often have tremendous strength.

Porter's Five Forces



Source: *Harvard Business Review*

Secular Industry Sea Change – the "E" External Headwinds and Short Idea Generation

In the interest of brevity and maintaining some of our secret sauce as an asset manager, we will stick to the topic here – *secular change in industry, diminishing any one-time Wide Moat, lending to a fertile landscape of short prospects*. We'd be pleased to discuss the grander scope of the work we do to identify such industries poised to undergo secular industry sea change, with you directly, upon request.

Disrupted Industries – A Subset: While not a fan of the expression, *disruption*, it is perhaps the best way to talk about some of the secular changes impacting certain industries. Let's focus on two: *Consumer Staples - Food Retail* and *Consumer Discretionary - Mall Based Specialty Apparel*.

Example - Consumer Staples - Food Retail: We have done a lot of work related to supermarkets in the US and Europe. European supermarkets, in particular, faced an onslaught of hard discounters, particularly *Aldi* and *Lidl*, a few years back. The hard discounter economic model is an extremely powerful one. Efficiency ensures that low gross margins translate into strong bottom-line profit.

Cost Advantages of Supermarket Hard Discounters

	TRADITIONAL SUPERMARKET	TRADITIONAL HYPERMARKET	LOW-COST HYPERMARKET	DISCOUNTER
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold and shrink	-69.0%	-73.5%	-76.0%	-81.0%
Gross margin	31.0%	26.5%	24.0%	19.0%
Store labor cost	-13.5%	-12.5%	-8.0%	-4.0%
Central costs	-14.0%	-12.5%	-10.0%	-8.0%
EBITA[1]	3.5%	1.5%	6.0%	7.0%

1 EBITA: earnings before interest, taxes, and amortization

Source: Oliver Wyman

Once hard discounters get going in a market, they start a positive cycle: they attract customers with fantastic prices; increase sales volume and customer numbers, while reducing operating costs; and deliver enough return on capital to reinvest in the customer proposition and fund expansion.

Discounters can offer great value because they have worked closely with food manufacturers for decades. They control how their products are produced, who can produce them, and what trade-offs to make. Having entered and grown their businesses in several countries, discounters have gained the additional advantage of working with regional manufacturers who are artisanal experts, e.g., pasta from Italy, which they can sell with great provenance across their entire estate.

They have scale, too: *Aldi* and *Schwarz Group* (*Lidl*'s parent) are the number one and number two sellers of own-brand grocery products worldwide. This allows them to take a hardline approach to costs, removing every last element of cost while retaining good quality.

Discounters exploit the traditional grocers' dependence on complex product ranges. A typical supermarket will give customers a huge breadth of options within each product category: for example, think of the range of instant coffee, filtered coffee, coffee beans, and coffee capsules available in the hot drinks aisle. The lower-selling niche variants may drive a small amount of sales (and a smaller amount of profit) but will also drive up operation costs for the retailer.

In comparison, hard discounters provide perhaps just one leading brand for each category plus an own-label version at a much lower price but with much higher margins. They may not win the fraction of customers who want a decaf latte capsule for their specific coffee machine, but they will satisfy the bulk of the other coffee drinkers by stocking the main brand and impress with the quality and price of their own-brand product.

Discounters' own-brand goods are high quality, attractively packaged and a tremendous value. Established grocers, wanting to avoid enticing customers to trade down, typically compete with entry-price own-brand products. These are often of low quality and packaged unattractively to differentiate them from the store's higher-margin range, creating a wide value gap that customers readily perceive.

Then there's disruption from online food delivery services, such as *Amazon*, *Fresh Direct* (in the US) and others regionally. Not only do such competitors have the prospect of similar reach with suppliers, but they also have a fraction of the operational costs associated with physical stores and store employees. Although online shopping has long threatened bricks-and-mortar retailers in other sectors, so far it has had less impact on food retailers. But this is changing. Online grocers have already captured 6% of the market in the UK,[3]

[3] *The Future of Online Grocery*, Oliver Wyman, 2014

largely driven by online offerings from all major bricks-and-mortar players as well as a maturing offering from online-only player *Ocado*. Although online grocers currently have a smaller share of markets such as the US and Germany, they are growing steadily, and there are credible signs that major players such as *AmazonFresh* and *WalMart* are ready to invest rapidly to accelerate this growth. *AmazonFresh*, in fact, launched service in London and Paris in June. Local media reports in Australia, suggest *AmazonFresh* plans to enter that market in 2017.[4]

Lack of Moat, Secular Decline Theme - Consumer Staples-Food Retail - Woolworths Limited (AUS)

Porter's Five Forces (Woolworths Limited AUS):

1. Supplier Power - Threat to Profits-High. Local growers, independent and family farmers, broader selling relationships with new expansionist entrants, exclusivity. Australian government relaxed barriers.
2. Buyer Power - Threat to Profits-Medium/High. Buyers have increasing options given new entrants. Price, convenience, heath sensitivity, consumer messaging will drive decisions, probably in that order.
3. Substitutes - Threat to Profits-Low/Medium. Rebranded supermarkets, narrower niche boutique offerings, other branded retailer expansion into food (i.e., *Costco* now in Australia, *WalMart*, *Target* in US), farmer's markets.
4. Risks of New Entrants - Threat to Profits-High. Hard discounters present, online offerings from existing supermarket chains, new online entrants coming. Seismic shift in terrestrial retail expands supply of big box stores suited to supermarket development at cheaper entry costs.
5. Competitive Rivalry - Threat to Profits-High. Larger existing competitors with little innovation. Margins pressured by hard discounters with lower cost structures. High exit barriers given contractual real estate (store lease) costs.

We are short the equity of *Woolworths Limited* ("**WOW**") as part of our theme of secular decline in Consumer Staples-Food Retail, due to the historic margin destruction hard discounters (such as *Aldi*, *Lidl* and *Costco*) cause traditional supermarket chain operators in the regions they enter. Further, the prospect of *AmazonFresh*' launch in Australia in 2017 will pressure any terrestrial (store-based) supermarket retailer given a pure play online retailer's reduced cost structure.

WOW appears to be a mess even without secular industry change vastly diminishing any moat. In addition to the supermarkets it operates, the Company also has a home improvement chain – *Masters* – as well as a general merchandise discount retailer, *Big W*. In food and liquor, the Company has been losing market share to *Aldi* and *Costco* – neither having yet fully implemented their build out plans in Australia. **WOW** has enjoyed 8%+ EBIT margins historically. The hard discounters typically drive EBIT margins down to approximately 4%~ in the markets they enter. **WOW** management has said that they are committed to matching price to maintain market share. **WOW**'s *Masters* chain was a 67%/33% Joint Venture with *Lowes Corporation* ("LOW"). The enterprise is carried on **WOW**'s books at an AUS$1.5bn valuation. LOW had a put to **WOW** on its 33% interest in *Masters* at "fair market value" in October 2015, which it exercised. They failed to agree on price, suggesting that **WOW** more than likely offered to pay less than AUS$500mm – what is implicitly suggested by **WOW**'s carrying valuation of *Masters*. When the amount payable to LOW is made and is public, aside from cash leaving the enterprise at October 2015 fair market value, it would likely de facto cause a change in the carrying value of *Masters* on **WOW**'s balance sheet. Further, **WOW** will still need to run *Masters*, despite the tarnish, and either sell it, wind it down and shutter, or a bit of both.

[4] The New Daily, *AmazonFresh to Offer Grocery Delivery in Australia*, June 10, 2016. http://thenewdaily.com.au/money/2016/06/10/amazonfresh-australia/

Our summary of the **WOW** short thesis, articulated via Tiburon's *BRACE* Methodology, appears below:

CASE STUDY | SHORT WOOLWORTH LTD ("WOW") EQUITY

Brace: To make steady; secure against pressure or impact

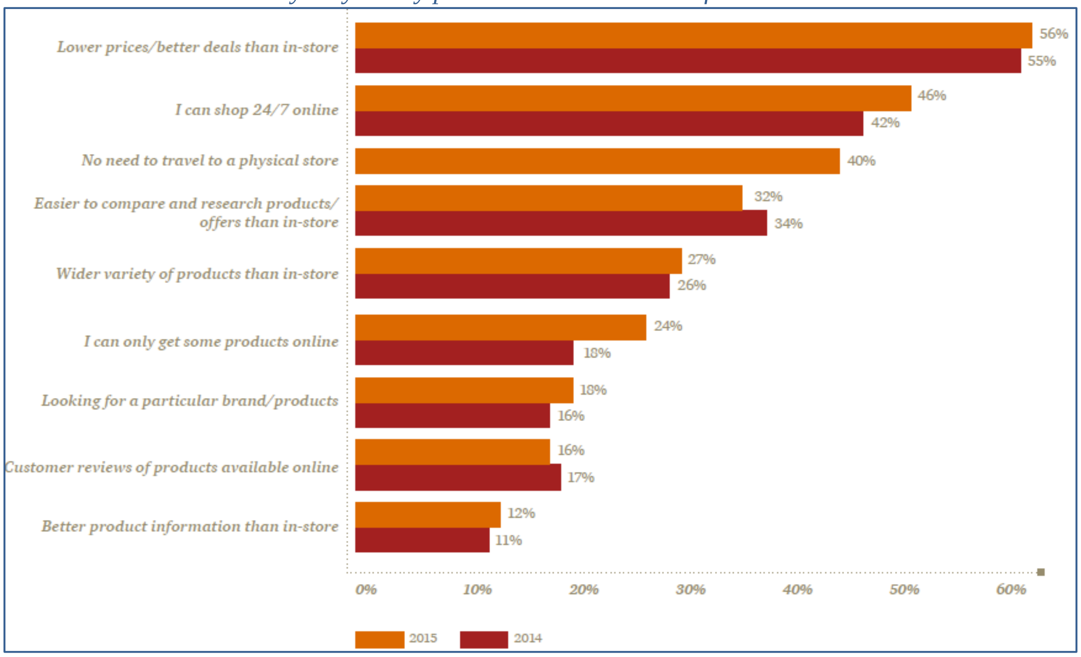
*The following case study has been selected to illustrate trade ideas. It is not known whether these specified case study will be included in the portfolio. The case study is being provided for discussion purposes only and should not be relied on as the basis for making an investment decision as the actual composition of the may vary.

- **Bottom-Up - Company & Industry Analysis**
  - Losing market share in its largest line of business (i.e. Australian Food, Liquor and Petrol) to discount supermarket chain competitors (Aldi, Costco)
    - Former Aldi executive has seen globally and expects discounter market share to ultimately shake out to ~20% or market
  - Management guiding FY 2016 Australian Food, Liquor and Petrol EBIT margins of ~5.0%
    - As has occurred when discounters entered UK market
    - Former Aldi executive has seen globally and expects full-line supermarket EBIT margins to ultimately compress to 3-4%
- **Revaluation Catalyst**
  - A payout to LOW on a put option it has in connection with its 1/3 stake in WOW's Home Improvement ("Masters") due within the next 1-2 months
  - Failure to liquidate Masters in timely and/or cost-effective basis
  - A sale of Big W (General Merchandise segment) at a price below the $1.5 billion it has been rumored
  - Failure to grow dividend and a likely decrease of dividend if margins continue to deteriorate
    - Recently cut dividend by 34%
    - Management committed to 70% dividend payout ratio
  - Further loss of supermarket market share, deteriorating EBIT margins due to aggressive discounter competition
  - Many challenges and much restructuring expected on path to less market share and lower margins
- **Actors (Interested Parties, Rational, Otherwise) Assessment**
  - Management stated plan to invest in price
    - 'Low Price Always' marketing campaign
  - Promotion of Food Group MD to CEO signals difficulty of attracting new outside talent
    - Additionally, is it optimal to rely on the individual who oversaw the demise in the first place?
- **Capital Structure Valuation**
  - Total debt of $4.5 billion (1.1x Debt/EBITDA). It has an investment grade credit rating (Baa2/BBB+), but is on negative outlook by Moody's and S&P
    - Moody's recently downgraded one-notch to Baa2 from Baa1, kept on negative outlook
- **External Assessment - Process, Technical, Legal**
  - Economic, market weakness in China. Australia derives 1/3 GDP from Chinese (commodity) trade
  - Large short interest

Example - Consumer Discretionary – Mall-Based Specialty Apparel: Physical stores remain the retail touch point with the highest frequency. More than one in three (36%) of a recent *PricewaterhouseCoopers* global sample goes to a physical store at least weekly. That is a significant difference compared to how often they shop weekly online via PC (20%), online via tablet (10%), and online via mobile phone (11%).[5] However, trend shift is palpable. The disruption coming to Mall-Based Specialty Apparel (and others) is a function of a confluence of mobile technology and social networks. Lastly, there's demographics: the 18-24-year old age cohort - this is the first group of adults to have grown up with the Internet and considerably more comfortable than older generations with say, mobile purchases vs online, online vs in-store.

Shoppers Buy Online due to Price and Convenience

Why do you buy products online instead of in stores?



Source: Global PwC 2015 Total Retail Survey

Risks to mall-based retail apparel has been a secular theme for us for a few years now - what we've dubbed a "dead man walking" theme. Retailer failures and store closures are impacting foot traffic. The failures (*Aeropostale*, *Eastern Mountain*, *Pacific Sunwear*, *Sports Authority*, *Wet Seal*, *American Apparel*, *Quicksilver*) and store closures are, in large part, due to the migration of sales from terrestrial store-based to online. With every passing day, week, month, year, consumers are increasingly comfortable with online purchase. First to get disrupted were commodity products, like smaller and then larger electronics (*Radio Shack*, *Circuit City*). As the consumer gets more at ease with the simplicity of receipt and return of product (and online sellers facilitate free returns), products once considered safely a store purchase - apparel - is next up.

Online prices can be more competitive given the lack of retail store and employee costs, however the fiercely competitive virtual marketplace competes to provide products as promptly as possible too. Shipping costs are increasingly borne by the seller. In the "virtual" mall, shelve space - visibility - is afforded only the largest, best priced and the most of the moment. Therefore, Mall-Based Specialty Apparel really must be highly differentiated by price and fashion. Apparel that is undifferentiated and commoditized is analogous to the commodity electronics once offered by *Radio Shack* and *Circuit City*.

Finally, as sales migrate online, as mentioned, visibility in the virtual mall is tough. On computer or tablet, a

[5] *Total Retail 2015: Retailers and the Age of Disruption*, PWC, February 2015

consumer might seek and find a favorite retailer site. They might even make it a "favorite" and bookmark it. However, as sales migrate online to mobile, the mobile interface is predominately an application. If the phone is the virtual mall's store front, just how many apps is a consumer going to download? *Amazon Prime*? Surely. *Uniqlo*, *Zara* – maybe. *GAP*, *Banana Republic*, *Old Navy*, *American Eagle Outfitters*, *Express*, *Abercrombie & Fitch*? You get my point.

Lack of Moat, Secular Decline Theme - Consumer Discretionary - Mall-Based Specialty Apparel – The Gap, Inc.

Porter's Five Forces (The Gap, Inc.):

1. Supplier Power - Threat to Profits-Moderate. Gap purchases private label merchandise from over 500 vendors. No single vendor is more than 3% of sales. Over 25% of purchases from China. There can be risk of transport and other disruption (think LA Ports a year ago), but this isn't really Supplier *Power*.
2. Buyer Power - Threat to Profits-Medium/High. Buyers have many options given the commodity-like nature of Gap products. Price, convenience, style all drive buyer decision-making, probably in that order.
3. Substitutes - Threat to Profits-Low/Medium. There isn't really a substitute for apparel, however, consumer dollars can flow (as they have in the last 2 years) to other goods.
4. Risks of New Entrants - Threat to Profits-High. There is little barrier to entry in the virtual world. Between direct-to-consumer online entrants, and more sophisticated, or broader reaching online retailers (*Amazon*), or overseas fast fashion market entrants (*Uniqlo*, *Zara*), commoditized apparel can get squeezed out.
5. Competitive Rivalry - Threat to Profits-High. There are many competitors in mall-based apparel retail. Industry growth is slowing while store based models are getting disrupted by online sales. High exit barriers given contractual real estate costs.

We are short the equity of *The Gap, Inc*. ("**GPS**") as part of our theme of secular decline in Consumer Discretionary – Mall-Based Specialty Apparel theme. The combination of high mall-store lease expenses, coupled with apparel shopping moving online put the sector at risk. Further, the commodity-like offering of **GPS**' products marginalize them in the mind of younger consumers. Finally, with limited virtual shelf space on a mobile device, **GPS** is likely out of sight, out of mind.

GPS operates *The Gap*, *Banana Republic* and *Old Navy* stores. The Company owns no real estate and is perhaps the largest mall-based tenant in the world, leasing over 3,700 stores. **GPS** suffers two related secular trends: They are over-stored (with concomitant lease costs with no asset value to the Company) as shopping move online from terrestrial and they offer undifferentiated, economically elastic-demand products – do you want to go into a store that looks like this for generic t-shirts, jeans, boxers or khakis?

Welcome to Old Navy

Source: Author, Old Navy Store – Fulton Street Mall, Brooklyn

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We listened to earnings calls of *The Gap, Abercrombie & Fitch, Express Inc., American Eagle Outfitters Inc.* and others in the past few weeks. All of them talked about mall traffic falling off a cliff in mid-March. All of them discussed store closures for 2016. Anecdotally, from these calls and other retailer announcements, we believe we are aware of mall-based retail apparel companies' plans for over 400 store closures for 2016 so far. This number doesn't account for unanticipated store closings and those of the bankruptcies listed above.

Our summary of the **GPS** short thesis, articulated via Tiburon's *BRACE* Methodology, appears below:

CASE STUDY | SHORT THE GAP INC. ("GPS") EQUITY

Brace: To make steady; secure against pressure or impact

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- **Bottom-Up - Company & Industry Analysis**
  - The Gap, Inc. (GPS) is a specialty retail company selling apparel and accessories under the *Gap, Banana Republic, Old Navy, Athleta*, and *Intermix* brands
  - Same-store sales continue on negative trajectory with no visible change in direction despite management comments about a better executed spring offering
    - GPS brands appear out of fashion and no longer relevant to millennial demographic (Gap brand in particular)
    - Competition intensifying from online retailers like *Amazon* and Fast Fashion competitors like *H&M, Zara* and *Uniqlo*
  - Trades at multiple of historical financial results (4.4x EV/LTM EBITDA and 9.6x P/E) reflecting declining business prospects and higher risk
- **Revaluation Catalyst**
  - Further store closures (management states that *Banana Republic and Old Navy* international footprints under review) and likely increase in lease cancellation payments and penalties
  - Decreasing gross profit margins as a consequence of continuing weak same-store sales and need for greater promotions to compete
  - Reduction in share buyback activity and dividend to preserve/improve credit rating?
  - Fast Fashion retailers' US store openings, further penetration
  - Hastened migration of consumer online; and then from desktop to mobile
- **Actors (Interested Parties, Rational, Otherwise) Assessment**
  - Executive level management departures
  - Last round of store closures by management focused on stores coming off of lease term ("gaming"), leaving underperforming stores with longer lease terms still at risk of closure in subsequent rounds
- **Capital Structure Valuation**
  - Recent credit ratings downgrades to speculative grade
- **External Assessment - Process, Technical, Legal**
  - Weak retail apparel environment
  - Disruption from online sales putting undifferentiated apparel most at risk
  - Economic and accounting exposure to foreign currency exchange risk, in particular Yen and CAD
    - "Substantially all of our foreign purchases of merchandise are negotiated and paid for in U.S. dollars"
  - Material short interest

Summary

If *Wide Moats* afford protections to value-based longs, the lack thereof leaves richly priced securities vulnerable, providing us similar protection on the short side. We are finding fertile ground for shorts in sectors undergoing *secular change*. There are many aspects of being short securities that make it more difficult to make money than outright longs. The upside is limited while the downside is not. One competes against the market's long-term positive slope, other investors, and the companies' management teams, all trying to prove a short thesis wrong. However, shorting company's securities in industries in secular decline, where such companies have vastly diminished moats and biased managements, sellside analysts and passive buy-side industry analysts slow, or unwilling to see industry sea-change, can make for attractive risk-adjusted returns when such companies more trailer park in tornado country than Castle protected by a Wide Moat.

Peter M. Lupoff **July, 2016** **Tiburon Capital Management, LLC**

Tiburon Capital Management, LLC
85 Broad Street 17th floor
New York, NY 10004
646.840.4925
www.tiburonholdings.net