Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: What Happens Next?

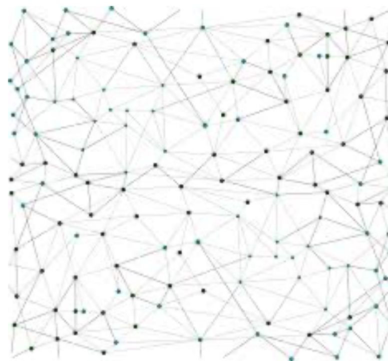
Date: 4/15/2020

This time last month we found ourselves drinking from a fire hose trying to comprehend the rapid and accelerating change our world was experiencing. I think we all will agree, a lot has happened since then.

As It Relates To The Economy

Vladimir Lenin is credited with saying; "There are decades when nothing happens; and there are weeks where decades happen." While I'm not one to often quote Marxism ideology leaders, I do believe that specific thought speaks volumes of truth for the present day.

To understand what is unfolding it helps to visualize the economy as a network connected by nodes. Each node represents relationships in the economy. Some of these relationships are between buyers and sellers, some are between employers and employees, and others are between capital providers and those in need of capital. In periods of economic distress, pressure is placed on these nodes. What is important is to keep the nodes connected for as long as possible. If the nodes stay connected, productivity can snap back allowing economic recovery to occur at a faster rate. This is why the government is adamant about flooding the system with cash.



A simple thought exercise is to think how fast layoffs occur compared to the speed it takes to recruit, hire and train a new employee. That difference between the two is the gap of lost productivity. What magnifies the effect is that our economy is so interconnected. What seems like isolated events in one sector often creates ripple effects in far unrelated sectors.

Why is this important?

Over the past month, US individual unemployment claims have soared beyond 17 million. The Oxford Economics Labor Department projects unemployment to peak at 27.9 million individuals for a collective unemployment rate of 16%, well beyond anything we experienced during the Great Recession of 2007 – 2008.

In addition, an oil price war sent crude to price levels unseen in the last 18 years. Making matters worse, storage capacity is nearly tapped out with grim hopes of bringing needed storage online fast enough to match demand. Running the math, it is possible oil could go "negative" with producers being forced to pay customers to simply take oil off their hands.

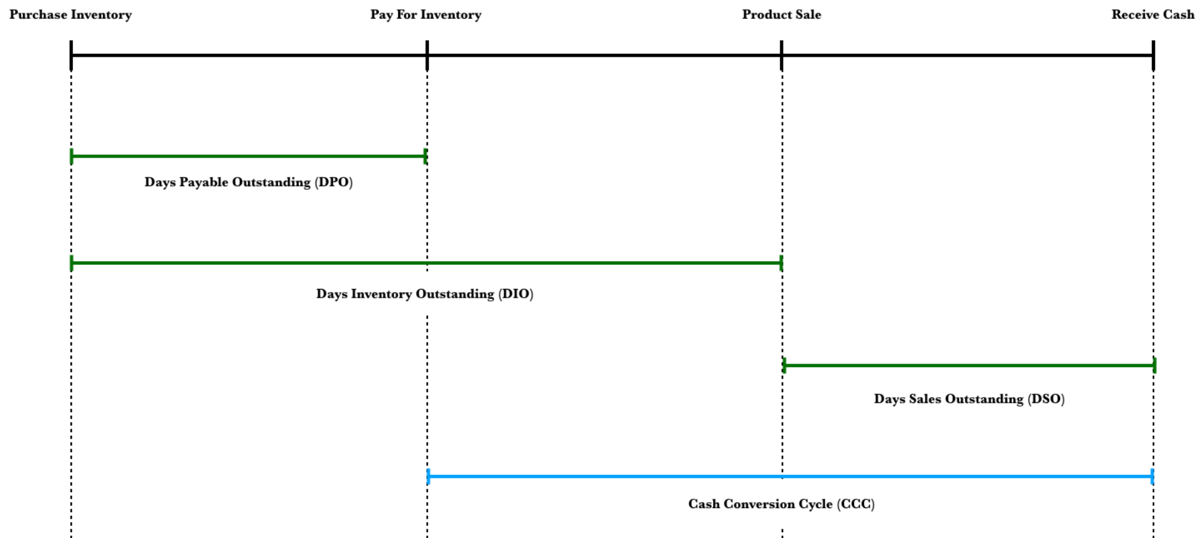
Shifting focus to America's food supply chain…what was holding strong early is now seeing splotches of vulnerability. Our food supply chains are vertically adapted, specifically designed to reach end consumers in the form

of either restaurant patrons or grocery consumers. This is creating a problem. Agricultural producers that cater to restaurants are finding few buyers for their goods. Prices for traditional restaurant items like Lobster have crashed. To add to the confusion, agricultural commodity prices are swinging widely for items more common in both restaurants and grocers. This will likely continue as food producers catering specifically to restaurants will not be able to integrate into grocery verticals, at least in the near term. This is creating an economic riddle of two markets, same commodity, different prices. More recently, rolling reports of processing facilities being taken offline have become more common. Workers in food processing plants work close together and when one case of COVID-19 is reported it can take the entire production offline. The effect of this will likely lead to supply and demand spikes at various points of supply lines. This will only magnify the volatility of overall commodity pricing.

Now remember, if we think of the economy as a collection of nodes, it is easier to understand why events in pockets of the economy are likely to spread consequences throughout. No one really knows what happens when you take a large portion of the world's largest economy offline for over a month, but it's a safe bet to assume the ripples will spread far and wide.

What's On My Mind

Cash Conversion Cycle – Everyone seems fixated on using standard months as a measurement to trace and project economic impact. I think that is slightly misleading. In my opinion a more appropriate time measurement metric is the cash conversion cycle. The cash conversion cycle helps us understand how long it takes a dollar to work its way through the business. To my recollection, the collective CCC average for US businesses is 72 days (prior to COVID-19). A logical conclusion to COVID-19 disruptions would be the collective average CCC days being forced higher. This will bring down returns generated as businesses will be slower to turnover short-term assets. I also anticipate businesses will only truly start to understand the severity of their cash crunch once they have gone through one full CCC cycle marked by the start of disruptions that began in late March.



Earnings Season – As we enter earnings season we already are hearing banks detail how they are positioning for anticipation of an extreme recession. Loan defaults have been consistent with operating environments prior to COVID-19, but that is expected this early. My attention will be focused on what we hear in terms of backlog cancelations, changes in accounts receivables and changes in accounts payable. Backlog cancelations will give us a good understanding of what was in the pipeline but has now been canceled. Account receivables will tell us the extent to which customers are delaying payments to suppliers. In addition, account payables will tell us the same equation, just further up the supply chain. And of course, I will be interested to see what the collective changes are unfolding in the cash conversion cycle.

Why I'm Optimistic

While it may seem I am all "doom and gloom," the reality could not be more to the contrary. If there is one thing history has shown us, it is that America has a knack for showing up when our backs are against the ropes. For example, at the start of World War II the production time for Liberty Ships took 365 days. By the end of World War II, production turnaround time on Liberty Ships was less than 24 hours. Dire needs push forward innovation, propelling overall productivity gains. Traditionally those gains remain in place once the catalyst situation passes. I have been amazed (but not surprised) to read about so many great companies finding ways to reinvent their operations to meet current day demands. In addition, we are seeing an acceleration of businesses adopting technology improvements to their operating infrastructure. The need to innovate was largely absent in the 2007-2008 Great Recession because the circumstances were financially oriented and did not directly pose threat to the underlying operating models. This is different. Companies that never thought they would have to figure out cloud technology solutions are figuring it out. Restaurants who never bothered incorporating online order and delivery are embracing it. These changes are occurring out of necessity but will in all likelihood create permanent productivity gains moving forward.

As to the shape of the recovery (U, V, L, W), I have no clue and I would be suspicious of anyone claiming they can tell you any better. I do think our greatest risk is a second (or third wave) of COVID-19 infection cases, similar to the Spanish Flu. This would create a need for another extended close to sectors of the economy. My intuition tells me if we can keep the majority of our "nodes" connected we will see something similar to a W, with the velocity of the recovery accelerating when a confirmed vaccine has been created. Overall my biggest worry is not surrounding the short term recovery. My biggest worry is the permanent psychological scarring a delayed recovery might create. There is a well-documented phenomenon that generations who go through severe recessions remain permanently risk averse with financial decisions throughout their career. This trickles through our economy creating less consumption, less willingness to invest in capital projects, and less overall participation in capital markets. One has to wonder, with millennials still shaken from the Great Recession, should this recession have a delayed recovery, will there be permanent psychological damage?

What I'm buying

Does it come as a surprise to hear we have been buying since the heavy selling began? Here at MCJ Capital Partners, we focus on high quality businesses selling at reasonable prices. Despite all my "exciting" talk around economics, we don't make decisions solely on macro related events. We focus on finding good companies from a bottom up approach. So when the markets turned, our "Big Board" was already full of high quality companies with strong balance sheets.

At the top of our Big Board were companies considered as multi-industry conglomerates. I have always been a fan of this type of company and plan on sharing why in future memos. As it relates to today, I think their structure offers them an unfair advantage to move and deploy capital, while single vertical businesses will be less nimble. I also believe as I stated in this memo, the ripples spreading in the economy will be far and reaching. Some industries we know are taking direct hits. Other industries have future trouble lurking in the shadows. Conglomerates operating across different verticals can weather the storm more easily as their operations are not isolated to just one industry. In the short term this will keep them solvent. Over the long term I believe this advantage will award them opportunity to pick up market share, as their single vertical competitors are preoccupied with just staying alive. This isn't the only type of business we have been buying, but it gives you a clue to how my thinking is unfolding.

To close this month's memo, I would like to share a lesson by Benjamin Graham that I was reminded of when reading an article by Wall Street Journal columnist Jason Zweig;

Forget about what the stock market is going to do. Instead, focus on what you, as an investor, ought to do….

First, determine whether you are an investor or a speculator. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. The speculator, on the other hand, cares mainly about "anticipating and profiting from market fluctuations."

If you're an investor, price fluctuations have only one significant meaning, an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal.

The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. He would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment.

The primary reason many individuals fail as long-term investors, is that they pay too much attention to what the stock market is doing currently.

Until next time,

M. Carter Johnson

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