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No Waiting Required

Evan Lorenz writes:

Netflix, Inc. (NFLX on the Nasdaq) was the best-performing FAANG (Facebook, Apple, Amazon, Netflix, Google) stock in 2018, with a total return of 39%. It is also the only FAANG to generate negative free cash flow. What follows is a connection between these facts and a collection of cheap stocks that just might excel in 2019.

Pause, for a moment, to wrap your head around a comparison between the video-streaming titan and Alliance Resource Partners, L.P., the low-cost coal miner (ARLP on the Nasdaq; *Grant's* Nov. 30, 2018). Alliance is relatively cheap at 4.3 times enterprise value to EBITDA; Netflix is absolutely not cheap at 84.6 times EV to EBITDA. Alliance shows a leverage ratio of 0.6 times debt to EBITDA, Netflix a leverage ratio of 3.1 times. Alliance pays an 11% dividend yield; Netflix pays no dividend. Yet, including dividends reinvested, ARLP delivered investors a zero-percent total return last year.

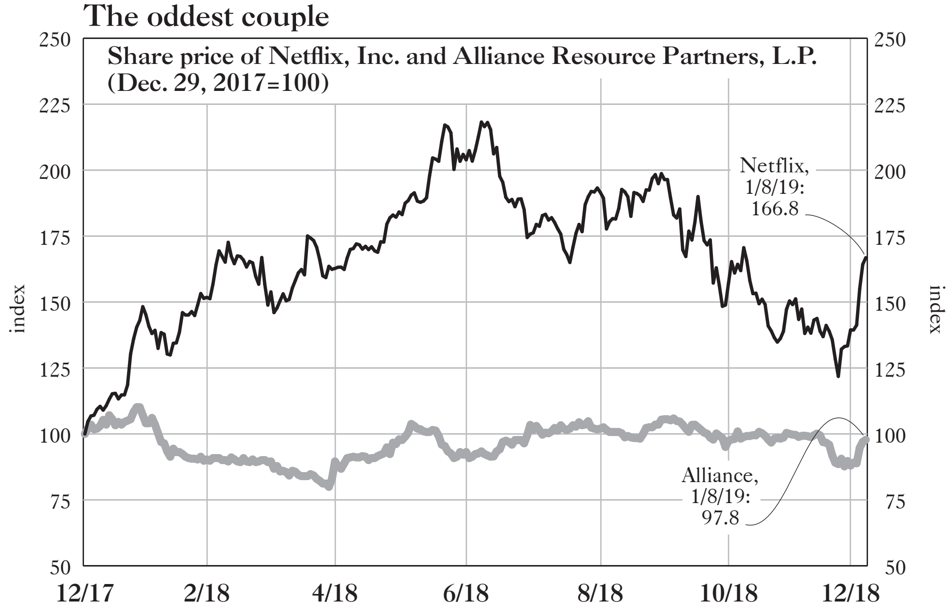
"The payoff for Netflix investors in free cash flow, should it ever occur, will be many years in the future," observe Mitch Cantor and Patricia Coronado, the husband-and-wife portfolio management team behind Mountain Lake Investment Management LLC, in their fourth-quarter letter. "By contrast, the payoff for Alliance Resources shareholders is 12% per year and growing [they wrote before this week's pop in the ARLP share price], paid every quarter. During the quantitative tightening regime, as interest rates and therefore discount rates rise, shorter duration investments like Alliance will become worth relatively more (or will fall less) compared to longer duration Netflix-type investments."

Companies that generate cash in the here and now rather than in the hazy future have one other factor in their favor: the ability to self-help. Alliance is repurchasing its shares (it bought 683,641 in the third quarter, out of a total 130 million outstanding) and investing in U.S. oil and gas royalty interests—"accelerated value creation" Cantor and Coronado call it. The duo, who manage $300 million along with their three children, count Alliance as their largest position.

Consol Energy, Inc. (CEIX on the Big Board) is a Northern Appalachian coal company that's also taking a page from the playbook of the late, great Henry Singleton, chief of the Teledyne conglomerate a generation ago (*Grant's*, Feb. 28, 2003). Today, Consol trades at 3.3 times EV to EBITDA; its net debt amounts to 1.5 times EBITDA; its third-quarter share repurchases totaled $8 million at an average price of $41.93, almost 10 dollars higher than today's price. On the Nov. 1 earnings call, CFO David Khani said the company would apply free cash flow to buying back shares and paying down debt.

In a phone call Monday, *Grant's* interrogators asked the Mountain Lake investors if the thought had occurred to them that, in coal, they are investing in the newspaper industry of energy. "It would take a massive amount of

The oddest couple



source: The Bloomberg

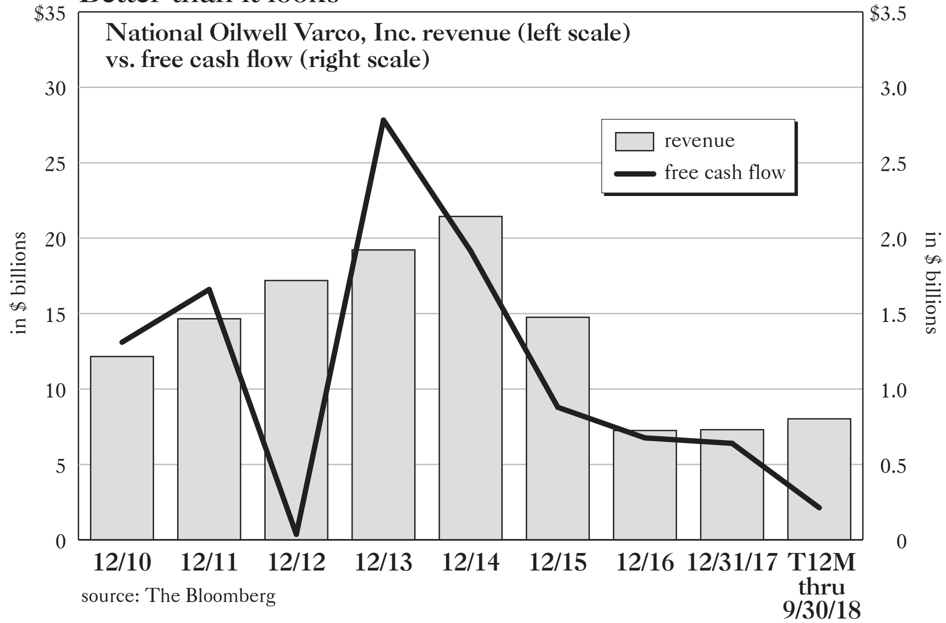
money to take us off the grid," Cantor replied. "Frankly, for the power plants that are currently in place, coal is very cheap and very competitive even with [natural] gas at $2.85 per mcf.

"We think a more likely case would be that if we're going to get off of coal over the next 30 years [there will be] limited to no new construction, and that the existing plants that are compliant will serve out their useful lives," Cantor continued. "In which case, we'll do just fine…Consol Energy bottomed in the cycle at a cash profit of $10 per ton. We think this year they are going to make $18 a ton which is what lines up with our estimate of $200 million of free cash flow for 2018 year just ended," vs. Consol's $907 million market cap.

"If you were going to say," said Cantor, when asked to name his favorite portfolio holding, "'The stock market is closed for 15-20 years, what would you buy today?' my answer would probably be National Oilwell Varco." The company (NOV on the NYSE) is a leading global manufacturer of capital equipment to the oil, gas and petrochemicals industry. More than "leading," indeed, according to Cantor and Coronado—as far as its happy customers are concerned, they contend, the ticker symbol NOV might as well signify "no other vendor."

Not that the company looks so value-laden. NOV's enterprise value trades at 17.3 times trailing EBITDA while the Street pencils in a $0.04 per share loss for 2019. However, the post-2014 break in oil prices has resulted in a corresponding collapse in the demand for oilfield equipment. From 2014 through the 12 months ended Sept. 30, 2018, NOV's sales fell to $8 billion from $21.4 billion. Yet over the past 12 months free cash flow weighed in at $213 million.

Better than it looks



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"NOV has continued to make small acquisitions capitalizing on the industry downturn and their competitive position has become even stronger," the Mountain Lake partners advise their investors. "Although almost no new equipment has been purchased by their customers in the last five years, sales and backlog have troughed. Seeing this, we acquired our stake last year. However, the fall in the oil price during the fourth quarter caused investors to conclude the recovery is another year or two away. At a valuation of under $10 billion with low financial risk, we are getting paid to wait for the eventual recovery."

The interview began with a question: "What's different about this cycle?" It ended with an afterthought which Coronado submitted by email: "I am 50 years old and I graduated from high school when Greenspan succeeded Volcker at the Fed," she wrote. "Since that time, rates have only declined (in general). One needs to be a student of history to navigate this environment."

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