

Downside Detection

Daniel Barker and Eric Almeraz of Apis Capital, Tucker Golden and Kincade Webster of Solas Capital, and Kris Medina, John Choi and Max Balzer of Medina Value Partners explain why they actively short, how their processes differ between shorts and longs, and why they're not high on the prospects for Tongwei, U.S. Physical Therapy and Jamieson Wellness.

INVESTOR INSIGHT



Apis Capital

Daniel Barker, Eric Almeraz

"There are still bubbles. There are still unscrupulous players. As we're reminded regularly, there's still irrationality."

Editors Note: When markets are hitting all-time highs, as they are today, investors almost by definition collectively see the glass half full rather than half empty for the economy, industry sectors and individual companies. To contrarians, such an environment is one where caution and an increased focus on what can go wrong might be in order. To explore that further, we spoke with experts on the subject of assessing downside, managers of dedicated long/short equity strategies Daniel Barker and Eric Almeraz of Apis Capital, Solas Capital's Tucker Golden, and Medina Value Partners' Kris Medina. They discuss the opportunity set today for short selling and identify downside potential in areas including solar energy, physical therapy clinics and vitamins.

You had been a long-only investor prior to starting Apis in 2004. Why decide to make shorting an important part of your strategy?

Daniel Barker: We thought when we started the firm that we were pretty good stock pickers but not very good at all at market timing. We focus primarily on emerging markets and small caps and wanted a strategy investing in those more volatile areas where we were comfortable with having our entire personal net worth in it. We've always tended to be net long so we will feel the impact of market direction, but we believed having a short book that allowed us to lessen drawdowns or even make money in bad years would help us outperform over long periods of time. That's turned out to be the case – every four or five years we're very happy to be shorting.

More generally, there's something to be said for just switching on that part of your brain. For me on the long side 99% of the world looks gray and I might just move on quickly when something isn't interesting. But there's value in looking more deeply at the other side of the story. Why aren't you interested, and is it possible things are bad enough that the stock could be worth a lot less? I think it's important to be positive in this business and imagine everyone's trying to make things work, but it's also helpful to maintain a healthy level of skepticism and really think through what could go wrong. I find we're more actively tuned into that when we're always looking at the short side.

There were times when I was a young analyst and I'd look at a company that was

selling, say apples, and I thought it was awesome that the margins were fantastic and the business grew so steadily. Now I'd look at that same thing and say, "That's a fraud, there's no way this business could possibly be this good." Too good to be true is a good place to start on the short side. That skeptical mindset we think makes us crisper as analysts and better fundamental investors overall.

In addition to "too good to be true," what other types of things catch your eye in potential short ideas?

DB: Anything with high leverage, high fixed costs and a declining top line is often a great place to start. We pay attention with management to bad actors, bad track records and hyperbolic language. Turnover in the C-suite, especially in more than one key position, is potentially interesting. It's the same with Board members, particularly when they serve in some sort of accounting-related capacity. I've also found ideas from time to time reading between the lines in sell-side research. We don't tend to rely on that for valuation, but a downgrade or just a "neutral" rating can signal something interesting on the short side.

Our short ideas typically fall into one of three buckets. The first we call melting ice cubes, where there's a legacy business that is facing a secular shift in demand. Old media would be a perfect example. Or movie theaters. Or publicly traded postal systems in Europe. These companies can start to look really cheap, maybe with free cash flow yields of 20%, but when your top line is shrinking and you have a lot

of debt that free cash flow can disappear very quickly. These tend to be somewhat longer-term positions – which on the short side can mean one to three years – as the secular grind plays out.

The second bucket we call battleground stocks, where you often find wild stories attached to businesses that on a fundamental basis just don't seem to make much sense. Meme stocks like GameStop would fall in this category. Speculative SPACs, many of which were tied to electric vehicles or autonomous driving or electric aircraft, fell in this category. Virgin Galactic [SPCE], which I still can't believe has any market value, is another example. These can be scary to short because they can trade wildly based on the narrative of the day, so we tend to keep these as smaller positions and typically don't hold them for long. Managing risk in these types of stocks kept them from hurting us too badly in 2021, while they ended up being down 80% as a group for us in 2022.

On a related note, we think it's too early to bet against the momentum here, but there are and will continue to be a lot of pretenders out there selling an artificial intelligence angle that probably isn't there. It will be a fruitful area to look for shorts – we've got a list ready, with 90 names on it and counting.

The third group we call broken growth, which is where the fads go. The Peloton kind of story. Hopefully we're going to wait on these for that first guidance disappointment or bad quarter. Say Peloton stock is above \$100, everything that can go their way is going their way but they're still not making money. That's probably not a good thing. On the first day they guide down or miss the stock might sell off 20%, but there tends to be a huge air pocket between what a growth investor will pay and when a value investor might step in, so that first 20% down is likely just the first of many down legs in that story. Which was the case here – the stock today is at \$3.50. Even if you shorted it at \$80 after that first profit warning, you still had a long way to go. Growth investors will always try to reinvent a reason their narrative isn't working, but they'll move

on pretty quickly if the company keeps missing numbers.

Another example of broken growth would be U.S. solar-equipment companies like SolarEdge [SEDG] or Enphase Energy [ENPH]. These were market darlings, growing like crazy with all the money being spent on solar energy and everybody loved these names at 60x earnings. Now there are 20 similar companies from China, they make fine products too and prices

ON TIMING OF SHORTS:

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in the market are collapsing. We're still there in both of these names and there are others elsewhere.

Eric Almeraz: We often find interesting thematic areas on the short side. Coming out of Covid, for example, there were an awful lot of companies that were significantly overearning, which made it a good fishing ground. Another area was commercial real estate as you looked around the world at all the companies impacted by fewer people out shopping and going into the office for work. We think it's pretty picked over at this point, but that was a fertile area.

In general, a fruitful area for the past 20 years to look on the short side has been when China decides it wants to promote a particular market, which is usually pretty bad for that market and its incumbent players. Early on it was in things like flat panel displays, televisions and computer screens, where market prices collapsed. More recently it's in areas like solar energy and electric vehicles.

China has massively incentivized its domestic production and consumption of electric vehicles, and in recent months more than 35% of new vehicles sold there were "New Energy Vehicles

[NEVs]" containing a battery to power it. Against a backdrop of a looming global trade war in NEVs, Chinese manufacturers continue to ramp production aggressively, which has squeezed joint ventures with foreign manufacturers in China that haven't kept up with aggressive domestic competition, particularly from BYD. SAIC Motor [Shanghai: 600104], for example, which controls JVs with General Motors and Volkswagen, has seen its market share drop from 19% to 11% in just four years. The willingness to flood the Chinese market with NEVs also impacts the supply chain, which has constructed far more capacity than will likely be needed as this type of production is localized worldwide. We are short a number of companies on the back of this NEV theme in China.

How do you think about position sizing on the short side?

DB: We typically have 35 or so names on the long side and maybe 100 on the short side. Position sizes also differ within the short portfolio depending on the type of idea. Because they can sometimes trade so irrationally and painfully our typical battleground idea might be only a 20-basis-point position, while for broken growth that's 30 to 40 basis points. Melting ice cubes are usually less volatile and we'll hold positions at 50 to 100 basis points.

With short names you're effectively putting less money into your best ideas as they're working. So if you still believe in them you have to feed them on the way down. When a high-flyer like SolarEdge goes from \$300 to \$180, there are lot of behavioral types of things kicking in telling you to cover. Maybe you stuck with it on the way up and now that you're finally starting to be right you want to get out when you can. If the conviction is still there, we hope to feed those rather than just let the position sizes get smaller on their own. We did that with SolarEdge but have stopped, though we still haven't covered what is now a small position.

It's a different world from the long side for us, with a lot more trading. Say a 25-basis-point position works and be-

comes smaller, but given how volatile the stock has been I'll take some money off the table and reduce the position size further to 10 basis points. If the stock goes up again and I still believe it's worth a lot less, I may take the position size back up. It's been a big winner for us, but we're still short Virgin Galactic, which in the mini meme stock craze earlier this month went from 75 cents to \$1.20. It was a tiny position, maybe 6 basis points, but that went up as the stock increased and I added more to it from there. Then the stock and the portfolio weight went down again. I think it's a zero, so we'll try to take advantage of volatility when we can.

Talk about the ongoing short opportunities you expect to come from overcapacity in the Chinese supply chain for solar energy.

EA: In trying to corner the energy transition market, China has fostered an explosion in capacity in companies serving the global solar-energy market. This is to the point where there's capacity to support 750 to 1,000 Terrawatt hours in added solar-energy generation per year, at a time when electric power production – from all sources of energy – grows at only about 600 Terrawatt hours per year. We don't think there's any way that solar-related capacity gets profitably put to work, which will likely result in continued downward pressure on prices and massive losses up and down the supply chain.

Chinese companies making things like solar modules, wafers, cells and inverters – or supplying such manufacturers with capital equipment or raw materials like polysilicon – made a windfall during the pandemic lockdowns when product prices shot upwards. That along with plenty of government encouragement caused them to pour money into capacity expansions that continue to this day, but as demand has cooled prices for raw materials like polysilicon and for solar modules in general have collapsed. We expect prices to likely remain low for a long time to come and that increasing trade protectionism will make it harder for Chinese suppliers

to flood global markets with their excess supply.

Why is Tongwei [Shanghai: 600438] a good representative example of the type of short opportunity you see related to Chinese solar energy?

EA: The company started out in 1992 in agricultural feed but expanded beyond that in 2007 into polysilicon, a key raw material used to make solar panels, for which it is now the largest global producer. They also make solar cells and other products used to deliver solar energy and

today are a pretty big company, with a total market capitalization in dollars of around \$15 billion.

As a result of the dynamics I mentioned, the price for polysilicon has gone from as high as \$40 per kilogram in 2022 to under \$6 today. Prices currently are under Tongwei's cost of production, its gross profit margins have gone from 40% to under 10%, and it is now losing roughly \$1 billion per quarter in free cash flow. Even with prices collapsing the industry continues to add capacity. They are not behaving rationally and the result is companies like Tongwei are likely to lose a lot of money

INVESTMENT SNAPSHOT

Tongwei

(Shanghai: 600438)

Business: Agricultural feed company that has expanded heavily into solar energy; now is the world's top producer of polysilicon, a primary raw material in making solar panels.

Share Information

(@5/30/24, Exchange Rate: \$1 = 7.23 Chinese Yuan):

Price	CNY 23.54
52-Week Range	CNY 21.09 – CNY 36.06
Dividend Yield	3.9%
Market Cap	CNY 105.98 billion

Financials (TTM):

Revenue	CNY 125.43 billion
Operating Profit Margin	(-0.7%)
Net Profit Margin	3.3%

Valuation Metrics

(@5/30/24):

	600438	S&P 500
P/E (TTM)	26.1	23.2
Forward P/E (Est.)	25.2	21.5

Largest Institutional Owners

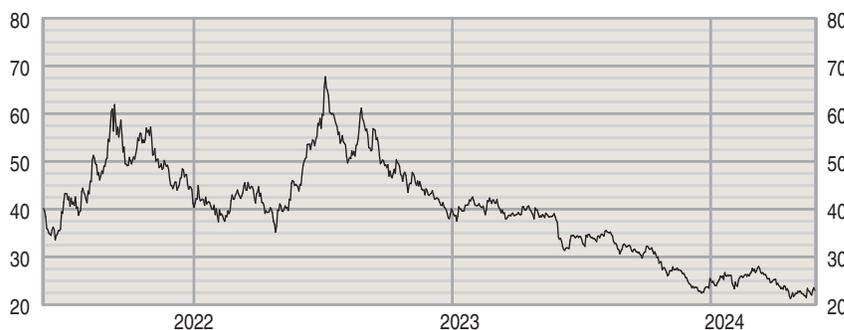
(@3/31/24 or latest filing):

Company	% Owned
Hong Kong Exch and Clearing	4.1%
Foresight Fund Mgmt	1.0%
National Council for Soc Sec	1.0%
China Merchants Fund	0.8%
China Asset Mgmt	0.7%

Short Interest (as of 5/15/24):

Shares Short/Float n/a

TONGWEI PRICE HISTORY



THE BOTTOM LINE

Out-of-control capacity expansion in the solar-energy supply chain in China will continue to result in significant losses for key raw material suppliers like Tongwei, says Eric Almeraz. If its business downturn lasts as long as he believes it can and the shares are valued where he believes they could be, the stock price would fall to the mid-single digits.

Sources: S&P Capital IQ, company reports, other publicly available information

and will probably need a lot more debt and/or equity to fund their operations. We don't think any of that bodes well for the share price.

How vulnerable do you consider the shares at today's price of around 23.50 Chinese yuan?

EA: As poorly as the company is doing right now, the sell-side community seems to be expecting a hockey-stick recovery that makes no sense to us. No one in the industry is taking capacity out and there's just not going to be enough demand to absorb it. If the downturn lasts as long as we believe it can, we could imagine the stock ultimately trading down to 0.3x to

0.5x book value, a common level you see in commodity names when there's excess capacity as far as the eye can see. That would result in a stock price in the mid-single digits.

This is a fairly broad-based theme for us and we're short a number of other companies in the sector. Those like Tongwei that have particular exposure to polysilicon include GCL Technology [HK 3800], Xinte Energy [HK: 1799] and Zhejiang Jingsheng [Shenzhen: 300316].

Are you as enthusiastic a short seller today as you were 20 years ago?

EA: The opportunity set is as good as it's ever been for shorting. Over the past 20

years look at the amount of trading that is now passive and driven by market-cap weighted algorithms. We absolutely believe that creates more mispricing, especially in the smaller-cap names we typically invest in. We'd argue there are longer tails of opportunities today on both the short and long sides.

DB: There are still bubbles. There are still unscrupulous players. As we're reminded regularly, there's still irrationality. As much as we might hope there was less of all of that, there's plenty out there to try to take advantage of on the short side. [vii](#)

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