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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Using a Non-Siloed Strategy to Find the Best Relative-Value Opportunities

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SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. Hayes: Sure. Intrepid was founded in 1995 by a father-son team, Mark and Forrest Travis. We're based in Jacksonville Beach, Florida, so kind of away from the financial market hubs, which we view as an advantage. Our goal is simple: We want to participate with the market on the upside and protect on the downside through a careful, thorough, fundamental value investing process.

We normally look to buy things when they're trading at a 20% discount or more to our estimate of intrinsic value. And we obviously spend a lot of time internally trying to figure out what that intrinsic value number is for individual securities and what degree of confidence we have in our analysis. Before any idea goes into the portfolio, it's assigned a devil's advocate whose job it is to figure out what might go wrong.

And then, on the fixed income side, which I work on, the philosophy is similar. We take both the "fixed" and the "income" part seriously, which I think is important to mention in a world of high credit risk and negative rates. We currently favor short-duration credits with cash flows that don't rely on the credit window staying open to refinance a company's debt. It's a crowded pond to fish in, but we pride ourselves in being able to find small, oftentimes unrated, off-the-run securities that are yielding materially more than credits with similar credit quality.

TWST: With the volatility in the market as we speak at the end of August, are there more people interested in some of the fixed income offerings?

Mr. Hayes: Absolutely. It's becoming very crowded. Just yesterday, I was talking to a trader who told me he has more European and Japanese buyers than he's ever seen before, and he's been doing this a long time. I think because, on both sides of the U.S., there are negative interest rates, people are searching for yield.

So a 1.5% 10-year or 2% one-month Treasury might not seem fantastic, especially since neither one really beats inflation. But to some investors, who are dealing with negative interest rates for their risk-free rate, it can be really attractive. The same goes for investment-grade and high yield securities, which are very much bid and crowded.

TWST: Do you see some people interested in defensive equities?

Mr. Hayes: Certainly. I think some of the dividend-paying equities, which have been seen as more defensive, are catching a bid, like utilities, things that are seen as holding up even if the cycle were to turn and we were to go into a recession. So dividends on a lot of these kind of stalwart companies have gone down in some cases, even below the 10-year Treasury. You have some of these companies that traded much lower earlier in the year after the December selloff that are now yielding barely anything. Then, there are companies like **AT&T** (NYSE:T) and a few others that had dividends in the higher single digits earlier this year and that have come down a bit with the price going up.

TWST: Do you want to highlight a stock that you find interesting now?

Mr. Hayes: Sure. I'll start with **Take-Two** (NASDAQ:TTWO). **Take-Two Interactive Software** is a popular

video game publisher with a wide moat, substantial growth opportunities and excellent management. The company owns or licenses the intellectual property behind some of the best-selling entertainment series of all time, including *Grand Theft Auto*, *Red Dead Redemption* and *NBA 2K*.

Investors sometimes eschew companies with a limited number of large content releases because of the inconsistency of cash flows. And although cash flow generation has been lumpy for **Take-Two** in the past, the company has steadily grown recurrent consumer spending as a percentage of net bookings over the past several years. One can think of recurrent consumer spending as the video game equivalent of same-store sales. It's basically the bookings generated for **Take-Two** from existing titles. We think that this shift will help smooth out earnings and free cash flow going forward.

Take *Grand Theft Auto*, which has sold over 110 million copies since being released in 2013, making it one of the best-selling entertainment products of all time. This nearly 6-year-old game is still one of the most played titles in the world and generated over half a billion dollars of revenue for **Take-Two** last fiscal year. If you go on Twitch, a website where you can watch people playing video games, it's one of the most consistently streamed games out there. And it's rare for video game publishers to engage players for more than a year or two, let alone six. **Take-Two** has managed to keep that title relevant by regularly releasing new content, characters and missions that gamers pay extra to access.

1-Year Daily Chart of Take-Two Interactive Software

Chart provided by www.BigCharts.com

Highlights

Hunter Hayes discusses Intrepid Capital. On the equity side, the firm uses a fundamental value investing process that seeks to participate on the upside and protect on the downside. The fixed income side has a similar philosophy. Mr. Hayes favors short-duration credits with cash flows. These securities don't rely on the credit window staying open. Mr. Hayes looks to find small, off-the-run securities that are yielding more than those with comparable credit qualities. In equities, Mr. Hayes likes to invest in things that people need to own and that he believes should do fine through the cycle. Despite value underperforming growth in recent years, Mr. Hayes is being patient and sticking to his principles.

Companies discussed: AT&T (NYSE:T); Take-Two Interactive Software (NASDAQ:TTWO); Alphabet (NASDAQ:GOOG); Apple (NASDAQ:AAPL); Amazon.com (NASDAQ:AMZN); Skechers USA (NYSE:SKX); Nike (NYSE:NKE); Under Armour (NYSE:UA) and Vistra Energy Corp. (NYSE:VST).

To put it in context, a lot of players spend an average of 100 hours or more playing just one title, like *Grand Theft Auto*. We think the barriers to entry at **Take-Two** are very high. Titles like *Grand Theft Auto V*, the most recent installment in that series, cost nearly $300 million to create. And past that initial steep entry cost, the most important input for a successful game is talented developers.

Assembling a good team takes years. Then, there's the actual time to develop the game, which for a AAA title can range from two to seven additional years. And then, there's also execution risk, as many games by first-time studios flop. Additionally, if a large company was poaching video game developers for a massive new project, it's likely that competitors would take notice. And from our conversations with **Take-Two** and others in the publishing space, there hasn't been any large-scale poaching occurring.

So we think it's more likely that **Google** (NASDAQ:GOOG) or **Apple** (NASDAQ:AAPL) or **Amazon** (NASDAQ:AMZN), someone with the scale to acquire one of these publishers, would do that rather than build out the capability to publish from the ground up. Video game publishers are expensive acquisition targets, with most deals occurring north of 20 times EBITDA. For reference, **Take-Two's** enterprise value is 18 times trailing 12-month's EBITDA today.

There's also been some concern for video game publishers around free-to-play games like **Epic's** hit sensation, *Fortnite*. We found that a lot of consumers of this content are actually new gamers and growing the pie for gaming consumption rather than redistributing it. **Epic** is actually selling **Take-Two** content through their online store and recently announced some cross-promotional efforts between *Fortnite* and *Borderlands 3*, an upcoming game **Take-Two** is publishing.

The video game space is growing rapidly; it shows no signs of slowing down. Over the past five years alone, sales for gaming software has grown at a compound annual growth rate — CAGR — in the low teens. The Entertainment Software Association estimates there are 2.4 billion gamers in the world and that 60% of Americans play video games daily, which we were surprised by. Opportunities like esports, cloud streaming and expanding broadband penetration around the world should contribute to continued growth.

Alongside that macro backdrop, there are more specific opportunities for **Take-Two**. Global expansion of the company's intellectual property, growth in the mobile category and

increased operating margins with scale are some of the low-hanging fruit. Management is superb and is led by Strauss Zelnick, an entertainment industry veteran who's been with the company since 2007, when its market cap was only around $1 billion. We think free cash flow will actually eclipse $1 billion in the next few years.

TWST: Do you think, in the sector, there might be a really interesting trend that's coming up? You mentioned mobile. Is there a new approach that we might see or a new type of game that might attract people's attention?

Mr. Hayes: Definitely. More so on the distribution of video game content. We think there are a lot of interesting things going on. Later this year, **Google** is launching Stadia, which is its video game distribution service. It's a way for gamers to access content via the cloud.

Traditionally, video games were played using a console or a PC, where the graphics were rendered locally, by whatever processor the gamer was using. With Stadia, you can go online and, through your internet connection, access **Google's** processors, their supercomputers, wherever they may be on the West Coast, or wherever's proximate to where you're gaming, and use their processors to render much better graphics that you then stream to your computer, your phone, whatever you use to game.

We think that this will massively increase the penetration of gamers. In the past, owning a console or a high-end PC has been a barrier for some gamers who couldn't afford it or just didn't have the interest. Now, you could be watching a YouTube video and see a tab at the bottom-right that says, "Play this game instantly." And boom, you're playing it instantly, streaming the game. And the technology behind that is really interesting, but that's a conversation for another day.

So with Stadia, they've announced a lineup of publishers that will be featured in the release later this year, and **Take-Two** features really prominently. *Borderlands 3*, which is kind of their blockbuster game that's coming out during this next fiscal year, will be featured in the lineup along with a **Rockstar** title, which we think may be *Grand Theft Auto*, but that hasn't been announced yet, and *NBA 2K*, which was the most meaningful contributor to earnings for **Take-Two** last fiscal quarter.

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In addition to that, yes, there are all sorts of new ways that gaming could evolve over the next few years. Mobile is really exciting and is growing in the double digits across the board. **Take-Two** has exposure to that through its **Social Point** division, which was a recently acquired studio out of Spain that develops exclusively mobile games.

And then, extended reality, which is kind of the catch-all term for virtual reality and augmented reality, offers pretty exciting opportunities. **Take-Two** does have some games that feature augmented reality and virtual reality. And we think they'll continue to expand into that category as the category becomes more accepted and people start buying more of the hardware around the category, like headsets and so on.

TWST: Do you want to mention another company?

Mr. Hayes: Sure. I'll mention **Skechers** (NYSE:SKX). **Skechers** is another one we really like on the equity side that came onto our radar late last year. **Skechers** sells shoes across the world, with over half the revenues coming from outside the U.S. That international portion grew almost 20% last quarter and really shows signs of accelerating.

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The company sells their shoes both at the wholesale level and direct-to-consumer through different store formats. The direct-to-consumer business is actually growing, despite the retail apocalypse narrative you hear on the news. Last quarter, for

instance, comparable store sales increased 4.2% in the U.S. and 6.7% internationally. Their stores are company-owned, held through joint ventures or franchised. And collectively, they have over 3,000 locations globally.

That combined with a healthy wholesale business is causing the company to grow in the high single digits. And we think they have room to expand their 10% EBIT margins after they finish building a new distribution center and continue to scale into the midteens.

1-Year Daily Chart of Skechers USA

Chart provided by www.BigCharts.com

A few years ago, **Skechers** was embroiled in a controversy around their Shape-up shoe that left a bad taste in investors' mouths. That's the shoe that Kim Kardashian endorsed during the Super Bowl commercial. Luckily, **Skechers** isn't the same concentrated company today. They're diversified across several categories, including leisure, walking, running and golf, and don't derive an overwhelming portion of their sales from any one category. Also, the most recent **Skechers** Super Bowl ad featuring Tony Romo talking about his **Skechers** slip-on shoes was a bit more our speed.

The stock has recently taken some lashings for its China exposure. Around half of the company's merchandise is manufactured there. And the distribution center I mentioned earlier is being built there. But management has said that they have a lot of levers for if/when tariffs are enacted that directly affect their business, like shifting production to Vietnam, which is not far behind China today in terms of manufacturing output for the company. In fact, management said at a recent conference that they've already shifted a significant piece of manufacturing outside of China and aren't seeing any quality-control issues.

We're closely monitoring the tariff situation, but we're also excited about the fact that **Skechers'** other international exposure is growing substantially with Western Europe, India, the Middle East and Mexico all expanding the top line in the double digits. At 8.5 times EBIT, which is a significant discount to most peers that have similar China exposure and most of which are growing less quickly, we believe the tariff risk is more than priced in and that the stock has significant upside. We also like the fact that the company has net cash on its balance sheet and basically no financial risk, which we think provides nice downside protection and the ability to be opportunistic if things get worse.

TWST: From the point of view of investors, what should they follow about Skechers, in the next year or two, to see how the company is evolving?

Mr. Hayes: Sure. Well, they do a good job disclosing growth across the segments in their earnings reports. But leading-indicator-wise, we think international growth in some of their key markets is important, some of the ones that I mentioned earlier. We think if you look at shoe sales over the past few cycles, they tend to be relatively consistent through the cycle.

We have a mantra here that our Founder is fond of saying that we like investing in beer, shoes and underwear, things that are going to do fine through the cycle, that people need to own. And when you think of **Skechers**, right, we're not talking about $600 luxury shoes. We're talking about affordable shoes that people might even tend to favor over a more expensive **Nike** (NYSE:NKE) shoe or **Under Armour** (NYSE:UA) shoe or what have you were the cycle to turn.

So some of the traditional things that one might follow when they think of consumer staple goods might not work the same way with someone like **Skechers**. But we're watching international growth. We think the tariff situation is important to monitor and, more than anything, the things the company discloses, as we think management has a good track record since the Shape-up debacle over half a decade ago.

TWST: Did you want to mention a third company?

Mr. Hayes: I mentioned earlier that we invest in debt and equity, and we like to work across the capital structure because we think that we can synergize from having people that look at both and that communicate with one another. A good example of that cross-collaboration is **Vistra Energy** (NYSE:VST). **Vistra** is a leading independent power company,

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which means it acts like a utility that generates electricity from power plants and distributes it to consumers but operates in competitive markets that are not regulated.

Vistra was actually spun out of **TXU Energy**, which was the world's largest leveraged buyout — LBO — back in 2007 and, consequently, one of the largest corporate bankruptcies in 2014. The spinout occurred in 2016, and the company immediately went public.

1-Year Daily Chart of Vistra Energy Corp.

Chart provided by www.BigCharts.com

We like **Vistra's** current 18% free cash flow yield on the equity side. A yield that high kind of implies that equity investors are treating it as if it's still part of a leveraged, cyclical and financially distressed organization. We don't think that's the case. The company's new management has emphasized an integrated business model that's reduced the volatility of the company's cash flows. The company is financially strong with net debt to EBITDA of three times and declining as the company actively pays down debt. And the company is generating so much cash that it's also repurchasing shares and recently initiated a dividend.

In addition to the equity, we also hold various **Vistra** bonds. Debt investors seem to have caught on to the change in the company's business model and financial position, now that it's no longer associated with a bankrupt parent organization, and are letting the company refinance that debt at a sub-5% rate while the equity continues to trade at almost a 20% free cash yield. Those refinancings have given us a nice premium on some of our **Vistra** debt holdings when they get taken out.

And we think of that 13% cash flow delta between the equity and the debt as a risk premium that's attractive both on an absolute basis and even more so on a relative basis. For comparison, we think the equivalent market-derived premium is around 3%, calculated as a 4.4% S&P 500 free cash flow yield and 1.5% 10-year yield.

TWST: Changing direction, as some investors are looking at fixed income products, and they might have invested heavily in equities in recent years, what would you want to remind them about fixed income?

Mr. Hayes: I would just caution against long-duration assets. If you look at a lot of fixed income funds that have had phenomenal returns this year and over the past few years, a lot of them have just been very long duration and have enjoyed kind of riding the yield curve down. If you look at the performance of the 30-year Treasury or if you look across the Atlantic, at German bonds, or I recently looked at the Austrian 100-year, which was issued a couple of years ago and has traded to almost a 0% yield and up to over 200 cents on the dollar after being issued at par, or 100 cents on the dollar, long-duration assets have massively outperformed with rates being lowered kind of unanimously across the world.

We don't think that trend lasts forever. Whether it's inflation or something else that causes rates to go up eventually, when they do, those longer-duration assets will not be a place where you want your money invested.

And we're in a yield-starved world. So a lot of fixed income managers are having to find ways to generate return that looks good and having to take on increasing amounts of risk to do so. We think a lot of that is with duration, but some of it is also with credit quality. So it's really important that whoever is managing your fixed income assets does the credit work, knows the companies well and has conviction that they can get paid back, not from the credit cycle staying open and these refinancings happening as money continues to be printed but on the company's own merits, which at some point they'll have to rely on.

TWST: We mentioned the tariff issues. If the United States and China could come to some kind of an agreement in the next six months to a year, whenever it might happen, would some of the current impact on the market work itself out? Is it the uncertainty of the whole issue that's sort of hurting things right now?

Mr. Hayes: Yes. If the tariff issue were to be resolved, we think that it's likely the equity market would respond favorably. But we think it's kind of missing the forest for the trees to just focus on the tariff issue. It's been front of mind because President Trump has tweeted about it so much and the news cycle covers it incessantly.

But we think that just focusing on what's going on domestically, the tariff issue aside and the impact of tariffs aside, we're more focused on the corporate earnings cycle, some cracks that we're starting to see form on that front. And just being long in the cycle, we think that the equity market might have a temporary bounce if the tariff issue were to be resolved. But in real economic terms, we don't know that it would have any sort of meaningful impact that could help turn around a cycle that's dying.

TWST: You mentioned how with one company it might shift some operations to Vietnam. Even without the tariff issues, is that something that might happen, where some of the operations in China might be sent — or are currently being sent — to other regions nearby in Asia?

Mr. Hayes: Absolutely. For reasons outside of tariffs too. As China growth continues to progress, we have heard from other companies that it's now becoming cheaper to source product from other Asian countries, countries like Vietnam. And yes, we think we'll continue to see that trend play out.

And with the looming threat of tariffs on the horizon, until that gets worked out, Trump is almost forcing companies to think about that because it is a liability, and any company with significant sourcing in China is getting docked for it. The stock is being discounted as a result of the China exposure. So you have to think many companies are considering moving their manufacturing operations to other countries, especially if it is getting cheaper, as we've heard from some of the companies we follow.

TWST: Is there anything we didn't talk about you'd care to bring up, either about the firm or some trends out there?

Mr. Hayes: I do think we're in an extraordinary environment. It's been a weird year, or really a weird few years, where value continues to underperform growth. We're a value shop, and we're sticking to our principles and continuing to look for things that are cheap by our estimate, and we don't think the current situation lasts forever. We think that at some point, things that generate stable cash flow and, in the case of some of our holdings, are growing nicely will shine again despite being currently out of favor. But we think we just have to be patient in this sort of environment.

TWST: Thank you. (ES)

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% of net assets of each company discussed in the interview as of 9/30/19	**Take-Two Interactive Software (TTWO)**	**Skechers (SKX)**	**Vistra Energy (VST)**
Intrepid Capital Fund - (ICMBX/ICMVX)	2.8%	3.2%	3.3%
Intrepid Endurance Fund - (ICMAX/ICMZX)	4.1%	4.1%	0.0%
Intrepid Disciplined Value Fund - (ICMCX)	2.4%	2.3%	3.6%

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