

Columbia Heights Partners, LP

Q1 2022 Update

June 6, 2022

	Columbia Heights Partners, LP	S&P 500
2019	72%	32%
2020	36%	18 %
2021	-4%	27%
Q1 2022	-8%	-5%
Annualized	25%	21%
Total Return	108%	88%

Dear Partners,

I am writing this market update as of June 6, 2022. Since November 2021, the Dow Jones, S&P 500 and Nasdaq have all traded lower.

The Nasdaq specifically is nearing a 30% drawdown.

At the lows, markets were down for 8 weeks straight which we had not seen since 1932. I do not think our economy is in as dire shape as 1932.

We surely have imbalances and areas where capital has been misallocated. This correction is a positive in that it quickly addresses the misallocation of capital in the SPAC and technology sectors. The misallocation of capital in the bond and fixed income sector may take some more time to correct depending on global demographics and the debate over deflation and inflation.

Inside the market, I am seeing individual tech stocks trade down 50-90%. Some high flying names such as Netflix, Peloton and Carvana have seen sharp drawdowns.

In addition, macro events such as a Russia/Ukraine War, China's Zero Covid Policy, supply chain back logs, US interest rates increases and a US fiscal spending contraction have put downward pressure on markets.

I believe the markets have over reacted.

One of the key debates, is whether we are in an environment of future inflation or deflation. Investors with large AUM and admirable track records are predicting both options. I am not sure who is right, but I will try to provide a view on the inflation vs. deflation question and provide some potential trades that benefit from both scenarios.

I will start with a quote from Milton Friedman:

“Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.”

-Milton Friedman

M2 Money Supply

I have done some work to look at M2 money supply since 1960.

I looked at money supply in 10 year increments. It is interesting that the 10 year CAGR varied by decade at a low near 4% per annum and 9-10% at the high end. This resulted in 10 year M2 growth ranging from 1.47x at the low end to 2.52x at the high end. The average CAGR was near 7% which is surprisingly high given that stocks tend to return 7% CAGR. The average increase is near 1.96x or 2x over 10 years.

From 2020 to 2022, M2 has increased 40%. That is surely way above trend. The question is from 2022-2030 will M2 growth rate slow to 3-4% for the next 8 years to return to trend.

2020 January M2 was 15.4 Trillion. 21.7 Trillion is the April 2022 M2. Trend would imply a 30 Trillion M2 in 2030.

Can Jerome Powell and Co control M2 to a more moderate pace from 22 Trillion to 30 Trillion over the next 8 years? And what will the side effects be?

The Case For Inflation

- 1) **Government printing of money**
- 2) Oil prices increasing
 - a. US not drilling
 - b. Food transport costs go up because of Diesel costs
 - c. US buys expensive oil from abroad
 - d. Russia War results in less supply
- 3) Demand in emerging markets for oil and other commodities

- 4) India and China middle class have increased demand for larger Carbon footprint and higher consumer per capita and GDP per capita
- 5) Government 'ESG' policies results in tighter Oil Supply
- 6) Oil companies not inclined to spend to explore
- 7) Governments propensity to interfere in the global economy increasing:
 - a. Carbon taxes
 - b. ESG
 - c. Stimulus Payments
 - d. Anti Globalization Trends
 - i. China population aging and labor costs going up
 - ii. Risk of political instability in China
 - e. 'NIMBY' policies on real estate
 - f. Oil 'windfall profits' taxes result in less oil drilling, leading to higher oil prices
- 8) Wage inflation
- 9) Politicians short term propensity to spend

The Case For Deflation

- 1) Demographics of aging societies globally
- 2) Technology Innovation and Productivity
- 3) Rising Interest Rates
- 4) 1970's inflation was caused by:
 - a. OPEC shocks consistently from 1965-1980
 - b. Nixon 'Guns and Butter'
 - c. Nixon going off Gold Standard
 - d. 15 years of inflationary policies
 - e. Large % of US Labor Force in Union
 - i. From 1983 to 2020, the % of Americans in a Union went from 20% to 10%. Down 50%!
 - ii. In addition, demographics are shifting to 'Red States' and 'Sunbelt states' where union membership is 4% range vs. 15%+ range in states like Michigan, New York, Illinois, and California
- 5) Fiscal stimulus decreases
- 6) 20+ year trend of lower fertility, aging populations, and technology innovation. Unclear if this secular trend has shifted.
- 7) China population decline
- 8) The cure to 'high commodity prices' is 'high commodity pricing'
- 9) Prices as signals still work
 - a. High prices of houses and multifamily rents will lead to developers to eventually add supply and buy cheap land and develop on it. As low ROI businesses, this margin will eventually be captured and return these 'commodity' businesses back to trend line

- b. Price signal on used cars and new cars will return to trend line. Again, prices will act as a signal and the low margin car business will remain a low margin business and eventually supply will be added by low ROI manufactures.
 - c. I find it unlikely that we remain in a permanent situation of lack of supply of cars and housing over the medium to long term
 - d. A lot of the inflation is driven by housing and car costs
 - e. Oil is the wild card and will have to assume price signals work for oil
- 10) The 'death of globalization' is exaggerated
 - 11) Remote work is 'deflationary'
 - 12) One time shock of COVID will go back to trend line. Parents will go back to work and the office once schools open back up
 - 13) US midterm election of Republicans injects fiscal discipline

Conclusion

My preference is to not make macro predictions.

Based on the above, it is clear that we have reasons to believe both narratives.

I try to focus on micro companies and not too much on macro because it is difficult to predict. I also think our companies will do well in either scenario because of an underlying technology advantage or secular shift.

I am inclined to believe we return to trend inflation over the next 8 years and the deflation narrative over the medium to long term. Or, at the very least, I do not see 'runaway inflation'.

However, in case I am wrong, it could make sense to be long volatility or a call option on oil in case Government interference in the economy results in a short-term spike in oil from \$120 to \$200-\$800 or above per barrel. I know this sounds extreme, but I am looking at 200/250 call spreads and 300 calls on oil as a 'tail hedge'. I may or may not add this trade.

The Media and CNBC

The media tends to focus on inflation and generating clicks so one needs to be careful to not pay attention to the incentives of some reporters in the media when it comes to short term reactions to news flow. I have noticed that pro inflation analysts, Federal Reserve members and other commentators tend to get the most press.

I guess it is similar to driving on the highway and the person who says "Look at that car crash!" gets more attention than the person that says "Look at that car that did not crash!"

Thought Experiment #1: British East India Company

One thought experiment I have been doing is thinking about the great companies in the 1800's, 1900's and 2000's.

My thesis is that we can maybe underestimate how big these companies can get.

It is interesting to look at companies like Standard Oil, General Motors, General Electric, TenCent and Apple that grow to be very large % of GDP in their respective markets. These companies tend to allocate capital efficiently and grow via M&A and organic growth. They also tend to spin off additional divisions.

If I look at TenCent prior to the China correction, Pony Ma had built an investment portfolio of \$100-\$300 billion from its cash on its balance sheet. To some extent, their success breeds more success because they have access to cash, deal flow and a distribution network.

Based on my research this far, the British East India Company seems to have been the largest company the world has ever seen. I am looking for the 'next' British East India Company.

Some current candidates include Tencent, Tesla and SpaceX.

I am beginning to read some books like The Anarchy by William Dalrymple and The Corporation That Changed the World: How East India Company Shaped the Modern Multinational by Nick Robins.

History on the East India Company

The joint stock company was founded in 1600 to trade in the Indian Ocean area. At its peak, the company had its own private army of around 260,000 soldiers, twice the size of the army of Britain. The company rose to account for half of the world's trade during the mid 1700's and early 1800's.

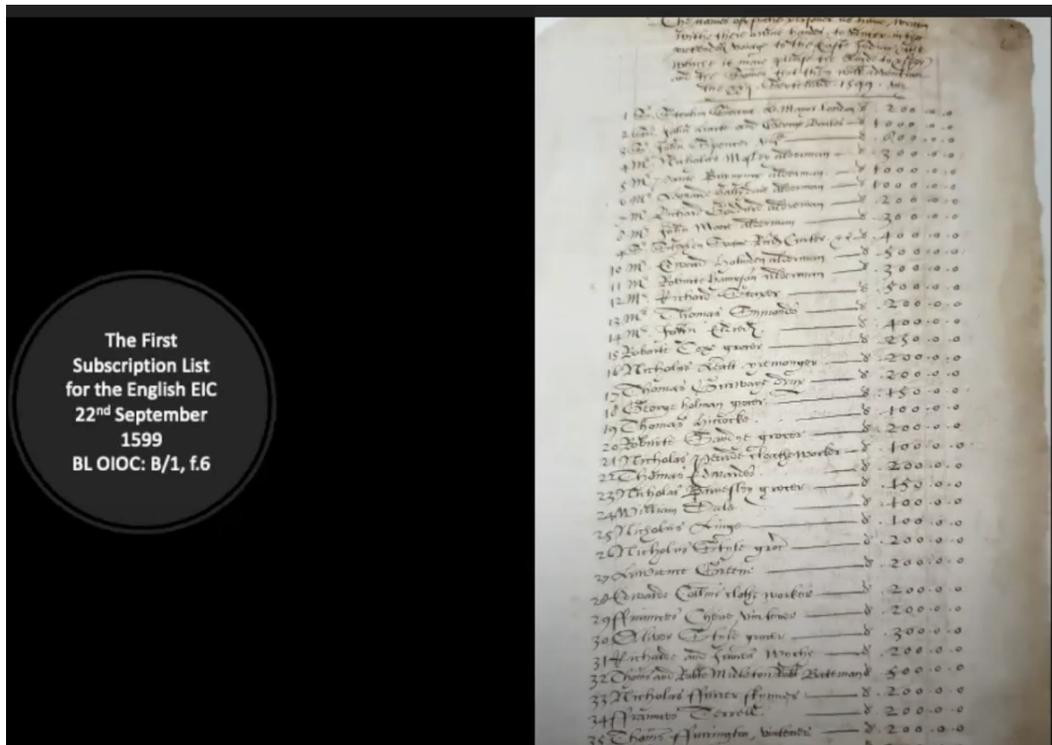
The British East India Company controlled the 3 richest provinces in India (Bengal, Bihar, Orissa) during a time when India which represented 40% of Global GDP. England during this time represented about 7% of Global GDP. It is a unique time in history when a small company on a small office block in London (Leadenhall Street) somehow manages to take over the economy and land and control of the richest country in the world. The wealth was primarily generated by the textile trade in Bengal.

It is hard to imagine a company today account for half of global trade. Global GDP is in the range of \$84 trillion and global trade is around \$19 trillion.

Half would represent revenue around \$9.5 trillion. For context, the largest revenue company today is Wal Mart at \$575 billion.

I am not sure any of the companies I hold will ever get this big, but it is just important to be reminded that companies can become much larger than we imagine, and their natural momentum can carry them over multiple decades. Tesla is certainly a candidate for this type of compounding, but only time will tell.

The first subscription list of the East India Company:



Thought Experiment #2: The art of stealing margin and “Tesla drinks Mary Barra’s Milk Shake”

The above is a somewhat provocative title, but as I have described in previous letters, company margins and return on equity tend to move down over time as competition enters a market. Capitalism and Darwinian Evolution are designed to solve for the most efficient solutions.

In the 2007 movie ‘There Will Be Blood’ starring Daniel Day Lewis, Lewis plays an oilman on a ruthless quest for wealth during Southern California’s oil boom in the late 19th and early 20th centuries.

In the final scene, Lewis’ famous line “I drink your milkshake!” is used to describe the process of oil drilling below his neighbor’s land.

This analogous to capitalism where companies in all sectors compete for margin. Companies in any sector have to ruthlessly protect their margin.

The incumbent auto companies have become accustomed to not innovating and in a classic incumbent's or 'innovators dilemma', they are in the process of being displaced by a younger, nimbler competitor in Elon Musk and his team at Tesla.

When Ford and General Motors were at their prime in the 1900-1950 time frame, they eliminated margin from other alternatives and opened up the American suburban lifestyle.

Tesla is redesigning the car manufacturing process to remove margin points and inefficiencies in the car industry. Elon has recently described the incumbent companies as more 'assembly' firms that outsource most of their components and have no true unique competitive or technology edge. Tesla has vertically integrated the process to build the car and added many layers of technology edge in manufacturing, process, robotic and potentially artificial intelligence.

Even though we are very early in the growth of Tesla's revenue trajectory, Tesla is already producing Gross Margins in excess of 30% and EBITDA margins in excess of 25%. This is before Tesla has really scaled.

Tesla Update

Tesla has now reopened the Shanghai Factory and with 2 full time shifts is doing 2,600 cars a day. A recent rumor has also suggested a 3rd shift being added at Shanghai.

2 shifts is 18.2k cars a week and almost 946k cars a year. That translates to revenue approaching \$60 billion and EBITDA near \$15 billion. This Shanghai factory will also be doubling its capacity. At a 20x Multiple of the \$15-\$30 billion EBITDA potential, the implied valuation is \$600 billion – for the Shanghai Factory alone. The market cap of Tesla recently traded near \$600 billion. This would also imply only 2 million cars per year in a country with 1 billion people.

That also implies that the market is ascribing no value to Berlin, California and Texas factories! These are markets that are almost 50% of Global GDP! The market is also putting no value on the energy business, solar business, energy trading business, Full Self Driving Software Stack, AI research team, DOJO super computer and many other internal Tesla research projects.

The Austin Factory and Berlin Factory are now open. Based on my projections the company could be doing 800-1 million cars a quarter by next year after all 4 factories have ramped. At 3.2 million to 4 million car run rate in 2024-2025, revenue could approach \$240 billion.

Tesla's capital expenditures per car when they started were \$80,000 per car. That number is now down to \$8,000. Projections have that number going to \$2,000 per car.

If Tesla makes \$10-\$20k of margin per car in Year 1, that is a 5-10x ROI in Year 1!
Putting a 10x multiple on the \$20k implies a 100x ROI for Tesla on any capital spent.

When you find a company that can deploy capital and make 100x its investment, my suggestion is to buy and hold tight through the volatility.

Also, per my thought experiment, if anyone could compete and capture this 100x ROI, they would all enter and try. Believe me, the incumbents and the clown show that are Nikola, Rivian and the other EV SPACS are trying their hardest. So far, they have not made any meaningful progress. One recent anecdotal example was a Ford software update that could only be done at the dealership and took 3 days for an over the air software update.

I believe it will be impossible for Traditional Auto to compete. Tesla's innovative rise reminds me of when Apple is able to ship via software a new camera update or GPS mapping update for \$0 vs the competition requiring a \$100-\$500 hardware update. The incumbents cannot compete.

If these themes can continue across technology and software, we may possibly be entering an age of abundance.

I will provide some context and update on some current fund positions below. To say the least, some are screaming bargains.

Position 1

Position company 1 has an enterprise value of \$2 billion. Net Cash is \$2 billion.

Q1 numbers were quite strong with EBITDA of \$150 million. Company could do \$20 billion on Revenue and \$1 billion of EBITDA in 2022. The implied multiple is 0.1x EV/Revenue and 2x EBITDA. Annual growth is 50-100%.

Company generates positive cash flow and has minimal capital expenditures.

Position 2

The company is in the advertising sector and selling between 2-3x EV/EBITDA. Company has started a buyback for 5-10% of the outstanding stock. Market cap is \$1 billion, cash on hand is \$400m and debt is 0. EBITDA run rate is \$150-\$200 million and growing 15-25% per year. Company has minimal capital expense and high free cash flow conversion.

Position 3

Position 3 sells for 20x EV/EBITDA, is in a duopoly business with a 100 year track record, is buying back \$15 billion of stock and growing EPS 15-25% per year.

Position 4

Position 4 sells for 20x EV/EBITDA, is in a duopoly business with a 100 year track record and growing EPS 10-15% per year.

Position 5

Position 6 sells for 9.6x 2024 EV/EBITDA and is growing 50% per year with 5-10 years of runway at scale.

Gorav Khanna
Managing Partner
Columbia Heights Partners, LP