

GameStop and Chesapeake Energy: A Tale of Two Very Different Distress Stories



By [George Schultze](#)

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To the surprise of many, the broad markets enjoyed a rapid recovery from last March's COVID-induced lows and have continued to rally in 2021. But, as the frenetic activity around the heavily distressed GameStop and AMC stocks helped demonstrate, the outlook for the rest of 2021 looks more uncertain. We can see numerous signs of asset bubbles with some investments trading at peak levels despite uncertain fundamentals. Much of this speculative ferment is due to the most extensive monetary and fiscal policies we've ever seen. There's no doubt that these measures were needed to keep the economy afloat during a terrifying pandemic, but eventually, the bill for all this spending will come due and the subsequent return to normal will be choppy at best.

With that in mind, it might prove interesting to compare what's happened to the stock of two vastly different companies that entered 2021 in distress: GameStop (ticker: GME) and Chesapeake Energy (ticker: CHKAQ). GameStop as we all know is a brick-and-mortar retailer of new and used video gaming consoles and accessories. In early January, GME was trading at <\$20/share, while CHKAQ was trading at about one-tenth of that price. Over the next few weeks, due to individual investors egged on by the WallStreetBets subgroup on Reddit, GME kept climbing to \$483/share. In roughly the same period, CHKAQ climbed to over \$5.50 as the company prepared to emerge from bankruptcy. However, CHKAQ was finally delisted and extinguished entirely on February 10, making all outstanding CHKAQ shares worthless! On that same date, GME was still trading at about \$50.

The big difference here is that one firm, Chesapeake, has emerged from bankruptcy after eliminating \$7.8 billion in debt with newly issued stock going to creditors. The company, which was once the second-largest U.S. producer of natural gas, will refocus its efforts in that sector. In its reorganization, Chesapeake renegotiated its marketing and midstream contracts, reducing overall cash costs/boe (barrel of oil equivalent) by 40%. Going forward, it will therefore likely soon earn an investment-grade credit rating due to strong expected cash flows and a substantially reduced cost structure. It seems likely that Chesapeake's new board will approve a stock repurchase program and that these catalysts should help drive its new common stock up towards fair value.

GameStop is an entirely different story. It's an old-style brick-and-mortar retailer being squeezed by the same forces facing all such businesses—competition on price and convenience from online retailers, expensive leases, and a lack of customer traffic due to COVID, to name a few. Realistically, it would be extremely difficult for a business like GameStop to ever bounce back which is why it seemed like such an

attractive short. The meteoric rise in its stock will likely become a textbook example of a bubble and, although it has so far avoided Chapter 11, it seems unlikely that it'll remain viable long term.

What happened with GameStop, AMC Entertainment and a few other names might be considered indicative of a new investor populism since it was a grassroots movement among amateur investors, some of whom made out quite well. This dynamic is driving what are being called "meme stocks." These are stocks issued by companies that are getting tremendous retail investor recognition while other firms with outstanding long-term fundamentals are getting ignored.

Meme stocks are mainly companies with very little revenue but exciting and interesting growth ideas. An analyst at Barclays recently reported that GM is finally getting a meme-type valuation because it's been getting so much press talking about the potential for flying cars and fully autonomously driven vehicles, even though they don't yet have any sales of either one. GM stock is benefiting nonetheless – last March, it was trading at \$16.80/share but has since appreciated to almost \$57/share perhaps in part due to its new meme-type retail investor recognition.

In sharp contrast with meme stocks are companies with long operating histories but mostly tied to the old economy. For example, Tesla vs. GM and all the other legacy automakers. Tesla's stock price headed for the stratosphere over the last several years while GM and its legacy peers were simply ignored until recently as they finally began to invest billions in meme-worthy new economy ventures.

Another sector where you can see this dichotomy is by contrasting Caesar's Entertainment (ticker: CZR) and Draft Kings (ticker: DKNK) in the gambling space.

Caesar's is one of the largest U.S. casino firms and, although it may be a little late to the game, it's starting to invest heavily in online gaming. It recently bought a stake in Superdraft, a fantasy sports online platform. Additionally, in September it agreed to acquire online bookmaker William Hill for \$3.7 billion. And while Caesars is currently finding favor among analysts, it still isn't trading anywhere near the meme-type multiple that Draft Kings gets from Mr. Market. In fact, Caesars' total market capitalization is only about \$16 billion while Draft Kings' is closer to \$24 billion.

It seems the market is quite willing to give the benefit of the doubt to a disruptive, new economy company like Draft Kings because equity investors are willing to pay for growth. But it's very difficult to successfully value a business like that. On the other hand, Caesars is a multi-billion dollar revenue business that steadily generates billions of dollars in free cash flow. That means an analyst can much more easily prepare a DCF valuation model on Caesars. He can reasonably conclude that Caesars will generate a certain amount of continuing cash flow which can be discounted back to the present value using a sensible discount rate. But, with a company like Draft Kings which may have a great new idea but doesn't yet have that much in the way of revenues and cash flow, it's much more difficult to come up with a viable valuation model. There are too many unknowns that would require wide leaps of assumptions about future market size and share based on unproven tangible data. Fortunately, an astute investor may employ additional tools, such as a careful assessment of management, to assist in gauging the likelihood of success with early-stage companies.

Super-high growth companies with unproven business models are all the rage right now, much as they were during the dot.com bubble. In contrast, businesses that have survived through multiple economic cycles are often neglected. The lesson that many of these new populist investors may not have learned yet is that not every great new idea will become the next Tesla, Microsoft, or Amazon. Another hard-learned lesson likely to come out of this is that all bubbles eventually burst and deflate.

As the number of Americans vaccinated against COVID grows, the U.S. economy should continue its recovery in 2021 and the market will likely continue upwards. Nevertheless, many firms are finding that the climate has changed dramatically and those with too much leverage are finding themselves in a considerably worse situation. And although the GameStop debacle may have scared away investors afraid of being caught in a short squeeze, it doesn't mean that there aren't great opportunities available on the short side. Similarly, while many super-high growth companies will fail, it is possible to find diamonds in the rough if you know what you're doing, and some of these might become excellent acquisitions by SPACs or otherwise.