Forbes

Are the Apes Now Running Wall Street?

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June 15, 2021

These are strange times to be an investor. It's become obvious over the last few years that facts don't matter in politics and now it looks like the same thing is happening in the investment world. Participating in equity markets has always entailed some risk, but historically, if one performed careful research, paying attention to fundamentals, a rational investment strategy could be devised. Not so with meme stocks, the latest monkey wrench thrown into the grooved gears of Wall Street.

Consider AMC Entertainment (AMC), which was recently on the verge of bankruptcy, now has a market capitalization (including net debt and lease liabilities) of over $41 billion. With 950 locations, that works out to over $43 million/theater, but AMC doesn't own most of those. It leases them from landlords.

Not willing to let this temporary opportunity pass them by, AMC management decided to take advantage of its meteoric share price by announcing plans to sell up to 11.6 million new shares. What was most interesting in the SEC filing for the offering was this caveat: "...volatility in our stock is caused...by a 'short squeeze' in which coordinated trading activity causes a spike in the market price...investors [who] purchase at inflated prices unrelated to our financial performance and prospects...may thereafter suffer substantial losses... once the...short-covering...has abated." There's always a warning that an investment entails risk but I don't think I've ever seen a statement like this. It's almost like saying "This stock will drop once the squeeze is over."

It's also been added to the Russell 2000 Index and will be the top-weighted stock when the index rebalances on June 25. At their size, AMC and its fellow meme stock GameStop can now move the index either up or down dramatically in any given day.

I listened to AMC's first quarter investor call where Adam Aron, the CEO, talked about how investor relations weren't a big deal in the past. Now, he said he has 3.2 million retail shareholders who own 80% of AMC so he's taken to Twitter to communicate with them. He noted in a nod to the Reddit and Robin Hood crowd, who refer to themselves as "ape" investors, that AMC will donate $50,000 to the Dian Fossey Gorilla Fund. So now we've gotten to the point where a firm is going to spend shareholder money to acknowledge a joke term for what these unsophisticated, momentum investors are calling themselves. Strange times indeed.

It is clear that there's currently an overabundance of capital chasing a dearth of ideas. With casinos closed for so long due to Covid, zero commission trades and apps like Robin Hood have made it easy for speculators to move stocks. But unfortunately, just like gambling in a casino, there will be a few big winners but many, many more players who lose their stakes. As the saying goes, "the house always wins."

It's getting so there are new examples everyday where an online group agrees to target a stock and drives it up to absurd levels before it drops 20-30% or more in a few hours. It seems that participants in these online forums are posting notes with suggestions like "let's drive up [insert company name] today" and then it happens. These groups seem to be acting in concert to manipulate the market by forcing short sellers to cover their resulting losses. It's just as sinister as the old penny stock "pump and dump" schemes where boiler room operators would cold call to bump up a stock price and then quickly cash out leaving suckers holding the bag. The underlying principle is the same, it's just a lot easier to do now. And maybe some of it is driven by bots. Certainly, none of this frenetic activity has anything to do with fundamentals.

For AMC to have a valuation of $41 billion, or Hometown International, which consists of a single sandwich shop with $35,000 in sales over the last two years, to be valued at $100 million, just doesn't make any sense. This is a temporary phenomenon, and the market will eventually return to some semblance of reality.

There have been other bubbles in the past, from tulip mania in the 1600s, Britain's South Sea bubble in the 1700s on through the dot.com and real estate housing bubbles of this century. Right now, we have a continuing bubble in fixed income securities, with $14 trillion of negative yielding government debt, as well as this meme stock bubble.

As we've said numerous times in this space, the worst positioned companies are those with negative cash flows and near-term debt maturities. For instance, GTT, another recent favorite of the Reddit crowd, is a telecommunications company that's facing bankruptcy. It still trades on the NYSE despite not having issued public financials for over a year. It currently trades at around $2.50/share, down from $4 a few days ago. But management's latest plan is to wipe out their shareholders entirely. GTT bonds, which are senior to equity, trade at just 12 cents on the dollar. So, somebody is going to lose their investment and it will likely be shareholders.

There are some companies that are meme stocks, which might be interesting opportunities. But for most, it seems like just a matter of luck as was the case with AMC. As a meme stock, even though its fundamentals were terrible, management was able to issue new stock and dramatically boost shares outstanding. Like a self-fulfilling prophesy, it was nearly bankrupt and then people bid it up like crazy, allowing management to sell more stock and all of a sudden, it has $2 billion of cash and the crisis is over. That may allow the company to avoid bankruptcy, but original shareholders have been diluted heavily and the company still has negative cash flows. Even in a peak year before Covid, AMC had less than $1 billion in free cash flow which compares unfavorably with its current $41 billion valuation.

Post-Covid, there is surely pent-up demand to return to movie theaters. But, in the interim, there's been a massive secular change. People with big screen HD TVs at home are bingeing on Netflix or watching new movies on Disney+ and HBO Max at the same time they hit movie theaters. Many theater fans will return but not enough to support a $41 billion valuation.

No one can predict at this point how this will all play out, but investors would be wise to be very careful in trying to tame this gorilla. It's a strange time to be an investor, but over time fundamentals will come back into play and the markets will revert to rational behavior. In the meantime, investors would be wise to be cautious when trying to benefit from meme mania.