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Unconventional Ideas May Yield Better Returns

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Investors should regularly look for an edge that will give them an advantage in a relatively efficient marketplace, and that's especially true for those who want to beat the market during these highly unusual economic times.

Interest rates are as low as they've ever been, with current benchmark Fed funds rates at just 0.25%. Separately, it looks like inflation is no longer just a risk but now an unfortunate reality. The Bureau of Labor Statistics reports that prices rose 6.2% in October, the largest annual increase since 1990, driven by supply chain and labor shortages as well as higher energy prices. Gasoline prices are up almost 50% from a year ago, with the national average at ~$3.50/gallon. And it's not just gasoline. Most commodities have rallied over the last year as well.

Looking at all these signs, it seems obvious that there's really no place to go but higher for interest rates. At the beginning of the month, growth in the U.S. GDP was ~6.7%, with the unemployment rate approximating 4.8%. High-yield debt default rates have plummeted to record lows, due to massive governmental support in response to COVID.

Fortunately, the economy has recovered, although not fully. The government certainly did the right thing by providing fiscal and monetary support, but a lot of that stimulus seems to be going on well past its needed timeframe. And with that, we're seeing significantly higher inflation as shown in the most recent figures.

And while default rates have dropped significantly due to massive fiscal and monetary stimuli, we see outstanding investment ideas among previously distressed companies. This "post-distress" equity opportunity includes both public and private companies.

We can use numerous companies to illustrate what happens to those that have successfully come out on the other side of distress. Two of these are Alpha Metallurgical Resources' post-distress stock (NYSE: AMR) and Chesapeake Energy Corp's post-distress stock (NASDAQ: CHK), both of which have benefited considerably from the upturn in commodity prices.

AMR is a metallurgical ("met") coal miner that emerged from a reorganization in 2016 after eliminating ~$7.8 billion in debt. In 2018, its predecessors merged to form the largest U.S. met coal producer.

Besides benefiting from a clean balance sheet, it also owns substantial tax assets (~$1.7 billion), which will offset future cash taxes for many years. Going forward, most industry analysts forecast that met coal prices will continue to rally. On the cost side, AMR management lowered its costs (by ~$20/ton) via headcount reductions, increased productivity, and by replacing certain high-cost mines with lower-cost alternatives. During Q3, they succeeded in reducing long-term debt and legacy liabilities by over $75 million. Despite these accomplishments, as well as the company's advantageous positioning with increasing demand for steel, AMR trades at only 1.55x TEV/EBITDA 2022.

CHK, on the other hand, is a low-cost natural gas exploration and production firm. One of the largest E&P companies in the U.S., it holds interests in world-class natural gas resources in Pennsylvania, Louisiana, Texas, and Wyoming. It emerged from bankruptcy in February 2021, simultaneously eliminating ~$8 billion in debt. The restructured company has a strong balance sheet built to generate sustainable free cash flow, a disciplined capital reinvestment strategy, and a commitment to ESG excellence. CHK's management projects ~$3 billion of free cash flow over the next five years and plans to maintain the company's balance sheet strength (under 1.0x leverage.) Even so, strong free cash flow allowed them to launch a new $1.375/share initial dividend.

During Q3, CHK management announced a transformative acquisition to acquire Vine Energy (NYSE: VEI). The deal, which was at a zero premium, was immediately accretive to free cash flow and added ~370 premium locations in the Haynesville basin with a >50% ROR at $2.50/MBTU gas. Notably, the Haynesville is a critical supply source of natural gas to the important and growing liquified natural gas export market. Finally, management expects the combined company to realize ~$50 million in annual cost savings since the two firms already operated right next to each other.

Separately, CHK management also announced an important new capital allocation framework to accelerate cash distributions to stockholders. The company already had a $1.375/share annualized dividend, as noted above. Post-closing of the Vine acquisition, this increased by 27% to $1.75/share. Additionally, they also initiated a new variable dividend, which will distribute 50% of all quarterly free cash flow to shareholders. This exciting new dividend catalyst was the primary event that spurred CHK stock to rally during and after Q3. However, at 3.13x pro forma TEV/2022 EBITDA, the stock indeed remains cheap.

In the above-cited examples of companies that recently emerged from distress, both are commodity firms positioned to do well given current macroeconomic inflationary trends. Looking into 2022, there will be many more opportunities in event-driven and distressed investing due to (a) massive issuance of low-quality debt and (b) rising interest rates. We're already seeing signs of potential opportunity among Chinese real estate firms. On the other end of restructuring, after companies emerge from distress, sometimes they're publicly traded, and sometimes they're private. Thus, a flexible approach among these two types of investments can double the opportunity set.

The current market is highly unusual with interest rates so low, inflation rising, and markets near record highs post-COVID shutdowns. As a distressed investor for nearly 30 years, I know that different times in the economic business cycle often present unique opportunities across different sectors. These can be very rewarding if you're patient and work with the right specialist to find and capitalize on these investments. However, it is important to keep in mind that distressed investing is a highly specialized strategy and not recommended for the inexperienced investor.