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BELOW CASH

FINDING OPPORTUNITIES IN COMPANIES WORTH LESS THAN THEIR NET CASH

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PAST

The market often presents an opportunity for investors to purchase shares in a company valued less than its net cash value (cash and cash equivalents minus total debt). From a book value lens, these companies could potentially be undervalued relative to the market capitalisation should they be liquidated.

Of the 29,508 listed companies with a market capitalisation above $50 million, 300 companies (excludes banks and insurers) are currently worth less than their net cash position, thus, have a negative enterprise value. Academic value investors will assume that simply spotting these companies can guarantee strong returns, but this is far from reality.

Among the 91 current publicly listed companies that traded below their net cash value five years ago (15th February 2018), 45 companies (or 49.5%) returned less than 0% in the following five years, while 12 companies (or 13.2%) returned less than -50%. The MSCI ACWI Index, on the other hand, returned 40.3% during the five years. Simply buying "cheap" companies without some form of analysis doesn’t guarantee great returns.

There are a few reasons that contributed to their woeful performance:

- Profitability: 20 of the 45 companies were operationally unprofitable in the following three calendar years. An example were the loss-making clinical-stage healthcare companies like Aravive in cancer therapeutics.
- Earnings: Only 12 of the 45 companies grew their EBIT in the following five years.
- Misalignment: Companies like Hengdeli Holdings, listed in Hong Kong, had misaligned interests between insiders and shareholders, which affected shareholder value creation.

> “49.5% of the companies valued below their net cash five years ago returned less than 0% in the following years.”

On the other hand, some companies delivered good returns among these negative enterprise value companies from five years ago. Among the 91 companies, 25 (or 27.5%) doubled in share price. Comparing this to the broader market, just 12.6% of publicly listed companies doubled in share price during the same period, which shows **some potential in these below net cash companies.**

We can attribute their performance to some of these reasons:

- Profitability: 15 of 25 companies were profitable in the following three calendar years. Intelligent Digital Integrated Security (IDIS), listed in South Korea which returned 221% in the five years, saw its EBIT margin expand from 0.2% in 2018 to 8.9% in 2021.
- Growing earnings: 10 of the 25 companies grew their EBIT by over 10% CAGR in the following years after 2018.
- Share buybacks: 14 of 25 companies took advantage of their low valuations and repurchased their shares. Daidong Electronics, which is still valued below its net cash value, has seen its share price appreciate by 153% since it announced its share buyback plan in March 2020.

TODAY

Exploring the list of companies valued below their net cash has benefits for investors beyond just being an idea bank of investment opportunities. We also realised that **during periods of heightened fear, the number of companies below their net cash typically increases**. For example, at the depths of the financial crisis, the percentage of listed companies valued below cash was 1.10%. Within two years, after the market had rallied by over 70%, this had fallen to 0.75%.

If we look at the Covid-19 induced decline in March 2020, again, the number of listed companies valued below their net cash was 1.18%. Within a year, just as the exuberance in markets began peaking, the number had fallen to 0.54%. Generally, we have noticed that when more than 1% of all listed companies globally are valued below their net cash, it could signal excessive fear or potentially attractive investment cases. Today, this value is at 1.12%, which indicates favourable conditions for searching for bargains.

> “We have noticed that when more than 1% of all globally listed companies is valued below their net cash, there’s likely excessive fear and potentially attractive investment cases.”

We wanted to understand where these potential bargains were from and analysed the dataset, which pointed to two interesting areas;

- 23.7% of all companies valued below their net cash are Chinese companies which is overweight China’s representation across global markets by number of listings. Two years ago, China represented 14.5% of the listed companies valued below their net cash.
- Healthcare represents 35.6% of all companies below their net cash despite representing just 9.6% of global market listings. Two years ago, healthcare companies represented just 4.6% of all companies valued below their net cash by the market.

China

Given how much negativity markets have priced in Chinese equities, we weren't surprised to see the increase and overrepresentation of China in the net cash dataset. Over the past two years, the MSCI China index has underperformed the broader market and currently trades at a forward P/E of 11.3x compared to 15.5x in the MSCI ACWI. The difference is more striking on a book value basis; the MSCI China index is at 1.51x versus the broader index at 2.61x.

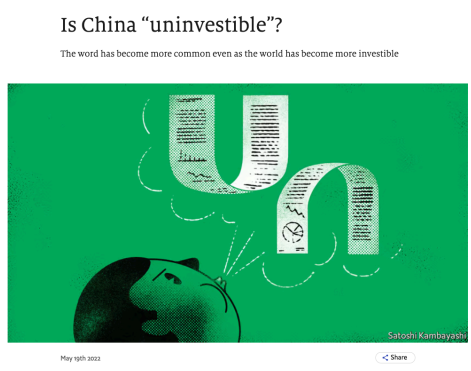

Image: Is China “uninvestable”? (The Economist)

A google search of the word 'uninvestable' has China in 18 of the top 20 links. Commentators have well documented the market pessimism for Chinese equities over the past two years, so we wouldn’t bother retelling the situation here. Our focus here is finding areas of the market where "excess" fear is and weighing the facts, fundamentals and opportunities.

From a top-down view of the Chinese net cash dataset, it’s clear where the pain is. Overall, the information technology and communication services industries combined represent 15.6% of all 300 companies valued below their net cash. In China, both industries are however, more represented as they make 26.5% of the 71 Chinese companies below their net cash. In our view, sentiment has played a key role here, and we believe there might be pockets of opportunities on this list.

We explore the investment case of one Chinese company we invested in that was below its net cash at the time of the initial research below.

Healthcare

Unlike Chinese equities, the pain in the healthcare industry hasn't been as documented across markets. One reason is that the healthcare index hasn't performed poorly. Despite its strong performance in recent years, the MSCI World Healthcare Index fell by just -4.97% in 2022 compared to -17.96%, while its forward P/E remains above the MSCI ACWI Index.

Among the top 50 largest healthcare companies, none are unprofitable and only 7 have EBIT margins below 10%. Giants like Danaher, Johnson & Johnson and Novo Nordisk have established a long and consistent track record of profitability regardless of the economic conditions.

To really see where the pain in the healthcare industry is, one has to go to the small cap biotechnology sub-industry, where **77 of the 107 healthcare companies below their net cash are**, despite biotechnology representing just 28% of all globally listed healthcare companies.

The reasons for this are twofold. During the pandemic, investors got excited about the prospects of any company related to themes like genome sequencing and cell-based therapy. In 2020 alone, the NASDAQ US Small Cap Biotechnology index had rallied by more than 100%; it's hard to justify a 100% rise for any index. Second, according to RSM, studies completed in 2022 are on pace for only approximately 80% of the prior-year completion, which isn't good from a fundamentals lens for these clinical-stage biotechnology companies. **When excessively high expectations meets poor fundamentals, catastrophe happens.**

More than two-thirds of the current below cash biotechnology companies went public after 2020 and among those that were public before the pandemic, all but five companies have fallen by more than -50% since then. In our view, there's some excessive fear in these smaller biotechnology companies, but we wouldn't recommend simply buying them given the speculative nature of their financials (only 5 of 71 are profitable). It's important that investors focus on either companies with a high probability of being acquired by larger pharmaceutical companies or have a clear path to FDA approval and profitability.

CASE STUDY

Zengame

We recently purchased shares in two companies valued below their net cash position at the time of research and purchase, Zengame, a Chinese card and board gaming developer and Huisen Household International Group, a leading panel furniture manufacturer in China with global customers. Given that the investment thesis in Zengame has played out, we will focus our case study review here.

After a global screen of the video gaming industry earlier in September 2022, we shortlisted Zengame alongside Playway, listed in Poland, as our two industry picks for the portfolio. At that time, Zengame had a net cash position of HKD 1.5 billion, while its market capitalisation was HKD 1.4 billion.

Zengame Background

- Zengame was founded by an ex-Tencent gaming team led by its current Chairman and CEO, Ye Sheng, who owns 22.6% of outstanding shares
- Zengame has over 40+ self-developed games, but most of its revenue and earnings come from its two flagship games, The Fingertip Sichuan Mahjong and Fight the Landlord
- In 2021, Zengame had about 6.9 million daily active users, down from 7.9 million in 2020
- Its games have a free-to-play model and depend on in-app purchases and advertising revenue, although the latter is decreasing
- Zengame was valued at just 3x P/E at the time of our research

Images: Zengame gameplay of its flagship games, Fingertip Sichuan Mahjong and Fight the Landlord. Both top the charts in China's mobile board and card games (Zengame's website)

> **Reasons for the negative sentiment in the Chinese video gaming industry**
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> - The Chinese gaming industry experienced its first decline since 2005
> - Regulators froze new game approvals for nine months in 2021
> - Additional rules were included to restrict minors from playing games during the week
> - Online advertising revenue growth is expected to slow in 2023

As we have seen from previous examples, being cheap relative to the book value is not enough and it's key that we assess other factors such as profitability, the potential for growth, aligned management and appetite for share buybacks that can influence the performance of these companies.

Profitability

Our first step was to assess its economics and future profitability potential. Over the past six years, Zengame has consistently been profitable, with its EBIT margin expanding from 12% in 2016 to 39% in 2021. Mobile gaming studios are fairly profitable when managed well, but a few factors have uniquely set Zengame above its peers.

First, Zengame has focused on games with Chinese cultural influence which helps the longevity and customer acquisition costs. For example, the concept in Fight the Landlord goes back to the 1950s and originated in the Hubei province. The card game is also often played in competitions with frequent prizes and tournaments, which increases in-app purchases by players. The strategy shift from advertising revenue to in-app purchases has also improved its gameplay and reduced and optimised its cost structure.

Earnings growth

Despite the broader Chinese mobile gaming market experiencing its first decline in H1 2022 (-3.7%), Zengame grew its revenue and operating profits by 40% and 37%, respectively. Growth for Zengame has come from two key drivers.

First, its expansion into live streaming via social platforms has improved marketing efficiency and awareness. Second, while its number of daily active users fell in 2022, its average revenue per user increased from RMB 65 to RMB 82 in H1 2022 thanks to its investments in user experience (reduced adverts in games), additional gaming features like the launch of more flower tiles in Fingertip Sichuan Mahjong, which is the number one card and board game on the iOS in China.

Share buybacks

As we learned from past examples, it's important for management in these below net cash companies to be aware that their companies are cheap and willing to take advantage of it. While Zengame already had a dividend yield of 9%, management initiated an equity buyback plan of up to 10% of its issued share capital earlier in 2022. Since then, its shares have rallied strongly and now left its below net cash valuation.

For us at Jenga Investment Partners, the below net cash companies remains a valuable source for potential investment cases and also serves as one of the key indicators we use to understand where there's panic and excessive fear in markets.