Not the best thing since sliced bread

Toast, Inc. (TOST) is a cloud-based restaurant software company that helps restaurants improve operations, increase sales, and create a better guest experience through providing restaurant management and point of sale system. The company made its Initial Public Offering (IPO) on September 21st, 2021 and as of 27th September, it is valued at US$28bn. As per its prospectus, the company has 48,000 customers (i.e. restaurants using its service), which values each customer at a hefty US$583,333. In our opinion, this looks highly unrealistic, even assuming a 50% CAGR over the next 10 years. This skepticism is not a reflection of our advocacy for entrepreneurship. As entrepreneurs ourselves, we like and support an environment which encourages such entrepreneurial spirit; however we also believe in investing in a good business run by promoters who understand the risks. What we have denounced from the inflation of Toast, Inc's market value is that investors are once again buying "priced for perfection" stocks without doing the math, which echoes the dot.com bubble. Such IPOs are more likely to be poor investments, except for the pre-IPO shareholders.

Toast, Inc. - September 27th, 2021

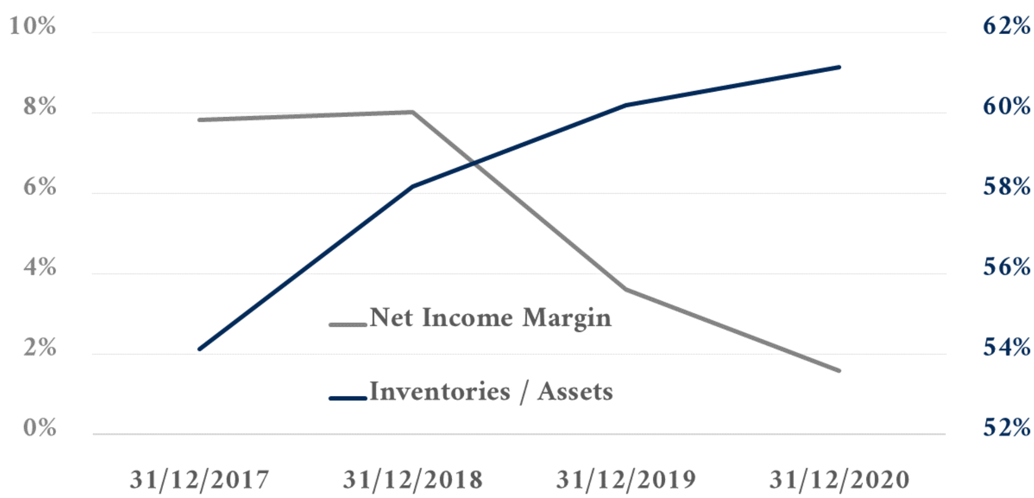
Market Capitalization (In US$)	28,000,000,000
Number of Customers	48,000
Market value of each customer (In US$)	583,333

Source Bloomberg, Toast, Inc.

Evergrande's (de)fault

The second event that caught our attention this month is Evergrande's default. While Evergrande's collapse was no surprise to us, its problems illustrate the risks an overleveraged Chinese property market presents to investors globally. If we were to look "under the hood", its financial ratios have been showing constant deterioration over the last 4 years as shown on the graph below. With its liability-to-equity ratio culminating at 5.5x, Net-Debt-to-EBITDA ratio at 7.9x and inventories accounting for 61% of its balance sheet (as of December 31st 2020), Evergrande no longer passed our investment filters.

Evergrande's Deteriorating Metrics since 2017



Source: Bloomberg, Lighthouse Canton, Data as of September 29th 2021

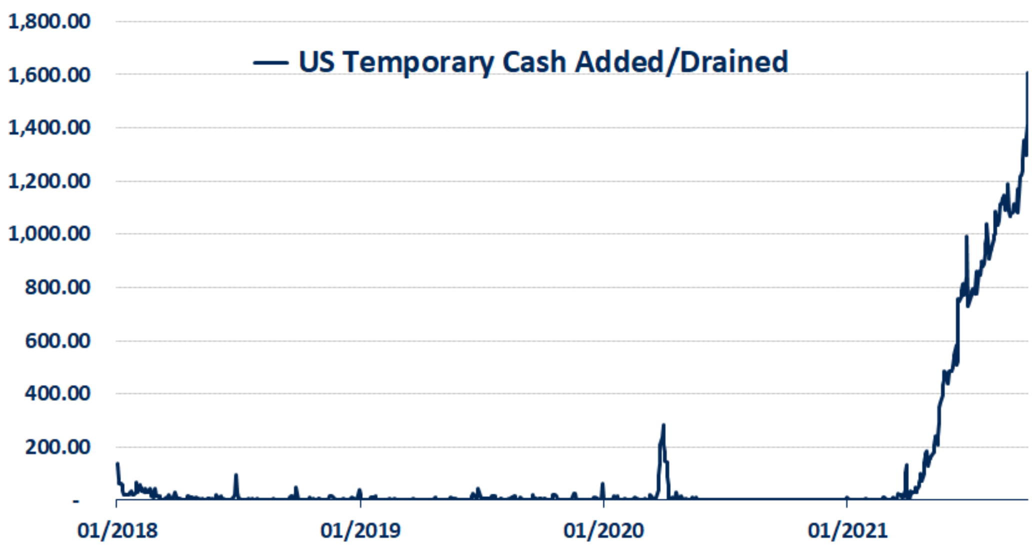
Its restructuring will undoubtedly impact many stakeholders negatively. Chief amongst them, banks will have to reassess the creditworthiness of their most indebted clients and stop assuming they will manage to refinance themselves indefinitely at cheap cost. Chinese local governments, whose income partially depends on the proceeds of land selling, are also likely to be financially impacted by the real estate slowdown. Lastly, deceived suppliers and redundant employees, who are the true victims here, are left holding the bag. Since the real estate sector accounts for 28% of Chinese GDP (Source: Bank of America, September 2021), the inevitable sector's deleveraging is bound to impact China's economic activity - although the extent of this impact is yet to be determined.

A wake up call for investors & Central Bankers

We believe both issues, Evergrande's default, Toast's hefty valuation, are somewhat related. Since Central Banks globally have been keeping interest rates artificially low, investors have stopped allocating capital efficiently, which inevitably leads to financial bubbles. Had Evergrande been unable to refinance its debt so easily just few years ago, the current mess might have been avoided. We view Toast Inc.'s exuberant valuation as a similar problem. With 70% of the bonds worldwide yielding less than 2% (Source: Bloomberg, June 2021), thanks to ultra-loose monetary policies, starved-for-yield investors wrongly assumed that they have no choice but to go long equities, which in turn often pushing valuations to imprudent levels detached from the reality of its fundamentals.

We hope Evergrande's collapse will act as a wakeup call to both investors and Central Bankers. While we understand the need for temporary supportive measures and flexibility during economic uncertainties, this however does not justify for complacency and obstinacy. Reverse repo transactions now cumulating at US$1.3 trillion (Source: Fed, September 2021) as indicated on the chart below, clearly indicates that commercial banks in the US are flooded with cash.

Overnight Repos – Federal Reserve Bank of New York (in US$ billions)



Source: Bloomberg, data as of September 29th 2021

The US Consumers Price Index (CPI) is now at 5%, well above the 2% long-term target, which is another sign that Central Bankers are probably a bit late as far as tightening is concerned. The precipitate resignation of regional Fed chief R. Kaplan and E. Rosengren at the end of September (both of whom were caught trading securities on their personal accounts), reinforce our view that Central Bankers will do whatever it takes to propel securities higher – even at the expense of ethics.

4 Investment guidelines

In light of the recent market volatility and the uncertainties which lie ahead, we would like to reiterate our view that well-designed portfolios should follow these simple investment guidelines:

1. Holding good assets, which refers to companies with strong fundamentals, should always be the first line of defense. The recent default of Evergrande is a reminder that holding bad assets rarely has a happy ending.
2. Exposure in riskier asset classes such as equities and credit should be managed more prudently, especially in this volatile and uncertain market environment. One way is to reduce the overall beta by investing in "Long/Short" and/or "Long Bias" strategies which not only helps to minimize downside risk but also allows for alpha generation on both the long and short side. For investors who favor long-only strategies, it is important to determine the quality of assets underlying the portfolio and also the pedigree of the portfolio manager such as his stock picking skills, investment process, portfolio construction and risk management.
3. The portfolio should be balanced with strategies which have low/no correlation to traditional asset classes such as Macro, Trade Finance, and Insurance to name a few, to serve as an effective diversifier and hence minimizes downside risks.
4. For investors holding highly speculative portfolios, an appropriate tail hedge is also recommended to dampen the downside risk. We would like to emphasize on the term "appropriate tail hedge" as otherwise might be counterproductive. For instance, while Gold is a good diversifier against USD weakening or further rise in inflation, it is a poor tail hedge as far as equities are concerned (e.g. both dropped severely in March 2020).