

Idea Brunch with Jeffrey Cherkin of Tourlite Capital

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Welcome to Sunday's Idea Brunch, your interview series with great off-the-beaten-path investors. We are very excited to interview Jeffrey Cherkin!

Jeffrey is currently the chief investment officer of Tourlite Capital, a low-net long/short fund he founded in April 2022. Before launching Tourlite, Jeffrey worked as an analyst at Spruce Point Capital and Basswood Capital, and did investment banking at Deutsche Bank. Jeffrey graduated from Brandeis University with a bachelor's in economics and master's in finance.

Jeffrey, thanks for doing Sunday's Idea Brunch! Can you please tell readers a little more about your background and why you decided to launch Tourlite Capital?

Edwin, thanks for having me on Idea Brunch. It is very impressive the following you have built across your platforms, and I look forward to continuing to follow your journey.

After completing my undergrad and master's in economics and finance from Brandeis University, I started my career in investment banking in the Industrials Group at Deutsche Bank. I worked on a number of very interesting transactions during my short time there, but I always knew wanted to be on the investment side of the business. I joined Basswood, a fundamental value-focused long/short equity fund. They manage a few billion dollars and primarily invest in the financial sector. It was a great place to get my feet wet.

I connected with Ben at Spruce Point and joined the firm in 2019. Spruce Point was a great experience, and I learned a lot during my time working with Ben. I always found short selling very interesting. Public short selling is a much different business than traditional long/short. Your research is always in the spotlight and the market and other investors provide you instant feedback on your research. We pursued a lot of unique and

interesting angles with our research process. We had a small team which was a significant change from my prior fund. As an activist short seller, you are looking for a different type of thesis than what I consider my traditional shorts. While this can be limiting, I felt there was tremendous value in combining many aspects of the Spruce Point research process to that from a more traditional long/short strategy.

I always wanted to do something entrepreneurial, and I had the opportunity to raise initial capital from a mentor who is a very successful investor. Mentorship is extremely important as this is an apprenticeship business. I have learned from prior colleagues and other investors. I am fortunate to have a mentor and investor who has been in the business for over 30 years, launched his own fund, and has assisted others in pursuing their own ventures. It is invaluable experience that has assisted me in all aspects along the way.

Tourlite launched in April of 2022. I believe my investment process, derived from my combined experience at a short bias and long/short fund, offers a differentiating perspective to analyze opportunities. The role of a hedge fund is to capture spread. This makes successful shorting just as important as picking attractive longs.

Unlike many long/short managers, you have a background primarily as a short-seller. What is your approach to finding longs and shorts? Does the duration of long and short trades differ?

Given my prior experience, it seems people put me into this “short seller” bucket. Tourlite is a long/short fund as we aim to generate alpha on both sides of the book. I know you’re a short seller at heart and will want to focus much of our time discussing it. I’m more than happy to do so.

Our portfolio on the long and short side is comprised of theses with the goal to achieve diversified sources of alpha. For longs we look for compounders, companies with positive expectation gaps above market expectations, orphans, and some special situations. For shorts, I divide our book into two baskets using a barbell approach. The larger of the two are traditional shorts. These include businesses over-earning, experiencing a structural decline, and forensic accounting angles. The second part of the barbell is aggressive shorts that include frauds and fades.

Our core long and short ideas have different durations. We like to own a typical long position for 2 to 3 years. With longs, you generally can be more patient for a thesis to play out. The nature of this is we may experience periods of underperformance in the absence of a catalyst. For shorts, our target holding period is from a few months to a year. There are inherent headwinds such as borrow cost and rising equity markets that make longer-duration ideas less attractive.

Do you have any favorite red flags over the years?

As past performance is the best indicator of future performance, an executive or board with a checkered past is a big red flag. The best is when an executive is on their second go around at running a fraud. A more common occurrence is being overly optimistic in investor communications which will likely lead to underperforming relative to guidance.

We were short Ranpak (NYSE: PACK) earlier this year and that is an example of a company that earlier in our diligence, showed signs of a few red flags. Rising inventory on an absolute basis and relative to peers was a signal that sales growth could be slowing.

Unprofitable/frauds are already down a lot, do you still see opportunities to short those here?

Yes, but at a point, it gets technically hard. Valuations are lower and short interest is higher. It is easier to short a stock from \$10 to \$5 than \$5 to \$2. There is still plenty of meat on the bones for a lot of these companies as shorts but it's generally a less appealing risk/reward at these levels than a year ago.

How do you manage risk to avoid short squeezes?

We approach risk management on both the portfolio and individual stock level. We limit our combined exposure on the portfolio level and generally have smaller individual positions in companies with higher short interest to account for the anticipation of higher volatility. I'll give you an example with Warby Parker (NYSE: WRBY). In August, we were short the stock into earnings. The stock spiked 20% despite the Company reporting inline revenue and lowering full-year revenue guidance by 10%. Two weeks later, the stock gave back all those gains.

What areas are most appealing on the short side to you today?

We see a lot of opportunity in two areas. The first is businesses that are overearning. We see this in many consumer and cyclical names. There are a lot of cyclical industrial companies with peak earnings at mid-cycle multiples. These are higher multiples than we would expect at this point in the cycle, as many assume we are heading into a recession. A lot of this has been fueled by the economic backdrop inflation has caused. In a recession, these earnings can be crushed. Second, certain consumer businesses are overly exposed to an economic downturn where we believe there is further downside to earnings.

What are some of the first things you do when researching a potential investment? What does that first hour of research look like for you? Do you do anything that few others do?

It often depends on how I come about the idea. I run a lot of screens to find ideas. I look at management's history to see if there is a track record of value creation or destruction. My process spends a lot of time focused on management and valuation. I check how much stock management owns and what are their incentives. Have they been buying or selling stock? I spend time looking at the company's financial and accounting metrics that might show signs of strain or strength. Early on, I want to get a good understanding of what the trigger points are for a stock. I'll spend time understanding the company's business, often by reading IR presentations and listening to past conference calls. At some point, I like to speak with management.

More focused on the short side, tracking bad actors, which can expand outside of management to include the board, auditors, and investment banks, is a valuable method to find opportunities. This is important for diligence as well as sourcing opportunities. During the SPAC frenzy, tracking other investors participating in deals and PIPEs was a more unique sourcing method.

What are some interesting ideas on your radar now?

I'm excited to share two long ideas and one short idea:

1/ **Perimeter Solutions** (NYSE: PRM — \$1.38 billion) is currently the sole qualified provider of aerial fire retardants. They are a mission-critical product that represents a small portion of customers' spend, and revenue is recurring in nature. Long-term secular tailwinds, of growth in the number and size of fires, support growth. Perimeter

is led by what we consider to be an experienced, best-in-class, capital allocation-focused management team and checks our boxes for an investment.

Based on our 2023 projections, Perimeter is trading around a 6% free cash flow yield. That is for a business with considerable competitive advantages that should grow free cash flow per share by over 25% per year for the next two years at least. This is a business mostly uncorrelated to economic cycles and we believe there is limited downside to normalized earnings. We see a path to nearly \$1 per share of free cash flow by 2025.

Revenue should be able to compound around 10% from a combination of increased volumes and mid-single-digit price increases. Volume growth will continue to be fueled by continued increases in acres burned, larger fires, and further stretched-out fire seasons. Outside of the North American Fire business, additional growth should come from underpenetrated international markets and the Specialty Products segment. International is currently around 20% of revenues and gaining traction. The second leg of Perimeter, which gets less focus and represents 1/3rd of revenues, is Specialty Products which, as of the third quarter, has grown year-over-year revenues 40% and has more than doubled EBITDA.

In our view, there are three main reasons the stock trades where it does today. The first and largest is concerns over the approval of Fortress, a potential competitor's product. We view the risk of them taking market share as unlikely. Perimeter is currently the only supplier with USDA approval. While it is likely Fortress will eventually be approved, Perimeter's infrastructure and integration into the supply chain provide a lasting competitive advantage to help maintain market share. This, combined with the fact that Perimeter's product represents only ~3% of customers' suppression spend, makes it challenging and unlikely for Federal and State agencies to switch providers.

The other two points are smaller but still seem to come up when speaking with other investors. The first is a lack of understanding of fire season cyclicity and the company's unique compensation structure. Fire seasons are not perfectly linear. What we focus on is that the overall trend in acres burned continues to support unit growth. There was some misunderstanding of the fire suppression market this year as there were a large number of acres burned in Alaska. Fire retardants are normally used in locations

where the fire is a threat to humans or infrastructure. That is less the case for Alaska compared to a hotbed such as California.

Regarding the compensation plan, our view is that if it is a clearly defined plan and you can model it out, you can account for it going forward. We like a management team that is paid to perform and has skin in the game.

2/ Another stock we own is **APi Group** (NYSE: APG — \$5.16 billion), a fire safety business that inspects, maintains, and repairs fire safety systems. The business is actually very different from Perimeter, but the similarity is that it is mission-critical. The installation and maintenance of these systems are non-discretionary and are regulated by law. APi recently made an acquisition of Chubb's fire and safety business from Carrier Group. The deal provides additional scale with its large European footprint. There is a significant opportunity for margin expansion and management is focused on improving Chubb's lower-margin business to APi's levels. We believe company guidance to be conservative and feel the market and sell-side analysts are underestimating the true normalized earnings power of APi's business. We believe the market is too focused on the Company's debt burden which is at 3.5x EBITDA. The Company has the cash flow to continue paying down the debt to management's target of under 2.5x.

Private market transactions have seen valuations around 20x EBITDA. APi currently trades at a double-digit 2023 free cash flow yield and single-digit EBITDA multiple. At a minimum, this business is worth in the mid-teens on an EBITDA multiple. The debt provides a lot of torque to move the share price higher. A 50% increase in the EBITDA multiple can result in a 100% increase in APi's share price before any growth or margin expansion.

3/ We like **Enagas SA** (Madrid: MCE – EUR4.04 billion), the Spanish utility, as a short. Looking to offset a domestic earnings base in terminal decline, Enagas has embarked on a series of terrible foreign acquisitions which have underperformed, capped off by the disastrous Tallgrass acquisition. At the time of the deal in 2020, Enagas promised its investors over €150 million per year in dividends from Tallgrass. All the volumes data and financial statements for Tallgrass subsidiaries are publicly available. In reality, Tallgrass has paid out zero dollars, is approximately 7x levered with declining earnings

and Enagas will have to inject hundreds of millions, if not a billion euros, to help fix the balance sheet. In turn, Enagas is now paying out over 160% of its earnings to support a dividend it cannot afford. Enagas will need to cut its dividend and write down the full value of its Tallgrass investment (>€1bn). Without the dividend support, the stock will collapse as it trades at 19x 2025 earnings despite negative earnings growth and peers trading at 15x.

What would you like Tournalite Capital to look like 10 years from now?

First off, my goal is to put up attractive risk-adjusted returns for our investors. Over time, I believe that will help attract additional capital into the partnership and help us scale. I have a vision for what I would like Tournalite to grow into. Prior to launching, I spent time at two funds. One was a multi-billion-dollar fund with over 10 investment professionals. The other had a 2-3-person investment team. There are things I liked and would like to emulate from both as well as things I would like to do differently. Growing the investment team would be the first step as assets grow. I recently read David Rubinstein's new book "How To Invest" where David interviews a dozen masters of the investment business. A common theme was none of them expected they would be where they ended up. I hope in 10 years that Bloomberg has "The Edwin Dorsey Show" and you'll still want to have me on.

Jeffrey, thank you for the great interview! What is the best way for readers to follow or connect with you?

Edwin, thank you again for having me. This has been a lot of fun. I continue to wish you the best of luck. If readers want to reach out, they can email me at info@tournalitecapital.com. Also, follow me and the firm [@jeffreycherkin](https://twitter.com/jeffreycherkin) and [@Tournalite](https://twitter.com/Tournalite) on Twitter.

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