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Associated Capital: A True $1.00 for $0.70

The investment thesis here is one of the simplest ideas I've come across in a while. Associated Capital (AC) is basically a big pile of cash and liquid investments that trades at a sizable discount to the value of those assets. It almost literally represents the ability to buy $1.00 worth of assets for $0.70. The stock trades around $28 per share and there is $40 per share of net cash, investments (and a few other assets that will be turned into cash). This gives no value to a hedge fund management company inside AC that runs a $1 billion merger arbitrage hedge fund and collects management and performance fees.

In addition, this company is majority owned by a capital allocator who wants the value gap to close, and has already announced his intention to buy back stock at these levels, which will be immediately accretive to value per share.

Why does AC Exist?

Well-known investment manager Mario Gabelli of GAMCO Investors (GBL) decided that the market wasn't giving his company credit for the value of the sizable excess cash and investments that GBL held on its balance sheet. So he decided to create a new company, stuff it with the excess cash and investments among a few other assets (as well as an operating business), and spin it off from GAMCO. The result is an under-followed, thinly traded company called Associated Capital (AC). Gabelli, who owns a majority stake in GAMCO, has kept his pro rata share of AC and he owns roughly 74% of the outstanding shares (18.9 million shares of the 25.4 million total shares outstanding).

What exactly does AC consist of?

AC's main assets consist of the following as of 12/31/15 (as well as the per share values):

- Cash: $205.7 million ($8.09 per share)
- Investments: $421.0 million ($16.55 per share)
- 4.39 million shares of GBL: $158 million as of 3/16/16 ($6.21 per share)
- $250 million GAMCO Note ($9.83 per share)
- Manager of a $1 billion merger arbitrage hedge fund (no value given to this asset)

The remaining items on the balance sheet basically consist of $69.7 million of receivables and $79.5 million of total liabilities (mostly payables). Subtracting the net amount of these liabilities as well as the small non-controlling interest ($15.5 million, or $0.61 per share), we get a book value for AC of

$40.07 per share. And again, this gives no value to the earning power of the group of hedge funds inside AC that manage over $1 billion.

So the majority of the AC balance sheet is cash and liquid investments (primarily investments housed inside a variety of Gabelli related funds and investment products). But in addition to cash and securities investments, Gabelli also took 4,393,055 shares of GBL stock that were held as treasury shares on GAMCO's balance sheet and gave those shares to AC, which can be held for investment or turned into cash at any time. As of 12/31/15 these 4.39 million shares of GBL were valued at $136.3 million on AC's balance sheet. Since the end of the year, GBL's shares have risen from $31 to around $36, and so these shares are worth around $158 million to AC currently.

GAMCO Note

One big reason I think this discount exists is because of the GAAP accounting requirements in regards to the GAMCO note.

What is this note?

It's a $250 million note issued by GAMCO to AC. But it is basically an asset that Gabelli created specifically for AC. The note is a GAMCO promise to pay AC $50 million in cash annually over the next five years, and in the meantime pay 4% interest on the balance outstanding. So GAMCO will make $50 million principal payments each year on this $250 million note, but it can be paid off sooner at GAMCO's option.

What is the significance of this note?

Because the note is considered a related party loan between GAMCO and AC, the value of the asset (which is very much worth $250 million to AC) is not included on AC's balance sheet. So the total value of AC's equity is listed on the balance sheet at $751.5 million (or $29.54 per share). But the true value of AC's equity (the "economic value" as the company refers to it as) is just over $1 billion (or $39.37 per share as of 12/31/15). If we mark the 4.39 million GBL shares at the current price of around $36 per share, AC's adjusted book value equals $40.07 per share.

As GAMCO continues to make principal payments on this loan, AC's GAAP book value will rise toward its actual economic book value. But the economic book value is the real value (the $250 million GAMCO note is a real asset). So I believe the stock price is trading based on the stated book value of $29.54, which hides roughly $10 per share of real tangible value. Anecdotally, I've recently discussed this investment idea with two separate small investment managers who both tried to correct me initially when I mentioned the book value was $40 per share. Another manager mentioned looking at his Bloomberg and seeing the same understated GAAP book value.

The AC filings (see recent 8-K) clearly state this simple discrepancy between GAAP accounting and real economic value, but an investor just screening for P/B ratios, or just simply looking at AC's balance sheet on Bloomberg or Morningstar will not immediately notice the "hidden" asset of $10 per share.

Here is a chart from a recent filing, summarizing the difference:

Associated Capital Group, Inc. Reconciliation of Total Equity to Adjusted Economic Book Value		
	Total	Per Share
Total equity as reported	$ 751,549	$ 29.54
Add: GAMCO Note	250,000	9.83
Adjusted Economic book value	$ 1,001,549	$ 39.37

(Note that my estimates are using the current price of GBL (AC owns 4.3 million shares), so the book value per share changes very slightly based on the current price of GBL.)

Operating Business

AC manages a group of merger arbitrage funds that collectively have $1.08 billion in AUM as of 12/31/15. The fund has a 31 year track record with only 2 losing years (it was down less than 1% in 2008). The returns have been mediocre (mid-high single digits), but given the low interest rates, the low leverage the fund uses, and the competitiveness of the merger arb space, these results probably aren't out of line with what should be expected. You wouldn't invest in this hedge fund if you wanted equity-like returns over time, but the fund does provide uncorrelated, low volatility, stable returns that significantly exceed returns from fixed income or other investment alternatives that aren't correlated to equities. AC gets management fees (1%) and performance fees (20%) from these funds.

(There is also an institutional research business tucked inside of AC that does around $10 million of revenue, but it's too small to be a meaningful contributor to results.)

What's the value of a pile of cash and investments if the operating business doesn't make any money?

I would argue that the value of cash and investments don't deserve to be valued at 70 cents on the dollar, regardless of how small the profitability of the operating business is in relation to the capital AC has. Think about this: most closed end funds don't trade anywhere close to this level of discount, and those CEF's typically are taking a management fee on top of other expenses. In this case, it's the opposite. There is a big pile of liquid investments and cash, and a small recurring revenue stream of 1-3% of assets that shareholders get in addition to these assets. If a closed end fund of easily identifiable liquid assets had a no costs (0% expense ratio), it would likely trade close to par. If it paid shareholders 1-3% of assets, it would likely be worth par at minimum.

In this case, AC hasn't been profitable yet (the expenses slightly exceed the management fees and other revenue at the moment), but I think there are a few ways that Gabelli intends to increase the revenue and profitability of the company:

1. Continue to grow the hedge fund. Given Gabelli's skills as a capital raiser, I would expect the assets under management of the fund to continue to grow. Over the past five years, AUM has grown at 11% CAGR, and most of this was due to inflows, not appreciation. Asset management is a very high margin business with a sizable amount of operating leverage, and so as the fund grows, the incremental revenue that comes from that AUM growth should be very valuable to AC.

2. Seed new funds. The form 10 filings state that they may use the GBL shares as well as cash to fund new investments, including seeding new funds. This is a simple business where AC provides capital to new investment funds in return for a slice of all future fee revenue (from management or performance fees) that the fund receives. It's an attractive business with the potential for explosive returns on capital in the event that one of the funds that it seeds does well and significantly grows AUM.

3. Let the investments in securities (mostly stocks) grow over time, which should produce index-like returns over long periods.

I think AC's book value will steadily grow over time through the compounding of the investments it currently holds, the cash that it can deploy into more investments or seeding relationships, and retained earnings as the hedge fund and other fee revenue streams get to scale. But regardless of the level of profitability at AC, I don't think it deserves to trade at 70% of the value of the net cash and investments.

Insider Ownership -- Gabelli owns 74% of AC

There are a couple reasons why I think the discount to adjusted book value won't last. One big reason is that Gabelli owns 18.9 million shares worth roughly $530 million, or 74.4% of AC. Gabelli understands value and understands capital allocation, and as the company stated in their form 10, they will consider dividends and share repurchases as a way to return value to shareholders. Gabelli knows that buybacks create value when they are done below intrinsic value. By buying stock at $28, AC would quite literally be taking $1.00 of cash from the balance sheet and buying that $1.00 for $0.70 in the open market. Given the current discount, any buybacks done at this price would be create sizable value for the remaining shareholders.

Given the low float and the low trading volume, these buybacks will take time to execute, but I wouldn't be surprised to see Gabelli initiate small tender offers over time if the discount persists.

I think the sizable discount to cash, Gabelli's $530 million stake, and the potential for accretive buybacks all combine to create one of my favorite investment situations: a stock with very little chance of permanent downside. I also think there is a high likelihood of decent upside (50% gain if the stock trades at adjusted book value, and 30% gain even if the stock trades at a 10% discount to book).

John Huber is the Managing Member and Portfolio Manager of Saber Capital Management, LLC, an investment firm that manages separate accounts for clients. Saber employs a value investing strategy with a primary goal of patiently compounding capital for the long-term.

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