ESG INTEGRATION IN SHORT SELLING

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Short sellers are often derided as criminals, pessimists, and/or vultures; the reality is that these terms are, more often than not, more applicable in describing their targeted companies. In this analysis, we argue that applying ESG integration concepts to short selling has the potential to uncover opportunities that can generate attractive returns, mitigate risk, improve diversification, and allow one to invest in better alignment with one's values.

As the portfolio managers of Appleseed Capital, we are long-term investors. We understand that long-term, enduring value for shareholders is created over years of hard work with smart decisions and prudent long-range planning on the part of responsible management teams. As part of our investment process, we examine environmental, social, and governance (ESG) factors when we evaluate investments, when we communicate with management, and when we vote on shareholder initiatives. It is the right thing to do from a social and environmental perspective, but we have also found from our own experience that it can also be a rewarding endeavor.

As risk managers, we are always looking for useful tools that can help us identify, mitigate, or avoid investment risk. By examining ESG factors, we believe investment risks in buying equities are lessened, which, in turn, reduces idiosyncratic business risk. When a company focuses on improving its safety performance, it reduces the risk of a safety-related lawsuit. When a management team is aggressively looking to improve environmental performance, the likelihood of a large environmental-related liability diminishes. When management incentives are properly aligned with shareholders, managers are less likely to risk a company's competitive positioning for a short-term gain of the stock price. With lessened investment risk, the probability of making money from a particular investment, in turn, should increase.

Appleseed Capital
Environmental, Social, and Governance Factors

Environment	Social	Governance
➢ Environmental policy ➢ Recycling policy ➢ Water management ➢ Sustainable transport ➢ Waste ➢ Climate change ➢ Sustainability best practice	➢ Health & safety ➢ Product safety ➢ Labor relations ➢ Community & stakeholder relations ➢ Consumer rights ➢ Supply chain management	➢ Business ethics ➢ Board structure ➢ Independent directors ➢ Chairman/CEO split ➢ Executive compensation and incentive structures ➢ Shareholder rights ➢ Conflicts of interest

Accordingly, we apply ESG analysis to help us avoid excessively risky investments, but we also use ESG analysis to identify attractive short sale candidates. Just as we expect companies with strong ESG performance to outperform the market over the long-term due to their lower risk profile, with all other things being equal, we also expect companies with particularly weak ESG performance to *underperform* the market. The key benefits of ESG integration with regard to short selling include the potential for 1) making money, 2) mitigating risk, 3) increasing diversification, and 3) aligning capital with an investor's personal or institutional values.

In Appleseed Capital's long/short strategy, common characteristics for compelling short selling candidates include weak balance sheets, rich valuations relative to cash flows, and high levels of insider selling. However, the presence of these factors by themselves is generally not a sufficient reason for us to sell a security short. Our high conviction short selling ideas should also have an additional near-term catalyst(s) that we expect will drive a company's shares lower.

To identify such near-term catalysts, we look for companies that we deem to be "ESG Miscreants." These are companies whose underlying businesses or management teams are *unethical*, *unsustainable*, and/or *unsafe*. These ESG Miscreants tend to share one or more of the following characteristics:

- Exhibit poor corporate governance and/or self-dealing behavior.
- Carry high litigation and/or regulatory risks.
- Sell products and/or services with limited or negative social value.
- Generate returns on capital that fall below their respective costs of capital.

Our expectation, when shorting the stock of an ESG Miscreant, is that the value destructive nature of the company will, sooner rather than later, be recognized by customers, regulators, or investors, driving the price of the company's stock materially lower.

Identification of ESG Miscreants

Common Characteristics for ESG Short Selling: rich valuation, poor balance sheets, weak cash flows, high levels of insider selling, large investment banking business with the Street, and offering products & services that are likely not to be economically viable in the long-term.

Short Selling and ESG Investing

Unsustainable Companies

Offer products & services that benefit from 1) from relative novelty and 2) are particularly sensitive to economic downturns.

Potential ESG Factors:
- *Products & services with limited or negative social value*
- *Lack of focus on societal shifts (i.e., organic food or environmental issues).*

Unethical Companies

Defining characteristics:
- *Constant restructuring expenses and write-offs*
- *Accounting shenanigans*
- *High management turnover*

Potential ESG Factors:
- *Weak corporate governance*
- *Bribery and corruption*
- *High litigation risk*

Unsafe Companies

Demonstrate questionable business models and/or are seemingly on their way to bankruptcy and/or consistently have returns on capital well below their cost of capital.

Potential ESG Factors:
- *Companies with poor ESG scores*
- *Board and executive governance*
- *Product safety*

Rationale for short covering:
- Investment thesis plays out as expected, and other, more attractive short ideas are available.
- The original investment thesis proves to be incorrect.
- Stock price momentum and/or short borrowing costs becomes too painful to remain in the stock in the short-term.
- Allocations to a particular short have become too high relative to our risk management processes.

Unethical Businesses

Unethical management teams use a variety of accounting techniques and rhetorical tricks to mask the weaknesses in their underlying businesses. These companies, which by definition are ESG Miscreants due to their weak corporate governance and unethical corporate behavior, often demonstrate a number of defining characteristics:

- Usage of constant restructuring expenses and write-offs.
- Significant conflicts of interest.
- High management turnover.
- Accounting shenanigans.
- Usage of novel and/or infrequently used non-GAAP operating ratios in their communications with investors.
- Complicated and difficult to absorb financial disclosures for what usually should be an easily understandable business.
- Excessive shareholder compensation, often funded with aggressive debt issuance.

Some unethical companies turn out to be grossly criminal enterprises, such as Enron and WorldCom, while others merely push the edge of the accounting envelope but stay within the rules. These companies try to take advantage of accounting management tricks like channel stuffing, gain-on-sale accounting, percentage-of-completion accounting, etc. With such businesses, the balance sheet and the cash flow statement paint a richer mosaic to us than the income statement, which is the primary source of manipulation by unethical management teams.

A prime example of a compelling unethical short candidate is Valeant Pharmaceuticals International (**VRX**). In recent years, VRX had been consolidating the financial statements of several specialty pharmacies without disclosing that fact in its financial statements. As it became obvious that these specialty pharmacies were artificially boosting VRX's reported results through several non-transparent accounting decisions, other problems were uncovered that were clearly the result of unethical or fraudulent management decisions.

<u>Unsustainable Businesses</u>

These companies benefit from products and/or services that seemingly are benefiting from relative novelty or temporary unsustainable demand and are often particularly sensitive to economic downturns or technological obsolescence. These sorts of companies might benefit from momentum investors causing a massive increase in stock valuation, catalyzed by impressively rapid revenue growth (but not necessarily earnings nor cash flow growth). Often times, fads have limited (if any) long-term barriers to entry, and the novelty from the fad invariably fades over time. These businesses benefit from unsustainable trends on the part of consumers, companies, or governments that will eventually end and possibly reverse.

CoreCivic, Inc., formerly known as Corrections Corporation of America (**CXW**), fell within the definition of an ESG Miscreant because of its unsustainable business model. CXW is the largest provider of prison detention and corrections services to U.S., state, and local governmental agencies. From a larger societal view, privately-run prisons have a very different mission than one run by a government agency; by definition, private for-profit prisons emphasize profitability above all else. As a result, private prisons focus on high levels of utilization rates, leading to potential prison over-crowding and unclean conditions; the American Civil Liberties Union recently stated, "These private prisons have also been linked to numerous cases of violence and atrocious conditions." In addition, investments in healthy food and reasonable healthcare are kept at a bare minimum, as the offering of nutritious food and quality healthcare negatively impact company profits.

Beyond the fundamental fact that the core value proposition of private prisons is questionable, CXW's business model exhibited a number of other negative characteristics:

- Prison populations have been falling.
- Private prison operators are the swing capacity in the system and are the first to be closed down.
- Contracts are short duration and can be canceled easily.
- CXW relies on enormous financial and operating leverage.
- Prison real estate has no alternative use.
- As a REIT, CXW's dividends paid have exceeded free cash flow for years
- CXW has given counterparties the option to purchase facilities at or below book value (~20% of total facilities) and CXW trades a material premium to book value and probably should trade closer to book value at most.

Simply put, the business model of private prisons is unsustainably flawed and broken. That statement was proved to be correct in August 2016 when the U.S. Department of Justice (DoJ) concluded that private prisons do not measure up to government-run prisons. In this case, CXW proved to be an unsustainable ESG Miscreant; valuation plummeted significantly once investors and the Obama administration recognized these facts and began to take action.

<u>Unsafe Businesses</u>

Unsafe companies have dubious business models and/or consistently post returns on capital that are well below their cost of capital. The products & services offered by such companies often times have limited or negative social value, and our expectations is that a negative reaction from customers or government agencies should eventually have a detrimental impact on unsustainably high profit margins and revenue growth.

Rayonier Advanced Materials (**RYAM**) is the world's biggest producers of cellulose specialty chemicals. Acetate tow, a chemical used mainly in cigarette filters, accounts for 80% of the tons of cellulose specialty chemicals sold across the world. Today, RYAM supplies a little more than 50% of the world market for acetate tow. Essentially, the Company is totally dependent on the unsafe products peddled by the tobacco industry. As governments continue to increase tobacco taxes to raise revenue and improve health of their citizens, and as tobacco consumers continue to quit this unhealthy habit or die off, we expect RYAM's customer base to experience a gradual but continuous decline.

Beyond RYAM's exposure to tobacco, a number of other items color our bearishness on the company. The Company has massive operating and financial leverage, which includes enormous off-balance sheet environmental and pension liabilities; that aspect of the business should not provide comfort to investors, which is particularly true when the top three customers soak up a whopping 60% of sales. Furthermore, the acetate tow market is oversupplied, and RYAM is a price taker in the market. Importantly, not only is the Company a high cost producer, but also most of the industry growth is in Asia where RYAM is ill positioned to benefit.

For all these reasons, we deem RYAM to be unsafe investment.

Other Short Selling Rules of Thumb

Given that the possibility of unlimited downside exists in our short sale positions, short-selling risk management remains paramount. Some key rules of thumb used by Appleseed Capital include:

- Limit potential takeover situations. Obviously, this rule is easier said than followed. However, if a particular company appears to be an excellent strategic fit for another larger company, this risk needs to be carefully monitored.
- Never short a stock just because valuation is high. As value investors, we find it easy to discover overvalued securities. However, expensive stocks can remain overpriced or, even worse, become more expensive; thus, finding ESG Miscreants that are unsafe, unethical, and/or unsustainable companies, combined with high valuations, represents an ideal short selling situation to us.
- Limit short allocations in stocks with high short interest. If short interest costs are high for a particular stock, that means 1) the cost of shorting better be worth the potential upside, and/or 2) short sellers with weak intestinal fortitude may abandon their shorts if the going gets tough and drive the stock price skywards. While the investment thesis may be right, the cost and volatility of that short may prove to be punitive.
- Avoid market-timing activities. Market-timing is impossible to do well on a consistent basis, so it is prudent not to make top-down market calls.

Covering Our Shorts

Having spent much of this white paper explaining our views of how to identify strong short selling candidates, a discussion over what would cause us to cover our short positions is warranted.

1) Our short thesis is proven to be correct. The investment thesis for a particular short proves to be correct, and the stock price declines to our estimated valuation. Therefore, the short thesis becomes less compelling, and we exit the position.
2) We get it wrong. Not all of our investments, long or short, pan out the way we originally anticipate. We take our lumps, try to understand our error so that we hopefully do not duplicate that error in the future, and cover the short.
3) The pain is simply too much. Certain times, stock price momentum and/or spiking borrowing costs can become unbearable for short sellers, and we make the decision to exit the short position.

We also recognize that we may re-initiate the position at a later time, should future circumstances dictate.

4) Our risk management process dictates a lower allocation. If a particular short goes against us in the short-term, the allocation to that short may go beyond what our risk management process allows. Accordingly, we will cover a portion of that short to limit the idiosyncratic risk associated with that short.

Weighing Shorts vs. Longs

Appleseed Capital has the ability to move from a 100% long position to a 100% short position as appropriate within the portfolio. Our exposure is not necessarily a top-down view of the investment universe; rather, we look at it as a bottom-up process. If our research team is finding a number of attractive long opportunities that informs our worldview; in that set of circumstances, one would expect us to have a significant long exposure. Conversely, if our research team is experiencing difficulty in identifying stocks to purchase and is easily finding attractive short candidates, then Appleseed Capital would more likely be focused on shorts.

Conclusion

In our view, a long-short ESG strategy offers considerable appeal, as we believe the unique blend of disciplined value investing and ESG investing is compelling. Appleseed Capital seeks to add alpha and improve diversification through its short book without significantly increasing the overall risk of the portfolio. With our unique ESG perspective, we believe that ESG investing inherently lowers portfolio risk by reducing idiosyncratic business risk; conversely, we hold the conviction that shorting stocks with poor ESG performance can provide a long-term source of alpha and allow for incremental downside protection in the case of a general market pullback. In particular, we think that adding a long-short strategy would provide heightened diversification to a portfolio of long-only ESG investments. Finally, shorting ESG Miscreants takes investing with one's values to a higher level, by potentially profiting from selling the shares of such companies.

Disclosure

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