Associated Capital ("AC") is an investment firm that is majority owned (86% economic and 98% voting interest) by Mario Gabelli. AC was spun out of GAMCO in November 2015 as a means to separate its fledgling alternative investment operations from GAMCO's traditional long-only business, with the aim of securing a higher valuation than GAMCO itself did (high-single digit P/E) at the time of the spin-off).

The company is comprised of two parts. The first, as mentioned, is the alternative investment management business, which operates investment partnerships and serves as general partner of its funds. At the most recent accounting (12/31/19), AC had $1.7 billion of assets under management, consisting almost entirely of event merger arbitrage strategies (88%), with the remaining assets mainly invested in event-driven value strategies. The goal of merger arbitrage is to capture the difference between the market value of a security and the amount a company is paying for an acquisition. It is non-correlated with the direction of the equity market and is driven by the successful completion of announced transactions. The event-driven value strategies seek investments that trade at prices that differ from the private market value as assessed by Associated Capital through its "Private Market Value with a Catalyst" framework. Catalysts, in these cases, can include spin-offs, stock buybacks, asset sales, management changes, regulatory changes, or accounting changes.

AC's other business consists of G.Research, which is a traditional/mature broker-dealer that provides institutional research and underwriting services. It generates revenues via direct fees and commissions on securities transactions for institutional investors, including GAMCO. Although G.Research provided AC with a more stable source of cash flow, demand for third party research continues to wane. As such, the company is exploring strategic options for the business, including a spin-off and a management-led buyout. Thus, the alternative investment management business is the more consequential of the two.

Since the spin-off, AC's alternative funds assets under management has risen 58.8%, from $1.08 billion to $1.71 billion at 12/31/19 (a 12% annualized growth rate). Nevertheless, it is still at a level that is not sufficiently aligned to its operating expenses. As a result, the company produces annual operating losses of around $15 million. This is offset with interest/dividend income and investment gains that greatly reduces the losses, or even results in positive net income for the company. Therein lies the tremendous risk/return advantage of the AC shares.

When the company was separated, GAMCO contributed a substantial amount of cash and securities in order to ensure that AC could survive on its own while it focused on increasing its AUM. As of year-end 2019, it held $348.5 million in cash, which could sustain its operating losses for decades at the current run rate. During times of crises, solvency risk is one of, if not the most, important risks to avoid. AC does not exhibit *any* solvency risk. This cash figure does not even include an additional $300.3 million of investments that AC owns, including GAMCO stock (GBL) (which might be lower now, given the decline in equity prices). Moreover, at an equity market capitalization of slightly more than $600 million as of this writing, the shares trade at an approximately 30% discount to book value, which in this case could be considered as liquidation value, particularly since that book value includes the aforementioned $648 million of cash and fungible assets. There is clearly a floor on the value of the shares.

On the flip side, Associated Capital has, in theory, unlimited earnings growth potential. Its AUM is increasing, which should bring with it higher investment management fees. However, even absent that, in the right environment, the company could still produce tremendous earnings via incentive fees. Typically, these are 20% of the gains. For example, if AC produced a return of 15% (which is not an unreasonably high return) on its AUM of $1.7 billion, the gross investment profit would be $256.5 million. It should be note that since 2011, its investment returns have been modest (but positive)—due in part to value strategies being out of favor—ranging from a loss of 59 basis points (the only annual loss) to as high as 5.8%. Nevertheless, taking its 20% fee on a 15% return would provide revenues of $51.3 million (assuming no hurdle rate exists). In 2019, total revenues totaled $31.2 million, of which incentive fees contributed to $11.2 million of the total. Thus, in this hypothetical example, even a modest 15% investment return would more than double its revenues, with very little associated increase in expenses, resulting in a disproportionate increase in earnings.

Of more strategic importance than incentive fees on the current AUM base, merger arbitrage is an inherently lower-volatility strategy. It is in the alternatives space, which has become increasingly attractive to institutional investors over the years, and might become yet more so in the wake of the current market collapse. In light of the scale at which institutional investors such as pension funds operate, it would take very little additional interest, should AC strike the right chord, to increase its AUM by billions of dollars more. In that sense, investment firms are far more scalable than the typical business.

Additionally, AC is not restricted to just the merger arbitrage or event-driven value strategies. For example, it has started a private equity fund (organized as a Special Purpose Acquisition Vehicle) focused on Italy. More funds, strategically initiated, could be forthcoming, which should improve the odds of increasing AUM and generating performance fees.

In this respect, the AC shares have similar attributes to a call option, except that while a call option can expire worthless, we believe the lower bound on the Associated Capital share is definitively not zero.

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