Some find gems hiding in plain sight, no cannons required.

From Star to Founder

EastRock

The Other Type of Contrarian

Adam Shapiro

March 20, 2023

SHOULD WE "BUY ON THE SOUND OF CANNONS, sell on the sound of trumpets?"

The closest equivalent to that contrarian ideal I can remember from my own experience is David Tepper buying bank shares in early 2009.

It was gutsy. It was smart. It made him a hero as bank shares recovered and his fund finished 2009 up 132%.

Personally, I would have been uncomfortable owning Tepper's portfolio at the time. In February and March 2009 alone, his position in Bank of America stock fell 10% or more on nine different trading days. Tepper believed the government would act in his favor, but other informed investors believed that government action would punish the securities he was buying. To my eye, reasonable people could disagree on where things were going.

In the end, Tepper was right. But I tend to believe there is an easier, less scary path to finding contrarian gems that hide in plain sight.

The search for contrarianism without cannon fire starts with a reality explained by Mark Twain: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

I believe the statement would be equally true if it said: "It ain't what you don't know that creates opportunities for contrarians. It's what you know for sure that just ain't so."

When I worked in a principal investing job at Goldman Sachs in the early 2000s, there were a number of things that everyone involved with commercial real estate agreed "ain't so":

1. It **ain't** a good idea to invest in data centers, because technology companies were lousy boom-and-bust tenants and data centers had no alternative use

2. It **ain't** a good idea to invest in land that was not fully entitled (approved for the desired use), because the entitlement process was unpredictable and binary

3. It **ain't** a good idea to invest in projects that involved environmental cleanup, because no one really knew how much contamination might be in the ground and where it might have flowed

4. It **ain't** a good idea to invest in Houston, because there was no limit on the supply of new real estate and demand fluctuated wildly with energy prices

While each of these categories was taboo for ostensibly different reasons, they all had one thing in common: members of Goldman Sachs investment committees had had bad experiences with them in the past. There was a name for the idea of going in front of an investment committee and suggesting that Goldman Sachs risk making the same mistake twice: "Career Limiting."

Later, at East Rock, we would break each of these four "ain't" rules, and we are glad we did.

I believe the bias I experienced at Goldman Sachs is a microcosm for the broader investing universe.

Which brings me to EOS Investors and Myrtle Beach.

For as long as I can remember, Myrtle Beach was understood by institutional investors to be an undesirable place to acquire commercial real estate. It was low-end, low-growth, and in a seemingly permanent state of over-supply of hotels and golf courses.

When I sat down with EOS to talk about resort properties five years ago, there was one thing I knew for sure: It **ain't** a good idea to buy anything in Myrtle Beach.

As background, EOS was a trusted partner of East Rock's and uniquely skilled at spotting mispriced hotels. At each hotel it acquired, EOS took over and improved operations with its own people, thus boosting the likelihood of investment success. EOS was founded and led by Jonathan Wang, who had a well-established history of "discovering" underappreciated locations like the Florida Keys. We were big fans of EOS and willing to hear them out on anything. But ***Myrtle?!?!***

For the rest of the story, I turn the "pen" over to Jonathan Wang:

JW:

For me, the Myrtle Beach story begins in 2008 – ten years before EOS made our first investment there. At the time, we were looking at all sorts of distressed debt during the great financial crisis. One pool of CMBS bonds we were analyzing included some hotels in the Florida Keys. As we did our due diligence, we realized that we had never seen a market that looked like the Keys. Demand had been growing for decades and was much steadier than other places, while supply was severely constrained. We ended up buying a number of hotels in the Keys before public REITs discovered the market and asset values went up 3-4x.

That experience made me recognize the value of regional resorts. In downturns they were more resilient, as people traded down from more expensive fly-to locations. Meanwhile, in good times, these markets tended to grow faster than average because they had limited supply and increasing local demand. Still, we spent years trying to figure out what would be the next Florida Keys.

Then, in 2018, a huge property complex in Myrtle Beach called Kingston Resorts came up for sale – and was met with widespread indifference. As Adam noted, Myrtle Beach was not known as a high-end destination at the time and few institutional investors played in the market.

But as we put the deal through our framework, it had some incredibly compelling dynamics. Kingston Resorts was the best asset in its market. Nearly 90% of its business came from fast-growing cities that were within driving distance. There had been negative supply growth over the last 10 years. And on top of that, we could buy it with a lot of yield. It was the most attractive thing we had seen since EOS launched.

East Rock was an early investor in EOS and, given the lower-end nature of the market relative to prior EOS investments, I gave Adam an early preview of our thinking. His initial reaction was not encouraging.

While I understood where he was coming from, EOS kept pursuing it. The more work we did, the better we thought the investment looked.

I went back to Adam, walked through the numbers with him, and he agreed to go see it in person.

The trip didn't start well. On the way down, Adam told stories about visiting Myrtle

Beach during college and finding it seedy even compared to dive bars in New Haven. When we landed, we headed for one of the reportedly top restaurants in town, which turned out to be a strip-mall Italian place with a sparse wine list that didn't include vintage years. So much for changing perceptions.

But as we walked around, it became clear that Myrtle Beach was a big market with great infrastructure and real demand. More tourists visit Myrtle every year than visit New Orleans. I knew I had Adam's attention when I was able to show him that 65 hotels had closed in Myrtle Beach over the last 10-15 years and were not replaced. High construction costs and other factors meant that very little new supply was in the pipeline. Revenue per available room (REVPAR) in the market was starting to accelerate. We showed how we could potentially drive already high income at Kingston significantly higher. It wasn't long before Adam became a strong supporter of the investment.

The Kingston acquisition soon led to another big investment in Myrtle – and eventually to EOS becoming the largest hotel owner in the market, as well as pioneers in the drive-to resort sector before it became mainstream on the heels of COVID.

While Adam may consider me a contrarian, it's not something I ever set out to be. I simply believe in following one's own path. If you have conviction in your path, you'll sometimes be led to places others aren't. That's when things get interesting.

Back to Adam:

At East Rock, a decision framing we like to use is that some investments make us feel "more fear than greed" and others "more greed than fear." Thanks to EOS's thorough due diligence and analysis, we were able to conclude that Kingston was a contrarian gem hiding in plain sight that we could invest in with no fear. We broke our own "ain't" rule and we are glad we did. It was a contrarian bet with no heroics, just plenty of operating income and a clear path to more.

NEWSLETTER
From Star to Founder
Insights from partnering with exceptional investment managers as they launch and build new firms

Published by **Adam Shapiro**
Managing Partner @ East Rock Capital, LLC | Generational Wealth Manager

EastRock

65 East 55th St, 33 Fl
New York NY 10022

T 212 630 5000
F 212 624 0231
info@eastrockcap.com