Value Ventures: July 2019
Long-term thinking in a world of short-term orientation.

Another Newsletter, Concentrated Bets and Seed Producers

by Mr. Bean on 8th July 2019

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Invert, Always Invert

This newsletter was born out of an obsession with value investing, discovering fantastic companies and an intense desire to get a little bit smarter each day. This obsession will pour through the pages of each monthly issue. There's no marketing gimmicks, no catchy tag-lines -- none of that. I want to take you on a journey as we try and uncover absurdly cheap and often misunderstood companies in the dark, forbidden corners of the market. Grab your hard hats and shovels, it's time to start digging!

When dissecting the structure of this newly-minted value investing newsletter, I reached for an adage from Charlie Munger: *Invert, always invert.* Li Lu, founder of Himalaya Capital wrote of Munger (emphasis mine):

> "*When Charlie thinks, he always starts by inverting. To examine how businesses become big, strong, and successful,* ***Charlie first studies how businesses decline and fail***."

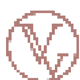
Like Munger, I had visions of how I wanted to format the newsletter -- but in a clearer sense -- I understood how I *didn't* want it to look, act and feel. So, I began inverting.

The fact is, most investment newsletters fail to provide the value their price tag claims to offer. Numerous publications focus on the latest stock tip, the hottest sector poised for *tectonic-shifting* growth, or the one-and-only dividend stock you'll need for that taxable account. Like a blind squirrel, these newsletters may hit a big winner eventually -- but its value disappears as quickly as it arrived. Taking an aggregated view, many newsletters aren't worth the price because they:

1. **Cover stocks that house thousands of Investment Banking analysts -- *providing no informational edge.***

2. **Highlight "hot" stocks -- i.e., the type of stocks that make CNBC's *Fast Money*. These are the kind of stocks that *people love to talk about at cocktail parties*, but also the kind that draw in "stupd" money.**

3. **Pigeonhole themselves into one style of investing -- market cap, P/E ratio, sector, etc. -- often *leaving low-hanging fruit for the taking* because it doesn't *fit their M.O.***



4. **Refusal to dive deep into the philosophy of value investing, the pitfalls, the emotional turmoil of watching stocks fall after buying -- *this creates an unrealistic picture of instant gains without the pain.***

5. **Fail to review their losing picks and what they can learn from them -- *resulting in a dishonest portrayal of track records.***

What To Expect

Armed with these thoughts, I set out to establish V*alue Ventures* -- what I would want from a newsletter. Through this process we developed a trail-guide of what *you*, the reader should expect on a monthly basis:

1. Deep research into off-the-beaten path companies that we believe to be absurdly cheap based on estimated intrinsic business value.
    a. *Examples: micro-caps, spin-offs,* SPACs, *liquidations, post-bankruptcies, etc.*

2. Passionate discourse on investment theory, philosophy and process (**Philosophy Corner**).
    a. *We want to take from the greats of the value investing world* (Burry, Buffett, Pabrai, Schloss, etc.) *and distill their philosophies into actionable practices.*

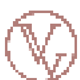
3. Discussions on Various Accounting Tools and Methodologies to spot good businesses that are "hidden" amongst ugly accounting. These companies (referred to as "good co. / bad co.") won't appear on traditional value stock screeners.

4. Review of V*alue Ventures* Portfolio (Quarterly)
    a. *Expect quarterly letters in the same format as you would read from your favorite value investors today. We value transparency and will probably spend more time discussing our losers than our winners.*

I can't guarantee I'll provide you with countless X-bagger investment picks, and I can't guarantee the V*alue Ventures* portfolio will kick ass over the next 12-months. In fact, any newsletter that guarantees returns is either ignorant, dishonest, or a combination of the two. But… I *can* guarantee top-notch research into off-the-beaten path companies, honest and transparent thoughts on positions (both winners *and* losers), as well as in-depth analysis of value investing methodologies and philosophies.

The name of the newsletter has a meaning. It's what I want this publication to be: an adventure into understanding businesses, competitive advantages, management teams and capital allocation decisions -- regardless of market cap, liquidity or sentiment.

Here's to venturing together, as we wade into the deep, murky waters of value investing.



THIS MONTH'S
PHILOSOPHY CORNER

All of The Eggs: The Power of Concentrated Bets

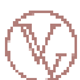
In order to beat the market, you must do something different than the market. You should zig when the market zags. We know these things, but do we actually stop and wonder *why* this is the case? I mean, sure, all of the world-class investors come to mind as real-life case studies, but why do all of them do it? Why did they all buy in to the idea that *less is more*?

When in doubt, ask yourself, WWWD -- What Would Warren Do? And Buffett's thoughts on diversification are poignant,

"Diversification is protection against ignorance. It makes little sense if you know what you're doing."

Ignorance. Beyond all other factors driving the diversification school of thought, ignorance steers the ship. There's true ***power*** to investing in a few concentrated bets. Peter Parker's uncle said it best, "with great power comes great responsibility." Concentration should *only* be used by those that *actually want* to beat the market -- those that want extraordinary returns over decades. In other words, you have to *earn* the right to invest concentrated.

Don't believe me? Here are a few investors that made their millions in a few concentrated bets:



- Benjamin Graham generated his greatest return ever from his highest concentrated investment, Geico. Graham, who would normally allocate no greater than 5% to any individual position, shifted a whopping 25% of his Fund into the Green Gecko.

- Joel Greenblatt's Gotham Fund returned its highest CAGR when the Fund held fewer than 8 positions. Greenblatt's been quoted saying he would routinely wake up and see his net worth in the Fund drop 30-40%. That concentration, however, enabled Greenblatt to rake in an *annualized* return of over 40% from 1985 - 2006.

- Michael Burry -- manager of Scion Capital and notorious for his Big Short -- became famous because he made a concentrated bet against the US Housing Market. Burry wouldn't be a household name for investors had he only allocated a small portion of his Fund to the trade. That one bet propelled Burry's cumulative returns to a mind-shattering 468% between 2000 - 2008. The S&P return during the same time frame? 3%.

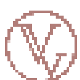
I could take up an entire newsletter with more examples. The fact remains: to beat the market, you must take concentrated bets in a few select companies. You might be thinking, "I get that, but why doesn't everyone *just do* that if they want to beat the market?" There's a little catch. In order to reap the rewards of long-term outperformance, investors **need** to accept periods of (potentially drastic) underperformance. Can you sustain a Greenblatt-like drop in net worth of over 30% due to a concentrated strategy? It takes serious testicular fortitude and brings us to the focal reason concentration isn't main-stream doctrine.

Concentrated Investing Will N*ever* Turn Mainstream

Sustained periods of underperformance is the biggest reason concentrated investing *will never* make it to the mainstream. Financial advisors can't risk their jobs picking a few stocks (even if they're great companies!) for their client portfolios only to have temporary headwinds ruin a couple quarters or years. Portfolio managers can't be seen with periods of underperformance as recent MBA grads are chompin' at the bit to take their spot. So what ends up happening?

Managers and advisers "closet index" -- creating portfolios that mimic a given benchmark. This isn't theoretical rhetoric either, I've seen this in the wealth management space *first hand!* Through closet indexing, PMs and advisors can rest assured their job security is (for the most part) safe. If their client's portfolio went down -- hey, so did the overall market! If the market ripped upwards, would ya look at that, so did your client's assets!

I think this is an ultimate *benefit* for investors like us that strive to outperform the market. In a world where information edges are disappearing faster than GameStop stores and numerical arbitrage opportunities are vanquished to the high frequency traders -- there



remains a Concentration Edge. Why? **The masses prefer a steady $1 selling for $1.10 rather than a volatile $1 selling for $0.50.**

Take Action: How You Can Implement Concentrated Bets

You're taking a first step into implementing the power of concentration simply by subscribing to this newsletter. I say that tongue-in-cheek, but it's true. Over a year, I'll write about twelve (what I think to be) potentially great investment ideas. In truth, I don't need all twelve ideas to work out to be content. Thanks to the Pareto Distribution -- where 80% of the results come from 20% or less of the inputs -- the number of correct picks needed falls to less than half. Here's how you can start implementing the power of concentrated betting in your portfolio today:

1. **Focus your Time and Capital on your Best Ideas**

For individuals with more than 20 positions, consider selling any idea you wouldn't put in your top 15. With this freed up capital (and time), you can study the businesses you own on a deeper level. This deeper understanding gives you the confidence needed to plow more capital into such ideas -- creating a positive feedback loop.

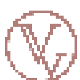
2. **Instill a Higher Portfolio Hurdle Rate**

One reason investors own more stocks in their books than they should is due to low portfolio hurdle rates. In short, it's too easy for stocks to enter the portfolio. Don't fall victim to boredom, fear or FOMO. A stock should *only* enter the portfolio if it's better than your *least* favorite idea. Determining that isn't black and white -- but here are some common questions to ask yourself (all of which will be discussed in further publications):

- Is this idea optically cheaper than my least favorite idea?
- Does this company have a greater risk/reward ratio than my least favorite idea?
- Is the new company in a better industry -- one with longer tailwinds for growth?
- Does this company have a better business? Larger moat?

3. Add One, Subtract One

For those with a fully-loaded portfolio (12-15 stocks), swap your latest best idea with your least favorite idea. Not only does this prevent your portfolio from growing in size, it helps keep capital invested in your best ideas -- our ultimate goal.



THIS MONTH'S
DEEP DIVE

Deep Dive: S&W Seed, Co. (SANW)

Leading Seed Producer Selling Less Than Book Value

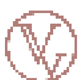
S&W Seed is a global agriculture producer engaged in the breeding, production and processing of various seed crops such as alfalfa, stevia, sorghum, sunflower and corn. A recent $70M licensing agreement with Corteva Agriscience turns SANW into a company with a rock-solid balance sheet, net cash for strategic acquisitions and instantly accretive book value over $2-per share. Current market prices offer a chance to buy a business trading at a 20% discount to tangible book value with clear industry tailwinds and a rockstar CEO, all while getting non-core segment growth for free.

Backing The Jockey: Mark Wong

In 2017, S&W brought on Mark Wong, a 40-year industry veteran to help turn around the money-losing enterprise. Glancing at Wong's track record, it's safe to say SANW hired the right man.

In the early 1980s, Wong built *Agrigenetics*, one of the first three founding companies to bring plants into the biotech space. *Agrigenetics* caught the eye of Lubrizol and in 1985 bought the company for $150M ($357M in 2019).

Then, less than 10 years later, Wong led *Agracetus*, a company focused on developing and commercializing value-added genes in soybeans. The company was bought by Monsanto in 1992 for $250M ($456M in 2019). If those two examples weren't enough proof, how about one more? In 2005, Wong sold *Emergent Genetics* -- an international seed company that



garnered the second largest market share in cotton in the world -- to Monsanto (again) for $325M.

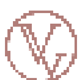
There's a nice trend to observe with Wong. He comes in, builds great products, sells them for high multiples to larger players and moves on to his next challenge. We believe Wong is well positioned to bring about similar success at S&W. Wong arrived at a company with issues, however, and the turnaround won't happen overnight. He's also putting his money where his mouth is -- owning shares of the company outright -- and engaging in a private placement with SANW during the company's balance-sheet restructuring.

Temporary Problems: Water Regulations & Operating Losses

Between 2017-2018, the company was financially rocked courtesy of increased Saudi Arabian water regulations. These regulations impacted "The Old" SANW due to low levels of diversification across their production facilities and customers. Wong mentioned the previous levels of concentration in the latest earnings report, saying, "*We were way too narrow a company before in the sense that we have one crop and it was alfalfa and it was focused on a couple of markets that were important to us.*" We agree. The old S&W couldn't afford another "surprise" from the Saudi region -- and if we know anything about geopolitics -- it's that surprises aren't all that surprising.

The combined consequences of Saudi water regulations and product concentration can easily be seen in SANW's income statement. After reaching peak revenues of $96M in 2015, top-line growth contracted to $64M in 2018. EBITDA margins compressed from over 9% to barely 2% as the company generated less than $2M in EBITDA in 2018. Earnings-per-share plummeted from $0.12 to -$0.22. This company certainly isn't popping up on any popular value screens.

In addition to these specific company issues, SANW has been caught in a broader industry bear market -- one of the worst ones the Ag sector has faced in recent memory. Just take a look at the below chart of DBA (agriculture specific ETF) :



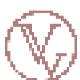
Clear Industry Tailwinds: Increased Demand & High Addressable Markets

Although the chart above paints a dreary picture, it is environments like these that spawn incredibly deep value opportunities. Plus, it doesn't hurt that it looks like we're nearing a secular bottom. Howard Marks once quipped, "*The herd applies optimism at the top and pessimism at the bottom.*" Buying at (what Marks describes as) *peak pessimism* gives us maximum margin of safety with limited downside risk.

The future supply/demand imbalances are impossible to ignore -- and it won't be long before crop prices reflect that inherent imbalance. S&W estimates that the planet will need to increase food production by 60% - 100% by 2050 to meet a 30% increase in overall population. Secondly, the expanding global middle class is earning more money, triggering a further dietary shift towards increased meat and dairy consumption. Growing livestock requires 7x the grain/crop intensity as opposed to growing soft-grains for consumption (read: *increased demand*).

S&W is well-positioned to capture the increased demand for dairy and beef cattle feed. Their main crop, alfalfa, is recognized as one of the most nutritious forages available with an addressable market around $400M annually. The company sports market leading proprietary seed varieties and has diversified its distribution to over 30 countries, removing major concentration risk.

The company is also investing heavily in Stevia production, an area management believes can have large payoffs as consumers switch preferences for healthier sweeteners. Already granted patent protection for four varieties of stevia, S&W aims to be the industry leader in stevia, and for good reason. The food sweeteners market is expected to grow roughly 4.5% CAGR by 2022 for a TAM of over $110B.



Further, the WHO (World Health Organization) anticipates stevia replacing 20% of the sugar market (read: the demand will be there).

Cheap With Catalysts: Licensing Agreement & Chromatin Acquisition

Money Talks: $70M Cash Transforms Balance Sheet

In late May, the company entered into a product-licensing agreement with Corteva Agriscience. For $70M cash, the agreement provides Corteva a fully pre-paid license to produce and distribute specific S&W-owned seed varieties. The cash is split between a one-time payment of $45M at closing and installments of $25M ending February 2021. Along with the cash, S&W **retains ownership of all assets originally acquired** in the Dec. 14 asset purchase between the two companies and Corteva terminates access to S&W's future product pipeline. The sale price indicates Pioneer paid roughly 3.2x 2020 revenues and 17x 2020 EBITDA for those specific alfalfa seed varieties.

How cheap does the company get with an extra $70M cash? For starters, S&W increases tangible book value by the $45M cash received at closing. This reduces net debt from $63M to $18M -- and transforms Enterprise Value from ~$150M to ~$106M. Add in the remaining $25M due by 2021 and the company becomes **even cheaper.** $25M flips S&W into +$7M net cash and reduces Enterprise Value to approximately $80M.

The agreement provides nearly 100% incremental upside to tangible book value:

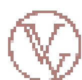
- Tangible Book Value as 03/31/19: $52.1M (***$1.57/share***)
- Proceeds from Agreement: $45M ($1.34/share)
- New Tangible Book Value: $97.1M (***$2.91/share***)

This figure *doesn't* include intangible book value, which adds an additional $1.18/share. If we add intangibles we get book value of over **$3/share on a stock trading at $2.60**.

Chromatin Acquisition: Buying $1 for $0.35

Back in February, the company took a major step forward in product diversification -- paying $26.5M (1.3x 2020 revenues & 13x 2020 EBITDA) for the state-run, bankrupt assets of Chromatin.

The company financed the acquisition via $5M in common stock and ~$22M in Series A 0% coupon Preferreds (which converted to common in November 2018). Chromatin is a pure-play integrated sorghum seed company with roughly 5% U.S. market share of hybrid sorghum seed production. Offering four different types of



sorghum (grain, forage, food grade and sweet), Chromatin comes pre-packaged with diverse product offerings and a plethora of end-markets from livestock feed to pasture/hay, to biofuel and milled flour.

There are multiple reasons for investors to be excited about this acquisition. First, S&W bought the bankrupt company through an invite-only auction -- beating out a European player 12x the size of SANW. Winning the bid proves to investors that management is able to both secure cheap assets while fighting above its weight class. Secondly, SANW bought the assets cheap, *really* cheap. Wong hints that the assets were bought at a >50% discount, claiming in the earnings call, "*We got the asset for what I consider to be a very, very affordable price, **maybe we paid $0.30 to $0.35 on the dollar for the asset**.*" While chatting with Wong earlier this week, he mentioned that these two deals (licensing and Chromatin) were two of the best deals he's ever made.

For $26.5M, the company received $20M in tangible assets ($9M in PPE and $11M in accounts receivables / inventory), a broad sorghum product offering, world class R&D testing programs, an existing pipeline of future products, global product registrations and an expansive domestic distribution channel marketing to 500+ farmer-dealers.

The third reason for investors to get excited about the purchase (and its price) is Chromatin's global distribution channel. With its multiple years of >$30M EBITDA losses, Chromatin was never able to fully invest in the channel. Wong commented on this underinvestment, saying, "*Chromatin did not have a lot of cash. And so as you might surmise, the farmer-dealer network was left a little bit underinvested over the last couple of years.*"

We don't know the scale of potential upside this channel brings, but we believe there's a high probability for it being greater than 0. The channel sports over 500 farmer-dealer connections spanning four continents. Within this network, Chromatin has access to five major agricultural retailers covering vital sorghum-growing areas. As we'll see in our valuation work, we end up getting this channel for free.

Chromatin is expected to produce between $17M - $20M in top-line revenue ($14 - $15M in remaining 8 months of 2019) with 30% - 40% gross margins. Management estimates minimally positive EBITDA impact in 2019 with a greater impact coming 2020 -- ahead of managements initial projections.

Valuation: Buy The Core; Get Rest For Free

S&W is currently money-losing, but through an EV/Sales lens, we can paint a clearer picture of what we're buying for $80M. The company breaks out revenues in two larger segments: Core and Non-Core. Core Revenues would be the alfalfa, sunflower and corn products. Non-Core Revenues include revenues from Chromatin and Stevia sales.

According to the company's Investors Presentation on the licensing agreement, Core Revenue in 2019 is expected to reach $27M. This means you can purchase the Core Revenues of SANW (which, by the way, are growing around 10% organically) for less than 3x while getting all the Chromatin sales and Stevia growth for free.

Now, let's suppose that the company is able to return top-line revenues to pre Saudi water regulation levels. If we assume a 5-year average top-line revenue of $73M (based from 2014-2018), SANW would be trading roughly 1x its revenues.

Risks: Complex Business, Factors Out of Our Control

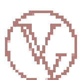
I'm going to plagiarize myself for a bit here, as the risks associated with SANW correlate strongly to the risks present in my analysis of Corteva Agriscience. In that write-up, I mentioned two ever-present risks in agriculture: Seasonality and Bad Weather. SANW might have the leading crops in its field, but if the weather doesn't cooperate, those seeds sit on the shelf.

Unlike Corteva, SANW is currently losing money -- presenting its own unique set of problems. Although their balance sheet is now in a much stronger position, the company still can't afford a bad acquisition. Wong goes so far as to mention this risk in the earnings call, saying (emphasis mine):

> "*One of the key issues for S&W was to make sure that those [Chromatin] losses did not survive the acquisition.* ***We cannot afford to have EBITDA losses from the companies that we buy.*** *They need to be accretive to our earnings.*"

Even *one* poorly-timed or poorly-bought acquisition could send SANW into a downward spiral towards zero (and short-sellers delight). For SANW to generate extraordinary shareholder value going forward, management must be prudent with its capital and with the price it pays for its acquisitions.

Another risk is geopolitical risk. We cannot forecast this, even attempting such an idea is a waste. Last quarter the company had to hold off recording $9M in revenues due to a military coup in the Sudan region. We don't know when the next coup will strike. However, we're confident in management's ability to diversify away from any geopolitical risks in the Sudan / Saudi region.



Summing It Up

The market, as it tends to do, is unimaginatively valuing SANW solely on the past; a singular-minded alfalfa seed company with high levels of debt and significant revenue decline.

Looking forward, the company will be a multi-seed offering business with zero debt, growing top and bottom-line figures and a management team that buys companies cheap and sells them high and has a long history of successfully doing so.

All of the above can be bought for a 20% discount to book value. Management's realigned their sales division, grown its distribution network and is well positioned to capture the all-too-predictable future growth in the seed markets.

Throw in an eventual recovery in the Ag sector and you have all the makings for a big return in this little seed company.

Macro Ops
700 Lavaca St. Ste 1401, Austin, TX 78701