Arquitos Capital Management

ALJ Regional Holdings – (ALJJ)

February 21, 2014

Current Price: $1.74
Disclosure: Arquitos Capital Management and/or its affiliates own shares of ALJJ at the time of this report. Please view our disclosure statement for more information.

Summary
ALJ is a unique holding company that recently acquired a subsidiary where ALJ can deploy their considerable net operating losses (NOLs). The subsidiary, Faneuil, was acquired at a reasonable price and has significant growth potential. Faneuil's leadership is strongly incentivized to innovate and cut costs. ALJ's chairman, Jess Ravich, is a demonstrated leader who has proven to be shareholder friendly while focusing on long term value creation.

Background on ALJ
I discovered ALJ in November 2012 when they announced they were selling their majority-owned steel subsidiary, KES, for $112.5m cash. ALJ is a holding company that had bought into the steel mill in the mid-2000s. Along the way ALJ borrowed against it and accumulated considerable NOLs. They also announced, after paying off their debt, they would commence a tender offer to acquire approximately 50% of their outstanding shares. The transaction closed in February 2013 and the tender offer closed soon thereafter. Through the tender, ALJ purchased 30m shares at a total cost of $25.2m.

At the quarter that ended on March 31, 2013, ALJ was left with approximately $30m total in cash, short term investments, a receivable, and about $2m in liabilities. They had approximately 27.5m shares outstanding. At that point ALJ had no operations, very limited expenses, and $176m in NOLs expiring between 2020 and 2027. Shares traded around 82 cents/sh.

ALJ's stated intention was to purchase another company in order to utilize the NOLs. Jess Ravich's in-depth experience as an investment banker meant this was likely to occur. In order to retain the NOLs and not have to convert into an investment company, which would have been a costly and undesirable situation, ALJ would have to purchase a new company within about a year of the sale of KES. This gave them until around February 2014. The value of ALJ would be maximized by purchasing a company that had predictable cash flow in order to apply the NOLs for years to come. It was also likely, given the potential target acquisition and Ravich's experience, that ALJ would be able to purchase a company much larger than its current assets through some sort of debt financing.

The worst case scenario would be that ALJ would not have been able to find a company and would have liquidated, losing the value of the NOLs. For an investor, ALJ liquidating would have been far from an optimal result, but with no cash burn and the stock trading at that time for about 25% less than its net liquid assets, the worst case scenario would still have produced a positive outcome. However, liquidation would have been a very unlikely result given the other circumstances.

As 2013 progressed, ALJ retired more of its shares and made some money on its short term investments. There continued to be no cash burn. The final quarterly report before the acquisition of Faneuil, September 30, 2013, showed 26.7m shares outstanding and net cash and liquid investments of $27.8m, or about $1.04/sh in net assets.

Faneuil Transaction

The acquisition scenario described above occurred on October 18, 2013. ALJ acquired Faneuil from Harland Clarke (a subsidiary of Ron Perelman's M&F Holdings). The acquisition was for 96.43% of Faneuil for $53m broken down as follows:

- $25m cash
- Contribution of $500,000 in cash for working capital purposes
- 3m shares of ALJ common stock valued at $2.5m
- A seller note to Harland Clarke for $25m (2 yr maturity with 5% interest in the first year and 7.5% interest in the second year)

ALJ acquired Faneuil at an attractive valuation when looking at 2013 figures. At the time of the acquisition, at the run rate of the first nine months of 2013, ALJ acquired Faneuil at the following multiples:

- 4.8x EBITDA
- 6.2x operating income
- 0.5x revenue

Faneuil also had signed two health exchange contracts that commenced in the last few months of 2013 and were not reflected in the financials at the time of purchase.

A little background on Faneuil. Their primary activities are as a government service processer and call center. Most revenue comes from the operations of their toll collection and processing services, health exchange contact centers, call centers for utilities, and medical device tracking. Clients include Florida's SunPass, health exchanges in Washington state and Tennessee, Bell South, and Dominion Power.

ALJ's Q1 2014 report covering the quarter ending on December 31, 2013 was released on February 14, 2014.

Faneuil's pro-forma results for the first nine months of 2013 aren't directly comparable to the actual results reported of the last three months. We don't know what the adjustments are and we don't know how Harland Clarke allocated certain expenses. Because Faneuil's contracts and cash flow appear to be relatively stable and predictable, I've decided to pro-rate the actual results to full year. Admittedly, this is a rough sketch, but it is the best we have to work with right now. Take these annualized numbers with a grain of salt and use them to compare to the actual results as they are released later in the year.

These annualized results are unlikely to be materially lower absent the loss of a contract. There should not be much seasonality involved. Results also could be materially higher if new bids are won. Given Faneuil's new-found freedom from Harland Clarke and incentives to grow, it is probably more likely that results turn out better than expected.

According to the CFO, the reported results don't include the first 17 days of October, so I've adjusted them to the full quarter and provided select annualized financials. See below:

	10/18/13-12/31/13	Adjusted for full quarter	Annualized
Net Sales	$ 25,833,314	$ 31,688,865	$ 126,755,460
Cost of Sales	$ 20,261,121	$ 24,853,642	$ 99,414,568
SG&A	$ 3,661,505	$ 4,491,446	$ 17,965,784
EBITDA	$ 1,910,688	$ 2,343,777	$ 9,375,108
Net Income	$ 1,470,123	$ 1,803,351	$ 7,213,404
Net Income/Share	4.6 cents	5.7 cents	22.8 cents

I used diluted shares outstanding of 31,619,913 since it is likely options will be in the money.

Valuation
At today's price of $1.74, ALJ trades at the following multiples:

P/E: 7.6x
P/EBITDA: 5.9x
EV/EBITDA: 4.9x

For the calculation of the enterprise value, I used the non-diluted number of shares and adjusted for the accounts receivables since Faneuil's customers are typically states, municipalities, and other stable (but slow) payers.

At what multiple should ALJ trade? I don't have an answer for that. We do want to consider that Faneuil is now free to be more entrepreneurial, which is likely to mean higher growth. Faneuil's leadership is also heavily incentivized to grow aggressively. In addition to the ownership stake that Anna Van Buren, Faneuil's CEO, acquired in the sale to ALJ (she owns the other 3.57% of Faneuil), she also is entitled to an annual bonus of 10% of EBITDA above $5m per year. At today's run rate, that bonus is in excess of $400,000 and could grow quickly.

We can look at competitors in the call center space, such as Convergys (CVG), Teletech (TTEC), and Sykes Enterprises (SYKE). These aren't perfect analogies because of size, activities, and location, but it is notable that ALJ trades at significantly cheaper multiples than these companies, in some cases half as much. Given the potential for growth, ability for ALJ to handle their debt load, and large tax benefits, ALJ should probably trade at a premium to their competitors. Of course this comparison may be moot if competitors are currently over-valued.

The quarterly report also mentioned that Faneuil "commenced implementation of two new programs that will recognize revenue in 2014." It is unclear if this refers to the healthcare exchange work for Washington state and Tennessee (which began during the past quarter), or if this refers to new unrelated contracts. Either way, this should mean an increase in revenue going forward.

While I can't currently put a price target on the stock, shares at $1.74 appear to be a safe investment given the underlying value of the company. This situation is akin to the uncertainty involved for companies that have been spun off. Their new flexibility and reduced bureaucracy often leads to surprising growth. While chances are good that will happen here, shares are also cheap if no growth occurs. If shares get above $2.75 (still only a P/E of 12, which would continue to be far below others in the space), then we'll have to get a bit more specific on the intrinsic value. Hopefully at that point we'd have a bit more information on operations and more of a history of results.

Debt

The biggest looming question is the $25m owed to Harland Clark and due by the fall of 2015. It appears likely that at least part of this will need to be rolled over. The new untapped $5m line of credit from M&T helps, as does the current cash level of $5.3m and accounts receivables of $24.3m. Additionally, considering Harland Clarke has a seat on ALJ's board and owns 3m shares, this debt is a bit unique. Because of these factors, I do not have major concerns about the ability to repay the debt, but it is something to keep an eye on if revenues were to decline or if Faneuil lost a major customer.

Information Arbitrage

What advantage do we have over the market? Why is ALJ cheap? This is the second level thinking that Howard Marks talks about and that I try to apply to our investments. I've identified three potential reasons why I may have an advantage. If I'm not able to clearly demonstrate that one of these factors is occurring, then I'm very hesitant to move forward with the investment. The goal is to "arbitrage" reality compared to perception. Examples are below:

- **Information:** An investor may have an advantage because he or she has more information than other investors. This could happen because of things like a company's size, its geographic location; a misunderstanding regarding the company, or because of knowledge of something such as forced selling.
- **Emotion:** An investor may have an advantage because other investors view the company in an unnecessarily negative way, perhaps because of a negative event, because the industry is hated or out of favor, or because negative headlines.
- **Time:** Finally, an investor may have an advantage because their time horizon is different than others. This allows long-term investors to benefit from short-term incidents such as a quarterly earnings miss, higher than expected and temporary capex, or the investment community's lack of focus on a company's balance sheet.

ALJ has 210 holders of record. While there are others who are following along, the company is too small for large, sophisticated institutional investors. This gives us a distinct information advantage. A good example of this is that ALJ's quarterly report, which was strong, was released on February 14, 2014. Shares barely reacted and volume was low until February 21, when the company issued a press release about the report. At the issuance of the press release at 10am on February 21, shares spiked and ended the day up nearly 10% on volume five times the average. Clearly few people noticed the filing a week earlier as the press release was nondescript and contained no additional information. For those that follow the company closely, there was nearly a week to make buy or sell decisions from the filing.

Additionally, other prospective ALJ investors may not appreciate the value of the company's NOLs. These NOLs are currently offsetting the company's tax rate by 34% and will continue to for many years. Another important aspect of the NOLs is that they incentivize the company's leadership to grow to a size to fully utilize them. When a company's leadership is inexperienced or lacks understanding of the principles of capital allocation, NOLs don't always have value. Here, Jess Ravich clearly understands their importance and has the means to maximize their value.

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<u>Risks</u>

I've mentioned the debt, which is the biggest risk. It should also be noted that the space that Faneuil operates in is very competitive. I saw at least one Faneuil bid online for a state health exchange where they were underbid by 25%. Click here for an example of a bid that Faneuil had submitted and lost in early 2013.

The other major risk is client concentration. One customer accounted for 42.5% of net sales and $6.9m of accounts receivable. Faneuil appears to be entrenched with that customer, and this concentration appears to be decreasing, but this is still clearly significant.

There is also a risk with the uncertainty regarding the health exchanges. This would appear to affect growth more than current revenue as it is unclear how much revenue, of any, Faneuil collected from Washington state and Tennessee over the past quarter.

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