Case Study: Spinoff, Tender, Acquisitions, NOLs and Uplisting at ALJ Regional Holdings
By Steven Kiel[1]

ALJ Regional Holdings (ALJJ) from 2012 to 2016 was a dream for special situation investors. That four-year period included a divestiture, large tender offer, several acquisitions (partially funded by several small private placements), and an uplisting to the Nasdaq to go along with becoming an SEC reporting company. After their initial divestiture, ALJJ also had $176 million of net operating loss carryforwards (NOLs) against a market cap of approximately $50 million (pre-tender). Most importantly, the company also had a dynamic, experienced leader who proved to be an effective capital allocator.

When this confluence of special situation events began, ALJJ operated in one line of business. The management of that business, a specialty steel manufacturer named Kentucky Electric Steel, was totally outsourced. By 2016 ALJJ was a diversified holding company owning a growing call center operator, Faneuil, a Las Vegas building contractor, Floors-N-More, and national printer, Phoenix Color.

Unbelievably, from February 2013 to October 2013 the stock traded below its net cash level of between $0.94 and $1.04 per share—and a lot of shares turned over. During that nine-month period from the time of ALJI's tender offer to the first acquisition, nearly $4.5 million worth of shares traded hands out of a capitalization of approximately $25 million This was after the company bought back $25 million worth of shares in a tender offer, or nearly half of their shares outstanding, at a healthy discount to cash!

ALJJ's performance during that time period was more than a grand slam – in fact, grand slams are much more common. It was like hitting four home runs in one game. Shares traded for 37-cents on October 1, 2012. By September 30, 2016 they were at $4.70, nearly a 12 bagger. That is a compound annual growth rate of 88.8%.

The best part? There was very little risk in owning shares after the February 5, 2013 divestiture until the first acquisition on October 18, 2013. The company had no debt, the CEO took no salary, and other expenses were minimal because it was a non-reporting company. I would love to tell you that I owned shares at 37 cents, but I did not buy until after the divestiture was announced and the details were clear. The result was that I made "only" 70% per year on my initial purchase. My investors and I appreciate your sympathies.

Charlie Munger has said, "The goal of investment is to find situations where it is safe not to diversify. If you only put 20% into the opportunity of a life-time, you are not being rational." By October 2013, ALJJ was 20% of my portfolio at cost. It could be said that I should have made it more.

Let's look at each special situation strategy that applied to ALJJ.

Divestiture

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[1] Steven Kiel is the president of Arquitos Capital Management. He is the portfolio manager of Arquitos Capital Partners, a private investment partnership focused on value-oriented and special situation investment opportunities. Steven is also the CEO of Sitestar Corporation (OTCQB: SYTE), a publicly traded diversified holding company.

On November 19, 2012 ALJJ announced that it was selling its wholly-owned subsidiary, Kentucky Electric Steel, for $112.5 million. Proceeds would pay off all debt and leave approximately $51 million in cash and $176 million of NOL assets. The sale ultimately closed on February 5, 2013.

While ALJJ was an unknown company *after* the sale announcement, it would have been more difficult even for very astute micro-cap investors to have come across it *before* November 19. Yet, at least one did, and he is worth highlighting here. Dave Waters of Alluvial Capital wrote up ALJJ in blog posts on August 10, 2012 and again on September 19, 2012. This is how I found the company prior to the divestiture announcement.

On August 10, Waters wrote, "An investment in ALJ Regional Holdings carries substantial risk, but offers significant rewards should the company's deleveraging efforts succeed. Management has shown respectable results since acquiring KES [Kentucky Electric Steel] and is substantially invested, aligning their interests with shareholders." Waters personally picked up shares in mid-October 2012 when they traded below 4x EBITDA. He was handsomely rewarded just a month later.

Tender Offer

At the time of the sale announcement, ALJJ also announced that it would use part of the sale proceeds to conduct a Dutch tender offer for 30 million shares at a price between 84 cents and 86 cents. Shares traded at 76 cents after the announcement. The tender was completed on February 8, 2013 at 84 cents per share.

There were several attractive parts to this tender offer. First was the overall size – for approximately half of all outstanding shares! Second, the tender price was below net cash and 9% above the trading price on both the day of the announcement and the last day an investor could decide to tender. Third, CEO Jess Ravich indicated that he would not tender his shares, giving him 45% ownership post-tender.

Amazingly, 33 million shares were tendered – 10% more than what the company offered to buy. Thirty million were accepted. Because the 84-cent tender offer price was below the company's net cash of 86-cents per share, net cash per share increased to 94 cents per share. Yet the trading price barely moved from the 80-cent price it traded at the day of the tender.

Acquisitions

After the tender, all signs pointed to an acquisition. As 2013 progressed, ALJJ repurchased more of its shares and made some money on short term investments. Net assets actually grew throughout the year because cash burn was very low. The final quarterly report before the first acquisition, September 30, 2013, showed 26.7 million shares outstanding and net cash and liquid investments of $27.8 million, or about $1.04 per share in net assets. The stock was priced at 82-cents.

On October 18, 2013 ALJJ acquired call center operator Faneuil for $53 million. ALJJ paid $25 million paid in cash, assumed $25 million in seller debt, and issued $2.5 million in ALJJ shares. Shares jumped from 83 cents to above $1.50 within 10 days.

ALJJ followed this up with a smaller acquisition. On April 16, 2014, it acquired Floors-N-More, a Las Vegas-based building contractor, for $5.5 million. This was paid for with cash, debt, and a small private placement with outside investors at $1.60 per share.

Then, on August 14, 2015, they made a big splash and acquired printer Phoenix Color for $90 million, paying with debt and a small internal private placement at $3.80 per share. Surprisngy, ALJJ's shares did not react strongly.

SEC Registration and Nasdaq Uplisting

ALJJ had one more thing up its sleeve for special situation investors. It was still a non-reporting company trading on the over-the-counter market. This kept demand for the shares low.

On May 23, 2016, ALJJ began trading on the Nasdaq after the SEC approved its registration statement. At this point, shares were at $4.12. In less than a month they would reach a high of $5.48, a rise of 33%.

Multiple Opportunities for Special Situation Investors

ALJJ investors had multiple opportunities over a four-year period to employ special situation strategies – they didn't have to be early or first. The CEO – the largest shareholder – was aligned with us, and the existence of substantial NOLs helped to telegraph the direction the company was headed. Purchasing shares for less than net cash prior to ALJJ's first acquisition was among the least risky opportunities I have come across in my career.

From there, cheap income statement valuations and additional company-specific items gave investors several chances to get involved, or re-involved, in the stock.

Someone who was initially looking to invest in ALJJ had two options. Let's call the first the arbitrage option. Between the date of the original Kentucky Electric Steel sale announcement on November 19, 2012 and the close of the tender on February 8, 2013?, shares fluctuated between 66 cents and 80 cents leading. For those who chose to tender, the potential return was between 5% and 27% with a hard catalyst.

The vast majority of investors decided to tender. There were 57.2 million shares outstanding then. Insiders controlled 21.1 million and did not tender. Of the remaining 36.1 million, 33 million were submitted to be tendered at a price below net cash per share. This high number of outside investors who chose to tender at a price below net cash was astounding.

The second, longer term option, was more enterprising: Hold onto shares and see what the company would do. This is what I did. I should note that investors who did tender could have gotten back into the stock many times over the next nine months at a price below the tender price and made additional money.

Holding onto shares after the tender offer was attractive because of the deal-making background of CEO Jess Ravich, his decision to retain his shares, the incentives that the large NOLs created, and the lack of cash burn. In fact, net cash per share grew over the next nine months while the trading price remained stagnant.

Decisions became tougher after the Faneuil acquisition. Investors then needed to analyze the company using more traditional metrics. Still, the cash flow multiple was so low after the first acquisition, less than five times, that an investor could take comfort in a large margin of safety.

After ALJJ uplisted to the Nasdaq and became reliant on the results of its income statement, immediate special situation investment opportunities disappeared. However, given the creativity of its CEO, new opportunities may arise. I'll be watching.