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Buried treasure

Evan Lorenz writes:

“Horrible value destruction over many years,” Martin Hale, the founder of Hale Capital Partners, said by way of setting expectations for Avid Technology, Inc., his pick to click at the Fall 2019 *Grant's* Conference. “It is quite overleveraged, and it looks awful.” It would, of course, at this stage of the cycle, Hale added. Then, again, the shares were commandingly cheap, and from that day till this they have generated a 437% return, compared with the 52% gain in the S&P 500 (reinvested dividends included).

The collapsing Nasdaq makes Hale's theme of fall and redemption timely all over again. Last week, your editors invited our friend and “technology re-invention” specialist to join us on *Current Yield*, the quite superb *Grant's* podcast, to discuss the risks and opportunities attending a branch of the stock market for which the word “volatility” might as well have been coined. (The podcast airs on April 15; but only you, paid-up subscribers, are made privy to Hale's new picks to click, below.)

Lazarus is the patron saint of the technology world. From 1981 through 2019, approximately 70% of this cohort suffered stock-price drawdowns of 70% or more, Hale's studies have shown. For a sense of scale, just 41% of the companies making up the S&P 500 registered the same decline over the same period.

“The interesting thing,” said Hale of that 70%, “is half go to zero, but one-in-five to one-in-ten recover 10x, and about 3% will be 50x winners. When you look at the history of technology, everyone wants to be a unicorn. The re-

ality is that successful companies are a phoenix with multiple periods of huge gains and huge losses.”

In the *Grant's* sound-studio-cum-storage-closet, Hale reviewed the pitfalls to which technology businesses are prey: poor governance (most boards can't calculate returns on invested capital); first movers becoming first losers (think Ask Jeeves or Yahoo!); CEO psychoses such as the narcissus syndrome (“want to be admired more than successful”) and the Tesla syndrome (“Hey, we can burn cash, too!”); the pitiless cycle of creative destruction and bad business models (WeWork, Inc.); and changes in investor expectations.

“The history of technology is the his-

tory of disruption,” said Hale. “Think of all of the mini-computer companies like Digital Equipment Corp., all of the companies long gone. It is a continual period of disruption. That's why tech is all product cycles. It's another reason why, when we look at companies in the orphan status or the graveyard, it's really new teams and new product cycles.

“In a way, one has to realize that tech turnarounds don't turn,” Hale continued. “They are often restarted by new teams and new product cycles.” It's only the rarest of companies that could have endured Amazon.com, Inc.'s 94% share price collapse (between December 1999 and September 2001) and gone on to succeed without a change in leadership or product offerings. He said

In many ways a singularity



source: The Bloomberg

he pegs the probability of such a recovery at close to one in a thousand based on data over the past four decades.

"New economy" stocks soared to higher valuations in this cycle than they did even at the dot-com peak, Hale told the *Grant's* listening audience. They traded at an average of 4.17 times enterprise value to sales on March 31, 2000—but at 4.56 EV to sales on July 1, 2021.

Of course, the two observational points are not entirely comparable. The largest tech concerns (the tenth decile in Hale's presentation) were slightly cheaper in 2021 than they were at their 2000 peak (9.2 times versus 10.7 times), but smaller tech companies (the first decile) were more expensive in 2021 than in 2000 (1.55 times versus 0.82 times).

By Hale's reckoning, tech valuations contracted by 33% from July 1, 2021 through March 28. "That sounds like a lot, and it may sound like a great buying opportunity, but we have to remember that if stocks retrace the pattern of the prior bubble bust, where the market bottomed in the third quarter of 2002, we would still have 69% further to fall."

It's a fascinating time, all right, Hale summed up: "Yes, there may be opportunities, but we also have to be very careful. The median cycle time for your 70% loss is about 18 months. So, if we just follow the medians, we have a good deal more time left."

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Stepping away from the Current Yield microphones, Hale and we got down to cases. With the caveat that "this is not investment advice nor is this a solicitation," our guest began to name names, starting with Hewlett Packard Enterprise Co. (HPE on the New York Stock Exchange).

Yes, *the* Hewlett Packard that Bill Hewlett and David Packard founded in a garage in Palo Alto in 1939. In 2015, the company split its consumer PC and printer business (HP, Inc.) and its enterprise assets in two. (On April 7, Berkshire Hathaway announced an 11% stake in the consumer business.)

While it has spun off additional divisions over the past seven years, HPE is today a hodgepodge, its component parts ranging from mediocre to exceptional.

In the mediocre department can be found the units dubbed "compute"

(servers and related hardware, delivering 43% of sales in the quarter ended Jan. 31, 2021) and "storage" (data-storage products and services, 16%), which posted a combined 0.1% year-over-year decline in revenue in the first fiscal quarter.

The exceptional category contains the units dubbed "high-performance computing & AI" (11% of sales) and "intelligent edge" (13%), which collectively grew by 7.6% year over year despite supply-chain issues. Rounding out the corporate stable is a customer-finance unit.

"It is so hated that it has had at least three failed turnarounds," said Hale of the HPE whole. "It has a boat anchor of a compute business that is hard to love, a storage business that is hard to like." What's partially hidden, however, are rapidly growing products such as GreenLake, a service that manages clients' on-premise and cloud-computing needs, and Aruba, which maximizes the performance of applications on internet-connected devices.

"When I think about the future of this company, the product is HPE GreenLake," CEO Antonio Neri said on the March 1 earnings call. "Everything gets delivered through HPE GreenLake, whether it's connectivity through a subscription model, whether it's computer storage that you can consume elastically with data services running on top of it, whether it's the services to operate in a hybrid [cloud] world. HPE GreenLake is becoming a platform of choice for many customers because it offers that flexibility and in an architecture that's edge-to-cloud."

Yet the stock trades at 9.8 times trailing earnings, 7.3 times this year's estimate and sports a 3.1% dividend yield. While the balance sheet showed \$10.2 billion in net debt as of Jan. 31, HPE's operating businesses are essentially debt-free; more than 100% of those borrowings were related to the finance unit.

Hewlett Packard Enterprise is not quite down the middle of the Hale Capital Partners fairway. CEO Neri is a HP lifer, having worked at the company since 1996, rather than an outsider, and HPE is mathematically unlikely to appreciate by 10–50 times from its current valuation since it already commands a \$20 billion market cap. But revenues are growing, the balance sheet is strong and the P&L ink is black, which positive attributes make Hewlett Packard Enterprise about the closest thing to a "wid-

ows and orphans" pick as exists in the bombed-out wing of the tech universe.

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G5 Entertainment A.B. (G5EN on the Nasdaq Stockholm Main Market), Hale's second idea, makes free-to-play video games for smartphones and tablets. G5's primary target is women aged 35 years and older (the prime of life —*ed.*). The G5 stable of games, which includes Hidden City: Mystery of Shadows, Jewels of Rome and Sherlock, features puzzles rather than action. Headquartered in Stockholm, G5 derives 61% of revenues from North America, 22% from Europe, 10% from Asia and 6% from the rest of the world.

Just why the stock has been dragged down by Russia's invasion of Ukraine may rather seem a mystery. A March 31 report by Sidoti & Co., LLC helps to explain it: "Most of its roughly 950 employees are in Ukraine and Russia. The positions in Ukraine are mostly quality testing and back-office, while Russia hosts user acquisition and marketing. Management said about 10% of its workforce has so far exited Ukraine, and of its Russian workforce, 20% left the country. About 870 employees have been able to work despite the situation."

From May 3, 2021 to date, the G5 stock price has collapsed by 66% in krona terms, valuing the equity at 9.8 times trailing earnings and 7.8 times the 2022 estimate; the dividend yield is 3.2%. As of Dec. 31, the balance sheet showed SEK 162.2 million (\$17.1 million) in cash and no debt. With a market cap of \$207.4 million, G5 is about 100 times smaller than HPE.

"It has a couple of good growth engines and a particularly good shot on goal with a new game," Hale said, referring to Sherlock. "It's a mobile-gaming company. The common misconception about mobile gaming is that it is a 'hits' business. We think of them as 'maths' businesses. Good CEOs are good capital allocators who are willing to cut off poor-performing games and able to not spend too much money and get strong cash paybacks on their titles."

Prior to the invasion, G5 appeared to be doing that. Yes, revenues fell 3% year over year in the fourth quarter of 2021. The Hidden City game, which was released in 2014, accounted for 33% of revenue and that percentage is gradually shrinking. The end of lock-

downs weighed on sales around the holidays: "People certainly spent a little bit more time outside or with their families than the previous couple of years," CEO and co-founder Vladislav Suglobov said on the Feb. 10 earnings call. Not to worry, though, as gamers glued themselves to their phones once again in the new year.

G5's M.O. is to develop its own games, which command higher margins than the ones it would have to bid for, and to sell through online stores that charge less than an arm and a leg (e.g., Microsoft's store, which levies a 12% commission, less than half of the 30% charged by Apple, Inc. and Alphabet, Inc.). Thus, in the fourth quarter, sales of "own-IP" games rose to 67% of total revenues from 61% in the same period in 2020. As a result, operating profit rose 8% year over year despite the decline in sales.

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Hale's final selection, mdf commerce, Inc. (MDF on the Toronto Stock Exchange), is both the smallest of the three, with a \$101.1 million market cap, and the one in the greatest need of help. Connecting buyers and sellers is the not-entirely-descriptive business model. Operations come in three

parts: e-procurement (55% of revenues in the quarter ended Dec. 31), which creates solutions for governments to manage bids and gives contractors access to buyers; unified commerce (32%), which facilitates online sales for retailers, grocers and manufacturers; and e-marketplaces (13%), websites that focus on specific market niches, e.g., www.carrus.ca, which caters to the automotive-repair industry.

While mdf's suite of businesses is growing (7.2% year over year in the December quarter, excluding acquisitions), the corporate whole is unprofitable. The third fiscal quarter showed a loss of C\$4.7 million (\$3.7 million) on revenues of C\$30.7 million. At year-end, the balance sheet showed net debt of C\$39.2 million.

"Mdf commerce did just about everything wrong in the book: a new CEO; three [equity] raises without a use of proceeds; bought a business called Periscope that he way, way overpaid for," said Hale. "He paid more than the entire market cap of the business. It's been a disaster of capital allocation."

Now that it is over-bought and paid for, Periscope burnishes the e-procurement division and gives the company a useful entrée into the United States. "We now have a network of over half a million suppliers transacting on our

platform with over 6,000 government agencies in 40 states and 10 provinces," CEO Luc Filiatreault said on the Feb. 10 earnings call. "Ultimately, once we've completed the integration, mdf commerce will offer a one-stop shop by way of a dominant marketplace central hub, where suppliers and buyers from all levels of government will do business together across all of the jurisdictions we cover."

That is all well and good, but mdf paid \$259 million for that business on Aug. 31, 2021 versus the current parent market cap of \$101.1 million. Since a peak on Feb. 5, 2021, the share price has collapsed by 83% in Canadian dollars. Thanks to the selloff, mdf trades at 1.6 times enterprise value to estimated 2022 sales, a "damn cheap multiple for a software business," Hale added.

Change may be afoot. Chair Gilles Laporte has announced he will not seek reelection at the next general meeting. Canadian pension funds Fonds de solidarité FTQ and Investissement Québec, which together hold 25.8% of shares outstanding and bought some of the stock issued to fund the Periscope acquisition, are nursing heavy losses. "As a fiduciary," Hale observed, "you can't let a company behave that badly for that long."

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