

GRANT'S

INTEREST RATE OBSERVER®

Vol. 31, No. 22a

Two Wall Street, New York, New York 10005 • www.grantspub.com

NOVEMBER 15, 2013

Introducing the *Grant's* Story Stock Index

No bull stock market is complete before the debut of the kind of equity that's valued on the quality of its narrative. It's the anticipation of earnings, not their actual arrival, that sets the speculative heart fluttering in the late stages of a proper levitation. "The road is better than the inn," wrote the immortal Cervantes centuries before the Twitter IPO.

Now unfolding is a review of the new crop of story stocks. We write for the not-so-far-receptive members of the Federal Open Market Committee, as well as for the sainted paid-up subscribers. Nothing flatters distantly projected earnings more than an ultra-low discount rate, as Evan Lorenz, our own in-house Chartered Financial Analyst, points out. Here, then, is a story of interest rates as much as of stocks.

"One hundred dollars of earnings 10 years in the future are worth \$38.55 today if discounted at 10%," CFA Lorenz reminds us. "At a 5% discount rate, they are worth \$61.39. But at a zero-percent rate, they are worth \$100—and would be worth that much from here to eternity." So while each of the 15 component companies in the *Grant's* Story Stock Index has its own story to tell, the unifying theme is ZIRP.

Not just any "shooter," to reclaim a term from the "great garbage market" of the 1960s, qualified for the *Grant's* index. Lorenz screened for stocks that are expensive on multiples of earnings, EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), or that show no earnings but trade at high multiples of revenues. When possible, our candidates exhibit other characteristics of a good short-sale specimen, in-

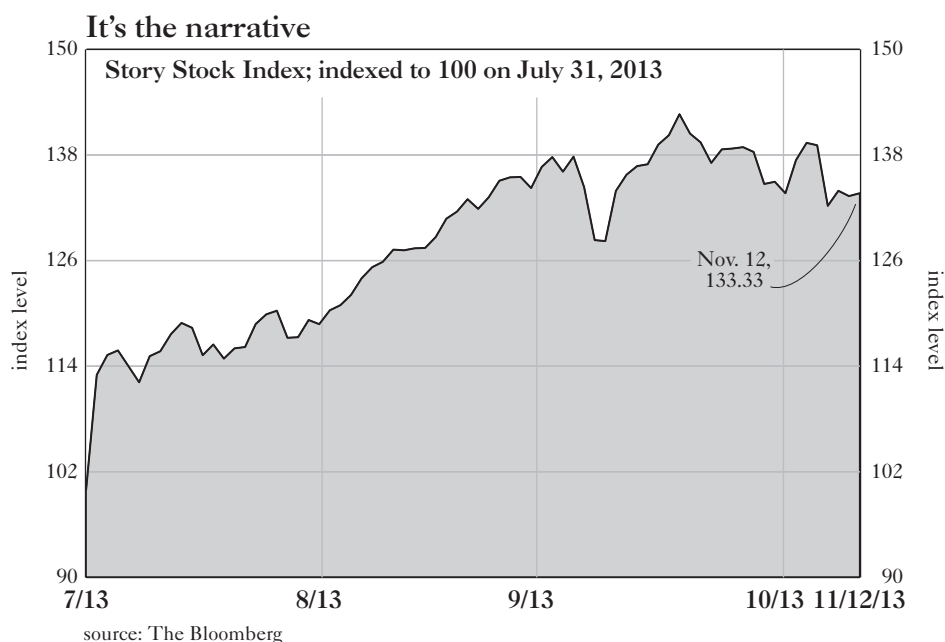
cluding insider selling and an adequate supply of shares to borrow (the exceptions on this latter score are Zillow and ChannelAdvisor). All but one of the names is a member of the Russell 2000, the exception being Sprouts Farmers Market, which we deal with elsewhere in this issue. Let's have a look at what the bull dragged in.

Tile Shop Holdings (TTS on the Nasdaq), our first exhibit, ticks the most critical story-stock box: It's valued not on what has happened but what may come to pass in the far reaches of the future. Founded in 1985 by the incumbent CEO, Robert A. Rucker, Tile Shop went public only in 2012. The company operates 83 stores that average more than 22,000 square feet. It operates them in

28 states, mainly in the Midwest and Mid-Atlantic regions, in which it sells tiles, both stone and ceramic, as well as setting and maintenance products. It buys straight from manufacturers; 58% of its tile comes from Asia.

Chinese quality control not being all that it might be, the heavy reliance on Asia raises concerns about product integrity. Indeed, Rucker conceded on the Oct. 30 earnings call, that some of the company's merchandise "may contain trace amounts of inorganic metals." He said that, to nip a potential problem in the bud, URS Corp. has been retained to investigate the company's supply chain.

Quoted at 48 times the 2013 earnings estimate, Tile Shop would like the world to know that it means to grow to 140 to



150 stores in the “near term” and to more than 400 stores in the “long term.”

And the world's a believer, to judge by the track of the share price. Home Depot and Lowe's Cos., which also carry tile products, change hands at an average of 21.8 times their 2013 estimates. Has Mr. Market, under the influence of Mr. Bernanke, perhaps gotten a little ahead of himself? As it is, Tile Shop trades at a \$1.1 billion equity market cap. Let us assume that it achieves its near-term goal of 145 or so stores. And let us further assume that, having built them, the company watches its earnings multiple contract to match the more mature valuations of Home Depot and Lowe's (the road is better than the inn, after all). In that case, if one applied Tile Shop's current tax rate and margins, a \$1.1 billion equity market cap would be in order. In other words, you could argue, Tile Shop is already valued as if it has done what its CEO has only promised it will do.

If Tile Shop commands a much higher valuation than its mega-box, do-it-yourself comps, a bull might interject, it's because Tile Shop earns so much higher margins than they do. In fact, the would-be national tile superstore chain reported a 27.7% EBITDA margin in 2012, more than double those of Home Depot and Lowe's.

One might suppose that the cost of being a public company would whittle Tile Shop's EBITDA margin, say by two or three percentage points; the law of diminishing returns may prove another source of margin compression. The store count grew to 53 from 42 in the three years through 2011. It jumped 28%, to 68, in 2012, and it's expected to rise by an additional 29%, to 88, in 2013.

In years past, says the front office, a new store would generate sales of \$1.9 million in Year 1, whereas recent openings produced revenues of \$1.8 million in the first 12 months of operation. Not that that fact is cause for concern, CFO Timothy C. Clayton assured dialers-in on the third-quarter earnings call. “[T]he performance of our stores in subsequent years is growing at a faster rate than previously discussed,” said Clayton. “We now find that, on average, our new stores grow at a 22% to 23% rate the second year, 12% to 14% the third year, at 7% to 9% in the fourth year.” How Clayton can be so sure of years three and four, we don't know; Tile Shop's recent growth spurt only started two years ago.

Story Stock Index (in \$ millions)

name	ticker	mkt. cap.	short int. float	price to est. 2013 earn.	—EV/est.—	
					2013 sales	2013 EBITDA
Demandware	DWRE	\$1,888	5.2%	—x	17.6x	—x
ChannelAdvisor	ECOM	841	6.7	—	13.9	—
Tile Shop Holdings	TTS	1,072	15.0	47.7	4.9	19.8
Opko Health	OPK	4,081	16.2	—	42.4	—
Boulder Brands	BDBD	917	13.4	49.8	2.5	15.4
Sprouts Farmers Market	SFM	7,058	3.4	101.8	3.1	39.2
Infoblox*	BLOX	2,274	3.9	80.5	8.0	50.9
8x8 Inc.*	EGHT	720	5.7	49.2	5.2	37.3
Constant Contact	CTCT	858	8.7	38.6	2.6	16.4
Mobile Mini Inc	MINI	1,785	4.1	33.6	5.8	15.2
Cornerstone OnDemand	CSOD	2,449	5.7	—	13.1	2125.3
Shutterstock	SSTK	2,569	11.9	87.8	10.5	49.1
Textura*	TXTR	709	18.7	—	18.4	—
Yelp	YELP	4,578	12.1	350.2	19.5	155.1
Zillow	Z	3,056	22.1	5188.0	14.8	121.4

*non-financial years

source: The Bloomberg

That it's no easy thing to manage an expansion like the one Tile Shop envisions is obvious on its face. But for any who doubt it, consider management's about-face on advertising outlays. A note in the 2012 10-K report boasts: “Unlike many of our competitors, we do not rely on significant traditional advertising expenditures to drive our net sales. We establish and maintain our credibility primarily through the strength of our products. . . .”

Compare and contrast Rucker's remarks on the Oct. 30 call: “Right now, we're testing television advertising in a few select markets to replicate a national advertising budget.” All in all, we are going to venture that not since the great mosaics of the churches of Constantinople has anything having to do with tile been so richly valued as Tile Shop is in the zero-percent Bernanke stock market.

Health is the narrative of our second Story Stock Index component company. Boulder Brands (BDBD on the Nasdaq) is the top maker of gluten-free foods in North America and a leading maker of buttery-like spreads without trans fat. Udi's and Glutino and Earth Balance and Smart Balance are among its brands. Its customers may be vegan, or gluten-intolerant, or trans-fat averse, or just fashionable. Whoever they are, management is betting there'll be more of them, and the stock market seems to agree. The shares are valued at 50 times forecast 2013 earnings.

“The bull case for Boulder is that the gluten-free diet is going mainstream,” Lorenz relates. “A certain number of Americans suffer from celiac disease, a disorder in which eating gluten—found in wheat, barley and rye—triggers an immune reaction. The National Foundation for Celiac Awareness puts the figure at three million, and it reckons that another 18 million may be gluten-sensitive. Boulder Brands estimates the combined ranks of celiacs and the gluten-sensitive at 43 million. It does Boulder no harm that the No. 2-ranked male tennis player, Novak Djokovic, ascribes his professional surge to a gluten-free diet.

“I have a number of relatives who are gluten-sensitive,” Lorenz continues. “While gluten-free is rapidly expanding from a low base, there are many reasons to doubt it will catch on with the mainstream like the Atkins diet in the 2000s, the low-fat diet in the 1990s, or even bran muffins in the 1980s. Reason No. 1, gluten-free bread lacks the taste and texture of bread made from wheat—if you have to eat it, be sure to toast it and slather it with cheese. No. 2, gluten-free recipes are typically higher in calories than ordinary ones. No. 3, gluten-free is more expensive.”

As for Boulder, you wonder about the quality of its revenue growth. In the third quarter, it achieved a 17% bump in sales with a 40.4% leap in accounts receivable. It was the ninth consecutive

quarter in which growth in receivables outpaced growth in revenues.

One wonders, too, about the Smart Balance division. In the third quarter, it chipped in 35% of sales and 46% of earnings, and it did so on the back of declining revenues—down by 4.4% after adjusting for discontinued product lines. Nor will competition likely be less intense after the scheduled April 7, 2015, expiration of the patents that protect the Smart Balance approach to heart-healthy spread manufacture.

Boulder Brands grew out of Smart Balance, but that core business alone could never have landed the company in the kicky *Grant's* Story Stock Index. Failed attempts to “leverage” the Smart Balance brand, in fact, led to a \$130 million write-down in 2010. Source of the current corporate sparkle is rather the gluten-free business. It contributes the lion's share of the 65% of revenue and 54% of profit that Smart Balance brands did not provide in the three months to Sept. 30.

How does the gluten-free business look from outside the corporate walls of Boulder Brands? To the CEO of Annie's Inc., John M. Foraker, who spoke at the Barclays Back to School Consumer Conference on Sept. 4, it seems to look a little faddish.

“Those [gluten-free] items are doing exceptionally well,” said Foraker. “They’ve been growing much faster than the total business for quite some time, but we are also cognizant that some consumers are in gluten-free maybe for diet reasons and other things, which may be not as sustainable. So we want to make sure that

we have products that taste great. So that’s limited what we’ve done there in terms of SKU proliferation.”

Net of cash, Boulder Brands shows debt of \$242.1 million, or 3.9 times trailing 12-month EBITDA. Over the past 12 months, operating income covered interest expense by 2.4:1. Debt is a fad, too.

A “storied story stock”—that’s Lorenz talking—is our specimen No. 3, Opko Health (OPK on the Big Board). Founded in 1991 as Cytoclonal Pharmaceuticals and known at other times as eXegenics, Opko has apparently never generated net income. It has tried but failed to produce cures for cancer, infectious diseases and macular degeneration. Still at it, the company is today trying to diagnose prostate cancer, to produce a long-lasting human growth hormone and to cure nausea related to chemotherapy. It owns a portfolio of miscellaneous businesses distributing and/or manufacturing veterinary and pharmaceutical products in Mexico, Spain and Israel.

Bulls are rooting hard for the success of an Opko test for prostate cancer; a clinical trial of the device, called 4Kscore, is slated for the first quarter of next year. A lingering cloud over the test is a critical editorial that appeared in the May 2010 edition of “Clinical Oncology.” “In this report,” said the editors of an article detailing the performance of the Opko product, “24% of all cancers and 14% of high-grade cancers would be missed . . . it seems that a change in screening practices that misses any high-grade cancer cannot be considered an improvement over standard screening.” In other words, it would seem, here is a

cancer test that misses cancer.

What remedial action, if any, Opko has subsequently taken to address the concerns of its critics, we don’t know. Some, the bulls must expect. An estimate by Jefferies & Co. ascribes \$4 out of the \$10 share price to the value of the 4Kscore test. On a hopeful note, the company launched the product in the U.K.; it did so in October 2012. On a somewhat less hopeful note, no trace of any 4Kscore-derived revenue is to be found in the company’s subsequent financial filings.

To be clear, we do not insist that Opko will not succeed in one or more of its myriad undertakings; a new growth hormone is said to look promising. All we are saying is that this particular lottery ticket, valued at 42 times estimated 2013 revenues, says as much about the stock market as it does about the present value of any reasonably likely future cash flows that Opko might one day actually generate.

Reviewing the flyaway stock market of 1968-69—that “great garbage market”—the author John Brooks, in his history, “The Go-Go Years,” had this to say about stocks like the ones in the new *Grant's* index:

“[W]hat a promoter needed to launch a new stock, apart from a persuasive tongue and a resourceful accountant, was to have a ‘story’—an easily grasped concept, preferably related to some current national fad or preoccupation, that *sounded* as if it would lead to profits.”

Tiles may not yet be a national preoccupation, and the top of this particular stock market may not yet be in sight. So be it. At *Grant's*, the watchword is vigilance.

Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc. PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else. Copyright ©2013 Grant's Financial Publishing Inc. All rights reserved.