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Long: Psychomedics (PMD) - \$7

I started my first full time job during COVID. It's been almost a year since I was supposed to be drug tested. Here's how you can make money on that.

Psychomedics Corp is a company that specializes in drug tests based on hair. Hair tests are the second most common method behind urine tests. They are a lot more accurate and detect usage going farther back compared to urine tests, but are more expensive. Their major blind spot is in detecting recent usage. The solution there is to combine a urine test with a hair test.

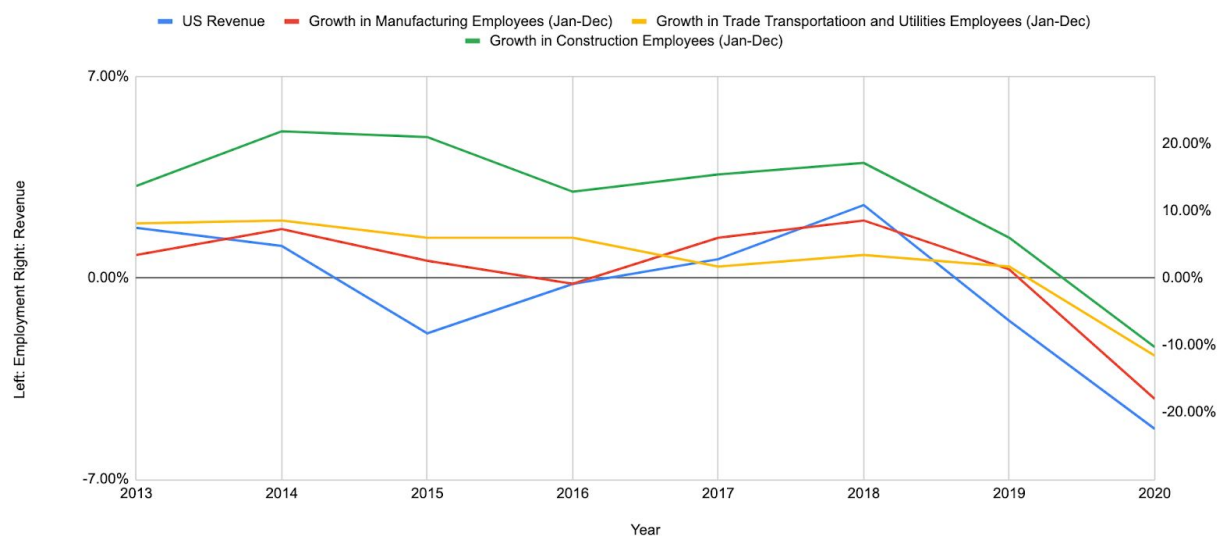
Only 3 labs offer FDA Approved hair-based drug tests: Psychomedics, Quest (DGX), and Omega labs. Psychomedics is the world's largest according to their 10-K. These tests are typically used when a lack of detection can be disastrous so the employer needs to know with more certainty. Psychomedics lists O&G, transportation, education and law enforcement as a few example industries. A major reason these industries choose hair tests is because urine-based tests are actually relatively easy to beat - see YouTube.

The reason why this stock is a buy is simple. People have lost their jobs and will eventually need them again. This operator has seen multiple cycles and, with 0 debt (2m PPP loan should be forgiven Q4 20-Q1 21), is well-positioned to withstand any prolonged slowdown and capitalize on the return to full employment.

1. Reopening

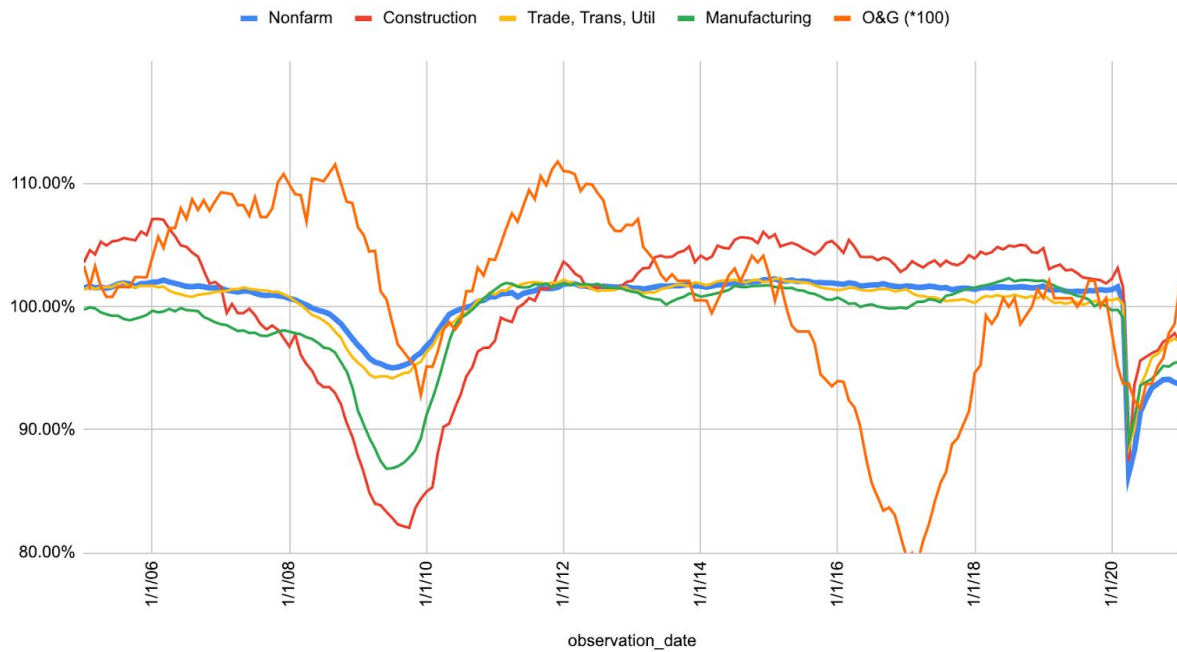
The company is anchored to the health of the labor market, specifically blue-collar and service jobs. Its customers mainly come from education, transportation, services (ie casinos), manufacturing, oil and gas, and law enforcement. The chart below shows that 2019 was an already-poor year for employment growth and that was reflected in the revenue decline of -6% that year (Operations in Brazil also played a large part in the decline). If we are at full employment (3.5% unemployment Jan 2020) there is not going to be much room for job changes (job->job or no job->job) which is where the company profits, since those are the times where potential employees are most likely to be tested.

PMD Revenue and US Employment Growth



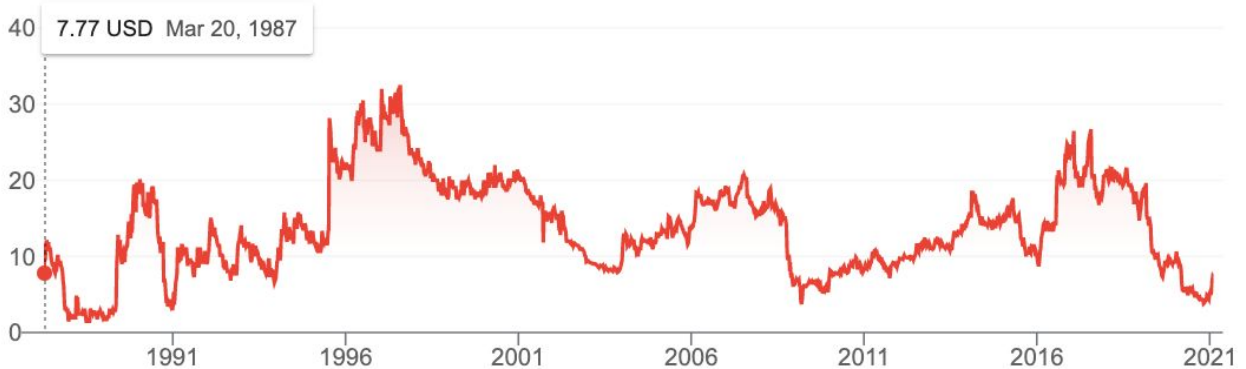
2020 has forced the cycle to run again. Unemployment remains elevated, with millions still unemployed or out of the workforce. While there has been some recovery, much of that likely has created a backlog of tests to be done (similar my anecdotal case). Further, Psychmedic's customer industries are still in a lull. The YoY difference in employment is still near 2008-2009 levels in many of the sectors.

YoY Employment %

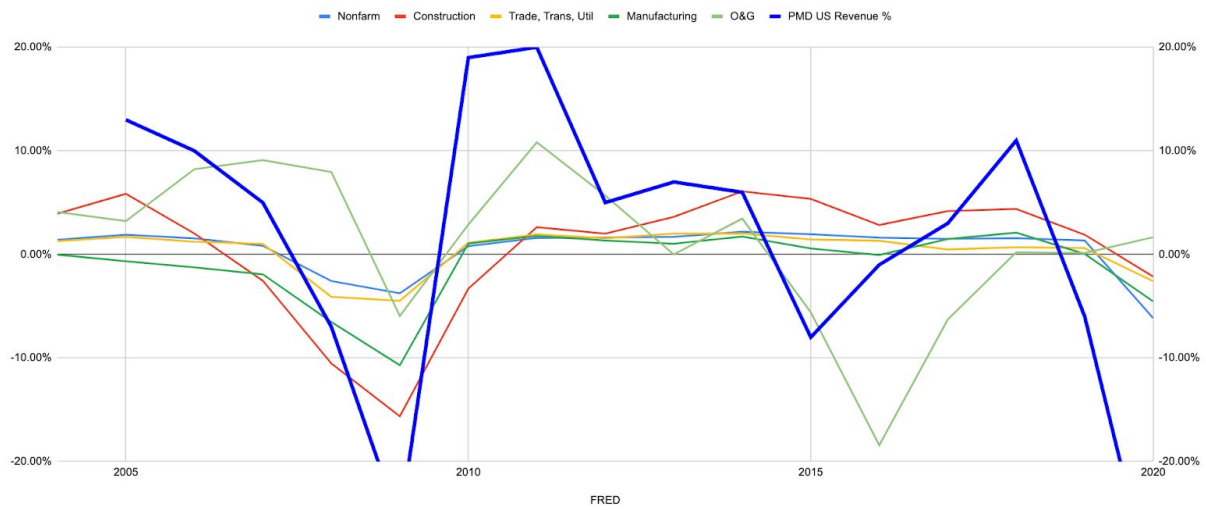


Psychmediccs has been operating as a public company for decades and closely tracks the boom/bust cycle of the US economy. There are obviously company-specific idiosyncrasies but the overall trend is clear. In the two charts below we can see that, since 2004, there have been 3 major dips. First with the great financial crisis, second with the dip in oil prices, and third with COVID. Following the first 2 periods were resummptions of growth. We might be able to assume that the greater the crisis, the greater the recovery, given the growth of 2010-onwards reaching 20% YoY.

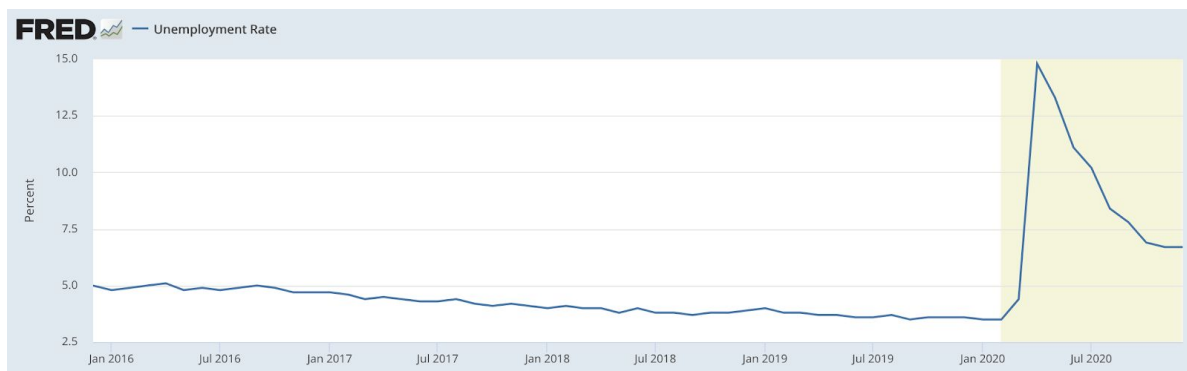
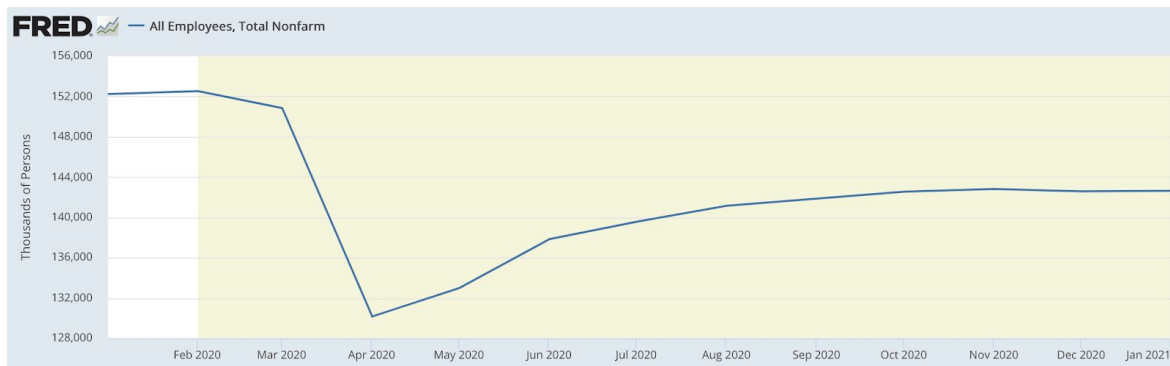
1 day | 5 days | 1 month | 6 months | ytd | 1 year | 5 years | max



PMD US Revenue vs Employment Growth



The most recent recession has left ~10 million people who were employed in January 2020 without work.





A fraction of the 10m will have left the labor force permanently. The remainder will need to return. Of that amount, a fraction will be in Psychmedics industries of focus and a fraction of that will choose the company to complete their tests. This difference is on the same scale as the trough of the GFC. After the bottom was found Psychmedics saw two years of ~20% revenue growth, returning to pre-crisis amounts quickly. If, given the stimulus and nascent demand, 2021 is anything close to a v-shaped recovery, it would be reasonable to expect a similar trend.



2. Brazil

The operations in Brazil seem random upon first glance. The initiative began in 2014 as an attempt to capitalize on regulation that forced drug tests on those renewing their licenses due to a high rate of DUI-related accidents. The stock price reacted to the operating success and possibility of halving the renewal time frame from 5 to 2.5 years which would have effectively doubled the market size. It's still a possibility, as it is technically a law passed but not implemented, but seems like we can't bank on it - especially considering the unrest in the transportation industry and upcoming elections. The company also believes that the sector (or their position in it, due to local undercutting - unclear) was set to decline before COVID. Like the US, there should be a general pick-up due to the broad economic recovery (current unemployment is 10%+), but remains dubious in the longer-term. Yet, since they have no formal operations in the country but rather work through a distributor (ie near-0 fixed costs), there should be no real downside on US operations (75% of revenue) if Brazil were to falter further.

3. Further catalysts

I am going to copy and paste this from Jeff Moore's [blog](#) which appears to be written by [Vanck Zhu](#).

"The federal government is in the process of requiring hair testing for the transportation department. If you read the public docs (link below), it appears that there'll be ~3M hair tests once this fully ramps and hair tests appear to cost about \$40 (maybe \$20 goes to \$PMD? just guessing...). Maybe \$PMD takes 1/3 of market share, or 1M tests (although I think there'll be some cannibalization as some trucking companies already require hair tests). \$20/test...is \$20M, which is quite material vs ~\$30M in U.S. revenues in 2019. If incremental operating margins are 25-30%...that's \$5M+ in operating income and you can see how this gets pretty exciting pretty quick.

<https://www.federalregister.gov/documents/2020/09/10/2020-16432/mandatory-guidelines-for-federal-workplace-drug-testing-programs>"

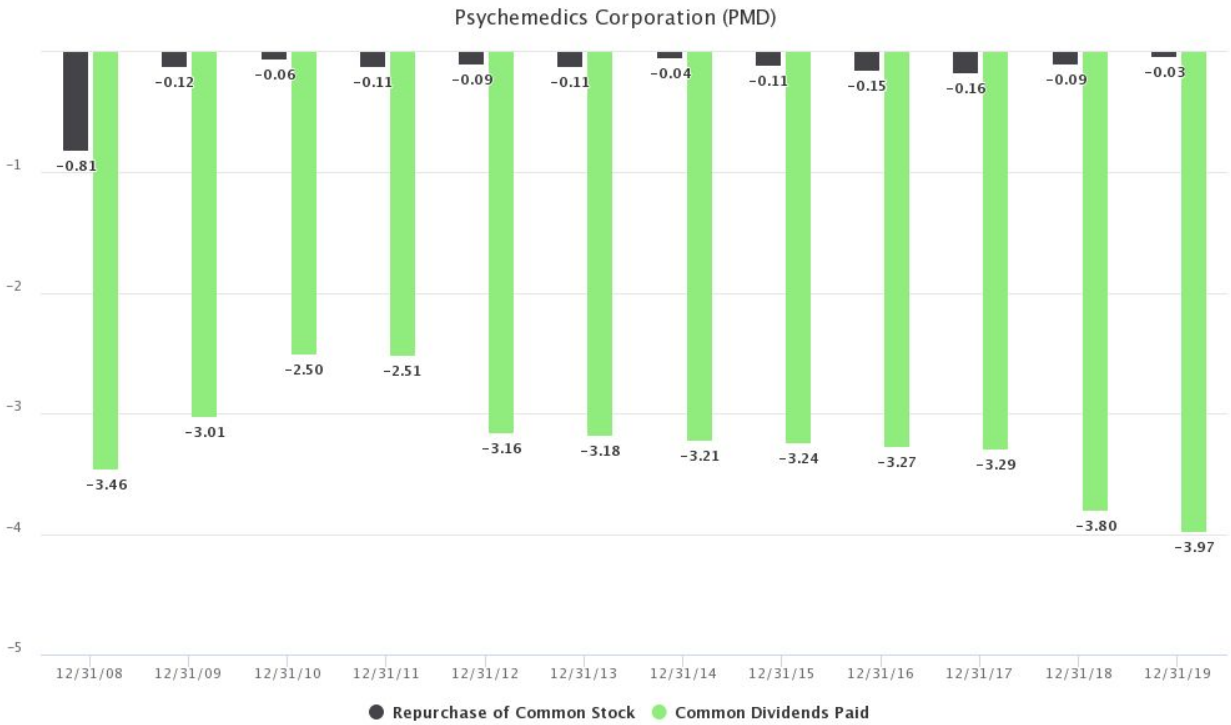
This stock is a buy based on 2019 numbers. A dub based on 2018 numbers. If the passage above is even half right, this should be a home run.

Though, looking into this more, this may be a false promise that has existed for a while, resting on the 2015 FAST act which opens up hair testing as a possibility. On this delay:

"We're looking at sometime into 2021 before these guidelines would even possibly be finalized," said Lane Kidd, director of the Trucking Alliance, a coalition of carriers that includes Schneider, U.S. Xpress, Maverick, Knight-Swift and others.

Even as just an option, there is a significant reason why they would want their drivers to take the test. Any usage can put the trucking company at risk, and it does seem like illegal drug usage is rampant in the industry -a study found that there would be 300,000 fired drivers if the law were to go into effect. The bill in question is a response to the opioid crisis that has affected much of the US.

4. Valuation



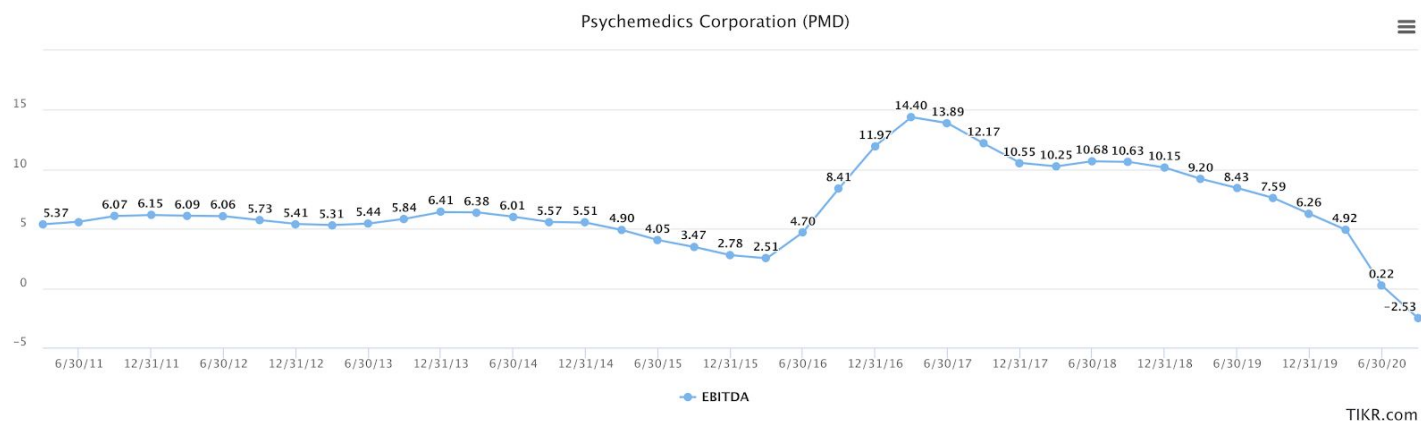
The company has not issued any stock in the last decade and continues to return capital to shareholders, primarily through dividends. With its most recent cash position of 1.8M at the end of Q3 20, they will need to return to profitability before resuming payments at the same rate. Given the vaccine being distributed, reopening regardless, and stimulus, that should be sooner rather than later. An amendment to their lease agreement with Bank of America also stipulates that they cannot pay any dividends until July 2021 where they also must have positive EBITDA. A resumption in payments at the 2019 rate would be a yield of ~10%.



2019 was an already poor year for the company due to the aforementioned slowdown in employment due to being at-capacity, a one-time charge of moving to a different lab due to their lease expiring, declining conditions in Brazil and FX costs. The company increased their dividend by 20% in 2018, and before that in 2012 by 25%. Assuming no change to 2019's payments of .72/share and based on historic yields of less than 5%, there is room for the stock to double. The most attractive feature of this investment is the margin of safety provided by buying this stock at peak forward yields despite the cyclical uptrend that ought to occur as hiring picks up.

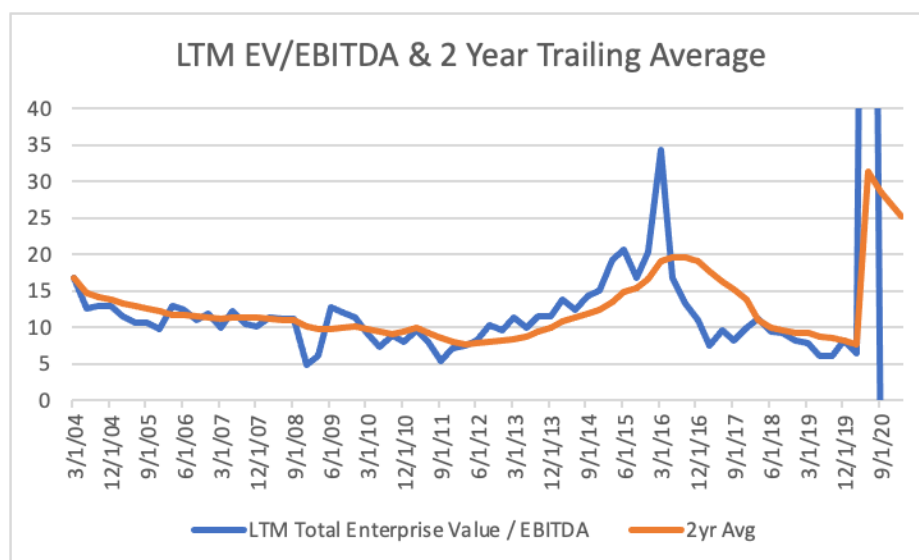
SP	DIV (2019)	Yield	Upside
\$ 7.00	0.72	10.3%	0%
\$ 10.29	0.72	7%	47%
\$ 14.40	0.72	5%	106%
\$ 24.00	0.72	3%	243%

Based on EV/EBITDA there is a similar scenario boasting limited downside and probable upside using conservative assumptions.



Above is the LTM EBITDA for the past decade. We can see consistent results, hurt by the drop in oil prices and employment in 2015, helped by operating in Brazil, and then the anomaly that is COVID. Using 4m as a conservative normalized floor against the historic average multiple of about 10x, we arrive at today's share price. Given the catalysts mentioned, expected pick-up in hiring in the US and Brazil, and the possibility of an expansion of requirements of hair-based drug tests, it's not hard to see why Psychmedics cannot do \$10m (2018's amount) or more in EBITDA within the next year or two, implying over 100% upside from current prices again.

EBITDA (MM)		4	6	8	10	12	14
Multiple	4x	\$ 3	\$ 4	\$ 6	\$ 7	\$ 9	\$ 10
	6x	\$ 4	\$ 7	\$ 9	\$ 11	\$ 13	\$ 15
	8x	\$ 6	\$ 9	\$ 12	\$ 14	\$ 17	\$ 20
	10x	\$ 7	\$ 11	\$ 14	\$ 18	\$ 22	\$ 25
	12x	\$ 9	\$ 13	\$ 17	\$ 22	\$ 26	\$ 30



Sources/further reading

https://www.standard.net/news/government/unreliable-racially-discriminatory-bill-would-stop-hair-follicle-drug-tests-in-child-welfare-cases/article_0c23b7f1-49ff-5717-81cc-52e930d50380.html

Bill aimed at removing hair-based drug tests in child welfare cases because “melanin in dark hair binds with the drugs for a longer time.”

<https://www.ttnews.com/articles/federal-drug-official-defends-proposed-guidelines-hair-testing>

<https://www.freightwaves.com/news/driver-issues/drug-testing-legislation-requires-hair-sample-opioid-testing-for-truck-drivers>

<https://www.ccjdigital.com/business/article/14939870/agencies-years-late-on-mandate-to-reform-driver-drug-testing>

<https://www.ccjdigital.com/business/article/14939959/driver-drug-test-reforms-fact-vs-fiction>

<https://talkbusiness.net/2020/07/nearly-300000-truck-drivers-would-be-fired-if-hair-drug-tests-were-required-uca-study-shows/>

FAST act related

https://www.valueinvestorsclub.com/idea/PSYCHEMEDICS_CORP/0979395610

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<https://sumzero.com/pro/research/ideas/14355>

Past Write Ups