ALJ Regional Holdings

June 10, 2015

Current Information
Price: $3.95
TTM P/E: 8.8x
TTM P/EBITDA: 8.7x
Net Operating Losses: $164 million, expiring between 2020-2028

Summary
ALJ Regional Holdings (ALJJ) is a unique holding company actively monetizing their Net Operating Losses (NOLs). The company previously was the majority owners of a steel mill, KES. ALJJ sold KES in February 2013, paid off all debt, tendered for half of ALJJ's shares (below net cash), and set about trying to acquire a new company. CEO Jess Ravich accomplished this in October 2013, acquiring Faneuil from Ron Perelman's M&F Global for $53 million. ALJJ then followed up that transaction with another deal, purchasing Carpets N' More in April 2014 for $5.5 million.

Currently, ALJJ generates nearly $200 million of revenue between the two subsidiaries along with nearly $16 million of annual EBITDA. Roughly 80% of the revenue is from Faneuil's operations and 20% from Carpets N' More. Faneuil is currently responsible for nearly all of ALJJ's EBITDA.

Investment Background
Arquitos began purchasing shares in ALJJ in November 2012 when they announced the sale of KES and the related tender offer. After the transaction closed in early 2013 the company announced they would be looking to make an acquisition. My view was that Jess Ravich understood the value of the NOLs and would not allow them to be wasted. Ravich is an experienced deal maker, working for Michael Milken in the 1980s and then running a small investment bank. He is currently a managing director at TCW.

After the KES sale closed, the company tendered for half the shares at a discount to the company's net cash. Ravich did not participate in the tender. Arquitos retained our shares and began purchasing more shares throughout 2013. Before ALJJ acquired Faneuil in October 2013 the company was simply a shell company with approximately $176 million of NOL assets. At various times throughout the year shares consistently traded for less than net cash and, occasionally, traded for nearly 25% less than net cash.

As 2013 progressed, ALJJ retired more of its shares and made some money on short term investments. Net assets actually grew throughout the year as cash burn was very low. The final quarterly report before the acquisition of Faneuil, September 30, 2013, showed 26.7 million shares outstanding and net cash and liquid investments of $27.8 million, or about $1.04/sh in net assets.

The investment thesis was that ALJJ would acquire a company larger than the amount of cash they had on hand. The worst case scenario was that they would be unable to find an acquisition and be forced to liquidate. That wasn't an altogether terrible result since the company was a net-net at the time. However, a liquidation would have wasted the NOL assets and would not have been an ideal outcome. In order to have a chance at using as many of the NOLs as possible, ALJJ would need to consistently generate $15 million to $20 million of taxable income each year.

The Faneuil purchase accomplished that goal. Faneuil was purchased for $53 million with $25 million paid in cash, $2.5 million in shares to the seller, and $25 million in a seller note at below market interest rates. The acquisition was done at less than 5x EBITDA and around 6x operating income. 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.

Faneuil's 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, and call centers for utilities. Clients include Florida's SunPass, health exchanges in various states, Bell South, and Dominion Power.

Faneuil generates predictable cash flow and requires low capex, making it a good acquisition for the purposes of monetizing NOLs. Faneuil has cut costs since being acquired by ALJJ, and has also grown revenue and EBITDA. Ravich put in place an effective employment contract for Faneuil CEO Anna Van Buren, which incentives her to safely grow EBITDA over the long term.

The Carpets N' More acquisition has not worked out as well, but it has served as a nice complementary subsidiary to Faneuil. Carpets operates in the Las Vegas housing market and has the potential to grow significantly as new construction rebounds. In the meantime, Carpets has become more efficient and curbed prior losses. The Carpets subsidiary is the lottery ticket when compared to the more predictable operations at Faneuil.

Investment Results

During the time period that Arquitos first began buying ALJJ shares in the fall of 2012, the stock has advanced nearly 400%. We attribute results to having an information advantage, recognizing the value of the NOLs, and appreciating the incentives involved for management and investors.

The company has no analyst coverage and is too small for larger, sophisticated institutional investors. This gives us a distinct information advantage. An example of this information advantage occurred after ALJJ released a quarterly report on February 14, 2014. The report was unusually strong, but 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 filing was nondescript. For those that follow the company closely, there was nearly a week to make buy or sell decisions from the filing.

Additionally, other prospective ALJJ investors in 2013 and 2014 may not have appreciated the value of the company's NOLs. Not only do they provide a tax benefit, of course, but they incentived the company's leadership to make decisions that ultimately led to the significant gains that followed. It was clear than CEO Jess Ravich understood the value of the NOLs and was making capital allocation decisions to maximize their use.

The big gains were made in the company during the transition period from a NOL shell company to today. Investors now analyze ALJJ based on its earnings power, while I was first attracted to the company because of its balance sheet. Shares are still slightly undervalued, and Arquitos continues to own the company, but our allocation has decreased significantly.

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