



MAYER'S SPECIAL SITUATIONS

— Your Guide to Big Profits From “Special Situations” —

Cash-Rich, Deep Value: Meet Jim Roumell

Dear Reader,

I hope you had a wonderful Thanksgiving.

We hosted the great feast at our house this year. Everybody pitched in with something. My 13-year-old daughter, Charlotte, baked two delicious pies -- an apple pie and a pumpkin pie.

A lazy three days followed, but I'm happy to be back in the chair to write to you.

I want to tell you about my recent visit to Roumell Asset Management's investor day...

***** Out of Favor, Overlooked or Misunderstood**

The year 2015 has been a frustrating one for stock picking.

That may sound odd. The S&P 500, an oft-quoted proxy for the stock market, is up for the year and only 2% off its all-time high. But the average masks what really is going on.

Basically, five stocks made up more than 100% of the gains of the S&P 500 this year: Amazon, Google, Microsoft, Facebook and GE. If you take out those five, the S&P 500 is down more than 2% for the year.

Most stocks are down this year. And some are down a lot. It doesn't take much work to find names trading 30% or 50% off their 52-week highs. And if you look at energy and gold stocks, you'll find stocks down a lot more.

So the usual proven method of looking for out-of-favor, overlooked or misunderstood securities hasn't paid off this year... which is all the more reason to pay attention to this approach now.

Markets run in cycles. And the profit potential in deeply undervalued small-cap stocks -- the kind we prefer -- is mouthwatering.

Here I'd like to bring in Jim Roumell. He's the founder of Roumell Asset Management. He runs a fund called Roumell Opportunistic Value (RAMSX). Roumell specializes in finding value, as the website says, in “out-of-favor, overlooked or misunderstood securities.”

This year has been tough, and the fund is down about 16% for the year. I give Jim high marks for transparency and forthrightness. His third-quarter letter includes a frank self-assessment and some lessons learned.

I recommend reading the full letter, which you can [find here](#).

I read a lot of these letters, and his is one of the better ones. He also writes about stock ideas. We'll get to one in a minute.

His portfolio is full of cash-rich, undervalued names. In fact, Jim notes in his Q3 letter that the portfolio is the likely the best capitalized portfolio in his firm's history. "As of the date of this letter, 100% of our top 10 equity positions are unlevered [no net debt] and have an average of 40% net cash-to-current market capitalization ratio. We have the greatest portfolio concentration in high-conviction positions (5% or greater weightings) we've ever owned."

Here's a snapshot of his top 10 holdings. They make up 68.9% of his portfolio as of Sept. 30. The table shows you the net cash in the stock as a percentage of its market cap (or the market price of the stock) along with a pair of valuation stats:

Name	Market Cap (\$ millions) ¹	Net Cash (Debt)/Market Cap ¹	Price/Book ^{1,2}	EV/Revenue ^{1,3}
SeaChange International Inc.	212	34%	1.3	1.2
Rosetta Stone Inc.	146	18%	3.9	0.5
Sizmek Inc.	177	38%	0.7	0.7
Paratek Pharmaceuticals Inc.	334	45%	2.4	NA
Covisint Corp.	84	56%	1.1	0.4
Samsung Electronics Co. Ltd. Pfd	100,024	56%	0.6	0.2
Sandstorm Gold Ltd.	316	16%	0.8	4.5
DSP Group, Inc.	202	59%	1.4	0.5
Liquidity Services Inc.	222	43%	0.8	0.3
QEP Resources Inc.	2,214	-80%	0.6	1.3

¹Source: Bloomberg
²Price/Book ratio is the market price of a stock divided by the book value per share.
³EV/Revenue is the enterprise value (market cap less cash plus debt) divided by trailing 12 month revenue.

This is a portfolio poised for great things.

I was at Jim's investor day at the Mayflower Hotel in Washington, D.C. I had gone last year and found it worthwhile. I was glad when Jim invited me back. I also met him for lunch several weeks later.

I'll share one idea that was at the investor day and is representative of the kind of name Jim likes. It is his second-largest holding: Rosetta Stone (RST on the NYSE).

Rosetta Stone you probably know as the company that teaches people foreign languages. We've all seen those ubiquitous yellow boxes at airports and bookstores.

But the company is in the midst of a transformation. It was primarily a business focused on consumers and language learning. It made it a one-time sale with a physical product. Today, it's focused on selling software to businesses and schools and meeting wider language-learning

needs. This is a recurring-revenue business model, where it earns subscription fees. And today, 72% of sales are recurring, versus a one-time product sale (that yellow box). The transformation here reminds me of the one we've watched develop at Cambium Learning. This is a stock we picked up in July and on which we enjoy a 23% gain so far.

The recurring-revenue, software-driven model is a much more attractive business. It produces high-margin, predictable cash flow. This turnaround has taken longer than expected, though, and I suspect there is some investor fatigue, which explains the low price.

To understand the low price, some context will help. The star in Rosetta's stable is a business called Lexia. This business enjoys 95% renewal rates and should grow 30-35% annually. Then there is an Enterprise & Education segment (which sells to schools, government agencies and corporations), the consumer business and Fit Brains (which is about games to increase memory and concentration, etc.).

Businesses like Lexia and E&E, called SaaS (for "software as a service"), sell for big multiples of sales. The current Credit Suisse SaaS industry index trades at around 4.5x sales.

Jim outlined a conservative valuation that gets you to \$13.50 per share.

The basic formula is: year-end cash estimate (\$40 million) + 2.5x Lexia sales (\$26 million) + 2.0x E&E sales (\$90 million) = \$13.50 per share. And that gives zero value to the consumer business or Fit Brains. (Rosetta bought the latter for \$12 million in December 2013 and has doubled its revenue since.)

There are plenty of transactions to support these valuations. Jim cited a 2012 buyout in which Pearson paid \$90 million in cash for \$42 million in sales for GlobalEnglish.

Another factor in this that I like: Value investors basically control the company now. Osmium Partners (10%), Nierenberg (9%), Roumell (6%), Senvest (5%) and Ariel (19%) own collectively half the stock.

The current interim CEO, John Hass, has a significant personal stake in the business and has options at \$7 per share. Osmium essentially picked Hass to run the company. And I'm confident the exit here is that the owners will sell the company for somewhere around \$13 per share. That could happen in 2016.

You can watch Jim conduct an excellent interview with Hass [here at the investor day](#) (my question comes in at 34:43).

Jim also posted his thoughts on Q3 [here](#).

I think it's a good idea. The downside looks low. The company is in excellent financial shape with lots of net cash. And the stock could double.

Jim's portfolio is full of this kind of thing. If you want exposure to it all and don't want to cherry-pick, park some cash in the Roumell Opportunistic Value (RAMSX), currently trading for \$7.20 per share.

Then go fishing, or whatever you do, and wait for the results to roll in.

Sincerely,

A handwritten signature in black ink that reads "Chris Mayer". The signature is written in a cursive, flowing style with a large initial "C" and "M".

Chris Mayer