Harvard Financial Analysts Club (HFAC) Investor Update

The Harvard Financial Analysts Club (HFAC) is a student-run organization at Harvard College that strives to give interested undergraduates hands-on financial education and investment experience. Full members share the responsibility of managing HFAC's open-end mutual fund. Our investment philosophy stems from the belief that financial markets are not fully efficient; there are arbitrage situations to take advantage of where we can generate meaningful returns from seeking out mispriced assets. However, the underlying goal for all of our investment decisions is capital preservation, or limiting the risk of loss of principal. On the whole, we believe that our active research in companies with low stock market values but the potential to achieve their intrinsic values will give way for investments that will achieve larger returns than the broader market over the long term. Since its creation in 1996, the HFAC portfolio has outperformed the Wilshire 5000 market index by approximately 2% annually.

HFAC currently holds shares in Axia NetMedia, Noble Roman's Pizza, Schuff Steel, and Sandstorm Metals and Energy. Our portfolio consists of micro-cap stocks—companies with a low market capitalization. Generally, microcaps yield a higher return during an economic recovery, but the volatility of the returns is greater due to the lack of knowledge about them in the market. However, this property gives us an advantage; it leaves room for us to do our own research on potential scenarios for the companies and to determine how such changes might affect the price of the stock.

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Company: Axia Netmedia Inc.
Current Price: $1.49
Target Price: $2.50

Axia Netmedia (AXANF) owns and operates high speed data networks, and generates capital by selling bandwidth. The networks themselves are constructed with government support, since the initial costs are so high. Currently Axia has overseen investment of approximately $2 Billion into 30,000 km of fiber across Alberta, France, Massachusetts, Spain and Singapore. Networks are currently operational in Alberta and France. The company expects 48% YoY growth in bandwidth usage into the foreseeable future. This growth will come as the company moves beyond planning and construction in Massachusetts, Spain and Singapore, and expands its current bandwidth traffic and offerings in Alberta and France. As its networks mature, they should become more profitable, as exemplified by the success in Canada.

On a fundamental level, AXX is well situated. Its current ratio is close to 1.7, indicating that the company is stable over the short-term. In fact, AXX could pay off all of its current liabilities using only cash and short term investments, and still have over $3 Million to spare. Despite being poised for growth without apparent danger of insolvency, AXX has a P/B ratio below 1. There are several factors which may influence the low valuation. AXX is illiquid, with less than $100,000 of stock changing hands each day. Additionally, it seems to have attracted little public interest. One crude example of its relative obscurity is the fact that AXX only has 3 followers on the popular market news site Seeking Alpha. Furthermore, the network operation and construction business is not flashy or exciting, and there are some worries about dangerous competition with wireless data providers. Despite this, the tremendous potential of major investments that will soon turn mature into profitability will create powerful opportunities for growth with strong downside protection.

It is rare for the market to misread a company; however, Axia's relative obscurity, unique temporal position, and lack of publicity make it a compelling long term buy. HFAC's current price target is $2.50 per share. Once it hits this marker, we believe that it would be prudent to re-evaluate the position of the company and potential for continuing growth before selling.

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Company: Schuff International, Inc. (SHFK)
Current Price: $11.60
Target Price: $19.44

Schuff International (SHFK) is a 36-year old family company that serves as the largest steel fabricator/erector in the United States. It is headquartered in Phoenix, Arizona and operates in Florida, Georgia, Texas, California, and New York City as well. Its main operations are the design, fabrication, and erection of projects, the delivery of ready-to-use constructions to buyers, the manufacturing of joists, and the manufacture of products relevant to the petrochemical industry. The majority of its markets are industrial, public works projects such as bridges, stadiums and convention centers. Although the company exists in a cyclical and fairly risky industry, the stock is thought to be heavily undervalued. Despite its volatility and value plunge following the financial crisis, analysts predict the construction industry (and consequently Schuff International stock) to be on the rise as a result of low rates and high levels of borrowing for construction projects.

SHFK demonstrates an impressive 77.20% quarterly growth. Adverse effects of the 2008 crash placed a high debt-load onto the company and scared many investors away, dropping the stock's price from $35 to ~$10. However, Schuff International has proven to be consistently profitable, with a normalized FCF yield greater than 20% and positive annual EBIT since 1995. Although the company has $56mm in debt (4x the EBITDA) its Altman Z-score is 2.8, suggesting bankruptcy is unlikely. This debt becomes increasingly less worrisome when considering the company's stable budget sheet, consisting of over $60mm in land and buildings alone, as well as the fact that the principal debt holders are all company founders. The EBITDA model predicts cash holdings to be $22 mm and $32 mm in 2012 and 2013, respectively, which is more than enough to cover debt requirements.

To conclude, Schuff International remains a promising hold and is estimated to be trading at .4x of book value, signifying a high potential premium. Analysts seem to have overlooked its consistent recovery, placing higher emphasis on its current debt and the adverse effects of the 2008 crash. HFAC believes that there is a great potential for growth in this company, having a target price of $19.44, around 169% of its current trading value of $11.51.

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Company: NROM
Current Price: $.85
Target Price: $1.80

Noble Roman's Pizza (NROM) is a pizza company headquartered in Indiana that specializes in franchising and supply chaining. The business operates on a unique model that earns most of its revenue from non-traditional (62%) and take-and-bake franchises locations (18%) as opposed to traditional franchises (12% revenue). The company gained some notoriety in 2008 when former franchise owners sued the company, accusing it of fraud. Fortunately, Noble Roman's received a favorable summary judgment in 2010 and all subsequent appeals have been rejected. In response, Noble Roman's countersued for breach of contract, claiming $3.6 million in damages and $1.4 million for legal fees. Noble Roman's claim was granted, but the final award is pending.

HFAC has decided to invest in Noble Roman's at a cost basis of $.90 per share based on a promising valuation analysis. The worst estimate for a discounted cash flow valuation places the value of the stock at $.72 per share, predicated on the assumptions of no groceries added per year, zero growth in non-traditional stores, no legal payment, and a 35% decline in franchise stores. However, we believe this estimate to be extremely pessimistic and unlikely. The base case, a share price at $1.13, is the assumption that underlies our decision to invest. This valuation assumes 100 groceries added per year, non-traditional store growth at 3%, franchise stores declining at 20% per year and $1 million in legal payout. Finally, the best valuation estimate is $1.67 per share, assuming an increase in 400 grocery stores per year, 3% non-traditional stores growing, franchise stores staying flat, and a $4 million legal payout.

The valuations take into account the possible risks of the Indiana Franchise Act and possible future legal complications, a smaller than expected lawsuit payout amount, the potential inability to sign new grocery stores, and the conceivable wasting of resources on standalone Take-and-Bake stores. However, the legal risks appear to be largely settled, and we have strong faith in the company to be able to overcome the potential management risks. Overall, the company promises to provide strong returns in the relatively near future, with very minimal loss in the worst case.

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Company: Sandstorm Metals & Energy Ltd. (STTYF)
Current Price: $0.40
Target Price: $0.74

Sandstorms Metals & Energy Ltd (SND.V) provides finances for late-stage, pre-production metals and energy companies. In exchange for these finances, SND receives what are essentially deep in the money calls on various commodities with long-term expiration dates. The company is currently undervalued partially since it is an obscure Canadian micro-cap spinoff, and also because of a bad deal with Royal Coal that scared away investors but is not reflective of the overall security of Sandstorm's contracts. The company has essentially zero competitors in its field and even with the most conservative assumptions about mine life, the value of the equity was $0.74. There are a couple of key reasons on why Sandstorms Metals & Energy Ltd. is worth investing in.

The unique finances model of the firm is attractive because powerful investors leverage to commodities with decent downside protection. Late stage, pre-production mining and energy companies need money quickly, and banks will take around 3 months to provide the financing while Sandstorm is able to do so in a third of that time. Unexpected production delays and swings in commodity prices also make a joint venture partner like Sandstorm preferable over a bank.

Secondly, the management team is extremely experienced and incentivized. Nolan Watson, the CEO, became the youngest CFO of a multi-billion dollar publicly traded company while he was CFO of metals streaming company Silver Wheaton. During his time as CFO, market cap grew from $300 million to $3 billion for that firm, which was the first company to apply a commodity streaming model in the context of the mining industry. His experience, combined with the niche position of the firm's business model, suggests a high potential for growth, justifying the $0.74 target price.

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