

## Exclusive Interview with Aaron Edelheit

We recently had the pleasure of interviewing Aaron Edelheit of Sabre Value Asset Management, a value-oriented investment firm founded in 1998. The firm manages the Sabre Value Fund and two distressed real estate funds. Edelheit graduated with a B.B.A. in finance from the University of Georgia in 1996. He is a philanthropist and serves on the board of directors of the Moishe House Foundation. Edelheit maintains an online blog at [aaronedelheit.com](http://aaronedelheit.com), which we have found educational and thought-provoking. Since June 1998, Edelheit has reported a compounded annual net return in excess of 12%.



**Aaron Edelheit**  
Sabre Value

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**The Manual of Ideas:** Value investors come in many different stripes. How does your approach differ from some other value-oriented strategies?

**Aaron Edelheit:** I focus on small to medium sized companies that most investors have never heard of. My goal is to find companies that are very attractive, but aren’t being followed closely due to their size, lack of analyst coverage or neglect. I look for change inside of those companies that investors are not seeing and that will make the company much more valuable. Specifically, I’m looking for spin-offs, companies restructuring, turnarounds and special situations, such as a company with two divisions, in which the poor division is masking the other division that is very attractive. And I take very concentrated positions, am patient and do not use leverage.

**MOI:** You have at times put in writing your thesis on your favorite ideas, both long and short. Let’s take a look at some of what you’ve written and extract lessons that may help us become better investors. In April 2009, when **Sprott Resource (Toronto: SCP)**, an investment firm controlled by respected Canadian investor Eric Sprott, traded at C\$2.65 per share, you wrote, “What if I told you there was a company out there that was predominantly sitting in cash, gold and silver bullion with no debt, whose tangible book value is approximately C\$3.50 per share, with little expenses, that was selling for C\$2.65 per share? Better yet, what if I told you that it is run by one of the best resource investors around, who has a proven record for making investors money and has increased book value from \$1.50 to over \$3.50 in two years?” Many investors reading your argument might have said, “Yes, I see that SCP is undervalued on a sum-of-the-parts basis, but what is the catalyst to unlocking value? Can’t the discount persist indefinitely?” Eight months later, SCP traded at more than C\$4 per share, with additional upside looking likely due to value creation in the interim. When dealing with investment vehicles such as SCP, how do you decide what discount to net asset value is sufficiently compelling, and how do you avoid the entities that do trade at wide discounts to NAV for a long time?

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**Edelheit:** Sprott was a compelling investment because it was trading at \$2.65 per share, had \$3 per share of cash and gold bullion and another \$0.50 per share of investments with no debt. Insiders were buying like mad and the company was buying back stock as aggressively as it could. The key to this not being a value trap is that the company was buying back 10% of its stock a year (still is) and there were no losses taking away that value. The catalyst was the buybacks and further investments that Sprott had made increasing the book value past \$3.50, which they have done.

**MOI:** You also wrote the following about Sprott Resource in April 2009: “While the market may not be buying, insiders sure are. The Chairman, Eric Sprott, has bought 631,200 shares in the last four months and the CEO, Kevin Bambrough, has bought 412,000 shares. And they have done this buying despite already owning large stakes.” How important is the existence of insider buying to your stock selection process? Do you use it primarily as “confirmatory evidence” or do you also screen for new ideas based on who’s buying their own stock?

**Edelheit:** Insider buying is very important. But it is critical when you see insider buying is happening as the stock goes up. Every time I see insider buying on the way up, the stock has always followed. I do both, use it as a confirmatory piece of evidence and use it to generate ideas.

**MOI:** You provided the following update on your valuation analysis of Sprott Resource (Toronto: SCP) in January 2010:

	\$/CAD	# of units	\$ per unit	Total value
Cash				\$41,364,405
Gold (oz)	1.06	73,971	\$1,100	\$86,250,186
Public Equities				\$25,989,024
Minority stakes in private firms				\$18,978,480
Waseca		73,640,000	\$0.60	\$44,184,000
Stonegate Agricom		63,600,000	\$0.50	\$31,800,000
One Earth Farms		30,000,000	\$1.00	\$30,000,000
Orion Oil & Gas (OIP)		229,000,000	\$1.50	\$343,500,000
Cash From Warrants		16,594,284	\$4.25	\$70,525,707
Fully Diluted S/O		113,953,284		<b>\$6.08 per share</b>
If Orion Oil & Gas (OIP) is at...	\$0.50 per share			\$4.07 per share
	\$1.00 per share			\$5.07 per share
	\$1.50 per share			\$6.08 per share
	\$2.00 per share			\$7.08 per share
	\$1.75 per share			\$6.58 per share

Obviously, as the table shows, the stake in **Orion Oil & Gas (Toronto: OIP)** accounts for a large portion of SCP’s intrinsic value. How do you think about the fair value of Orion—does the recent market price of C\$1.50 per share accurately reflect intrinsic value?

**Edelheit:** I think it does reflect intrinsic value. Orion is a fast growing exploration and production, energy company focused on Alberta, Canada and has 2,650 boe/d of production on its way to 7,000 boe/d of production by year’s end. Orion has 18 million barrels of oil equivalent (MBoe) in proven and probable reserves and is about 45% light oil and 55% natural gas.

There are number of ways to try and value OIP, which is important since it is the biggest piece of the valuation of Sprott. The two I am focused on is on a multiple of debt-adjusted cash flow for 2010 and on an enterprise value to reserves.

Orion currently trades for around 7 times cash flow for 2010. On a multiple of cash flow it appears a bit expensive compared to many other Canadian juniors, which trade for 4-5 times multiples to cash flow, but Orion, is growing really fast, much faster than comps. It should grow its production this year 180% from beginning of the year to year-end. Further, it has little or no debt and it has a well-capitalized partner in Sprott that removes financing risk.

On an enterprise valuation to reserves it comes out cheaper than comps with a valuation of about US\$19 per barrel. Most comps trade on average for over \$20 per barrel equivalent.

Here is the bottom line for investors in Sprott: OIP has to trade below \$0.50 per share versus its current price of around \$1.50 for Sprott to be worth less than its current stock price.

**MOI:** You have successfully invested in companies undergoing a business model change. In particular, you have highlighted companies adding a new recurring revenue stream while a legacy revenue stream might be declining. What is attractive about these kinds of companies, both in terms of the fundamental shift as well as the market's inability to value them properly?

**Edelheit:** Wall Street and investors love recurring revenue models and rightfully so. When a business has a high degree of predictability, investors give it a higher multiple. When a company can shift or enter into a business that allows it to go from selling products to selling products and a service it can become very powerful, as investors are sometimes slow to appreciate it. You can have years of great returns from one stock based on such a change.

**MOI:** What parallels do you see between the opportunity in **KVH Industries (Nasdaq: KVHI)** and your experience with CAM Commerce?

**Edelheit:** My experience with CADA (used to be CAM Commerce's symbol, was bought out in 2008) is what made me so excited about KVHI. CADA sold glorified cash registers, or point of sale systems. This was a crappy low margin hardware business that the company struggled in. They had about 10,000 of these systems installed in mom and pop retailers, when they developed a payment processing system to process credit card and check transactions. They went to their mom and pop retailers and said use us and we will group all of you together and save you 20% on your payment processing cost as if you were a big retailer. To the mom and pop retailer, this was a no brainer, you just save money. To CADA, they got 50 basis points, or 0.5 cents of every \$1 that got transacted. Suddenly, CADA had a cash cow of a business growing at leaps and bounds. When I first discovered CADA, the old hardware business was disguising the new payment processing business. The stock went from \$12 to \$40, where it was bought out three years later.

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*“First, thinking that just because you don’t invest in levered companies and you yourself don’t use leverage, doesn’t make you immune to the stupidity and craziness of what other people are doing. Second, buying on the way down was a terrible practice that I just won’t repeat going forward. I bought too early and too aggressively. Third, when a company disappoints move on, do not linger. I lingered with one investment and it hurt a lot.”*

Fast forward to today and KVHI, which historically made antennas for leisure marine boats and RVs to get satellite TV. You can imagine how good the RV and leisure marine boat business was in 2008 and 2009—terrible. Those businesses were down 50% to 77%! This tremendous decline was masking that KVH had developed antennae to get broadband internet in the middle of the ocean for a fraction of the cost of existing alternatives. Further, KVH was now offering not only the antennae, but the monthly service of providing the Internet to shipping companies, the Coast Guard and oil service boats as well. Suddenly, KVH has a recurring revenue business.

KVH also has a defense business providing fiber optic gyroscopes to the military so that soldiers can operate guns from inside of Humvees and not be exposed to sniper fire or explosive devices. At one point last year this business grew 767%! There are only three companies in the world that offer these kinds of devices.

Both this defense business and the satellite broadband internet business are about to bust out into the forefront as the old line businesses have troughed and the size of the new businesses outweighs any old legacy products. Despite KVH’s excellent performance last year, CADA shows me it is just the beginning.

**MOI:** Stepping back to your core investment approach, are you generally more attracted to companies that might be described as Greenblatt-style “good” and “cheap” businesses or to Graham-style balance sheet bargains?

**Edelheit:** I am very flexible. I will invest in good and cheap and balance sheet. It just depends on the opportunity.

**MOI:** How do you generate investment ideas?

**Edelheit:** Insider buying, spin-offs, turnarounds, restructurings and reading what other really smart money managers are doing.

**MOI:** The art of portfolio management often takes a backseat to the art of security selection, but the former is just as important. Can you shed light on your approach to portfolio management, touching on portfolio concentration, leverage, and short selling?

**Edelheit:** I don’t use any leverage. I’m mostly long. I do some short selling, though it is currently only 20% of the portfolio. I have very concentrated portfolios and focus my investment research and know my companies well.

**MOI:** Late 2008 and early 2009 presented many challenges for value investors but also threw up some of the best bargains in a long time. How did the volatility affect your investment process, and have you tweaked your approach in any way as a result of last year’s experience?

**Edelheit:** I learned a lot from 2008 and 2009. I made a couple of mistakes that really hurt. First, thinking that just because you don’t invest in levered companies and you yourself don’t use leverage, doesn’t make you immune to the stupidity and craziness of what other people are doing. Second, buying on the way down was a terrible practice that I just won’t repeat going forward. I bought too early and too aggressively. Third, when a company disappoints move on, do not linger. I lingered with one investment and it hurt a lot.

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**MOI:** What is the single biggest mistake that keeps investors from reaching their goals?

**Edelheit:** Themselves. For investors, the combination of emotion, fear of loss, greed for gain, how your brain works are all so important and few pay attention to it. I think knowing yourself—what are your weaknesses and your strengths—is critical to being a good investor. I work on it every day.

**MOI:** Are there any “off-the-beaten path” books that have made you a better investor?

**Edelheit:** I just read a fantastic book called [“The First Tycoon,”](#) by T.J. Stiles, about Cornelius Vanderbilt. There were many lessons and ideas I drew from the book about what made him so successful, and I think there is a lot to learn about history as well.

**MOI:** You maintain a blog at [aaronedelheit.com](#), in which you “explore the stock market, faith, Tikkun Olam and humor in no particular order.” For those unfamiliar with the phrase Tikkun Olam, could you explain its meaning and significance to you?

**Edelheit:** Tikkun Olam is the Jewish belief of repairing the world. The idea is it is each one of our jobs to help in our own way to help heal a broken world. For me this means being a better person, volunteering and doing acts of charity with money and time. It is very important to me and helps drive me in how hard I work on a daily basis. This way there is more for me to give back to others.

**MOI:** Aaron, thank you very much for your time.