Lessons From a Dozen Years of Short Selling

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12 Reasons Not to Short (1)

(Excerpt from Chapter 11 of More Mortgage Meltdown)

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Shorting looked easy in 2008, but in reality it's a brutally tough business. In many ways, it appears to involve nothing more than applying the same analyses one uses when determining whether to buy a stock: on the long side, investors generally seek companies with good management, strong growth, high margins and returns on capital, little or no debt, clean balance sheets, and sustainable competitive advantages – all at a low price. Conversely, short sellers look for weak or dishonest management, low or negative growth, margins and returns on capital, high and increasing debt, accounts receivable and inventory, and weak competitive advantages – all at a ridiculously high price.

But shorting is not simply the opposite of long investing. It's much harder and more dangerous for a number of reasons:

1. Your upside is capped and your downside is unlimited – precisely the opposite of long positions. When shorting stocks, you could be right 80% of the time, but the losses from the 20% of the time that you're wrong could exceed the accumulated profits. Worse yet, a once-a-century storm such as the internet bubble might wipe you out entirely. If there's even a 1% annual risk of such an event, that tiny risk translates into a 39.5% chance of the freak event occurring over 50 years.
2. To prevent such an occurrence, most short sellers use stop loss limits, meaning they will start covering the short if it runs against them a certain amount. This means short sellers not only have to be right about a stock, but also about the timing. If a stock rises significantly, many short sellers will lock in losses, even if they are later proven correct.
3. In order to short a stock, you first must get the borrow from your broker, who has the power to call in the stock you've borrowed at any time – or, worse yet, buy stock to cover for you. Brokers are most likely to do these things if the stock is rising quickly, and they're probably doing it to other short sellers as well at the same time, so all of this buying pressure can cause a stock to rise even further, triggering even more covering. This vicious cycle is called a "short squeeze" and it isn't pretty – we can show you the scars on our backs.
4. Shorting has gotten much more competitive. There are now a few thousand hedge funds (and who knows how many individual investors) looking for the same handful of good shorts, in contrast to a few dozen a couple of decades ago. This results in "crowded" shorts, increasing the odds of a short squeeze.

12 Reasons Not to Short (2)

(Excerpt from Chapter 11 of More Mortgage Meltdown)

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5. A short squeeze can also be created if the "float" – the number of shares that trade freely – is suddenly reduced. Such a case occurred in October 2008 when Porsche, which owned 35% of Volkswagen, unexpectedly disclosed that it had raised its stake in Volkswagen to 74.1% through the use of derivatives. The German state of Lower Saxony, where Volkswagen is based, owns 20%, so that left a float of only about 5% of VW shares on the market. Three popular hedge fund trades had been to short VW based on weakening car demand, go long Porsche and short out its ownership of VW to "create" only Porsche, or go long VW preferred stock and short the common stock, betting on relative underperformance of the common. In any case, for whatever reason, nearly 13% of all VW common shares were short, so moments after Porsche announced its higher stake, the mother of all short squeezes ensued and the stock instantly quintupled from $200 to over $1,000, momentarily making VW the most valuable company in the world. This was extraordinarily painful for many shorts.
6. Short sellers used to earn interest on the cash they held while they were short a stock, but this has all but disappeared due to low interest rates – and brokers even charge "negative rebates" on hard-to-borrow stocks, meaning that short sellers have to pay 5%, 10%, 15% or more in annual interest to get the borrow.
7. The long-term upward trend of the market works against you (yes, believe it or not, markets used to go up most of the time).
8. Gains are taxed at the highest, short-term rate.
9. It generally requires many more investment decisions, thereby increasing the chances of making a serious mistake.
10. It's a short-term, high-stress, trading-oriented style of investing that requires constant oversight.
11. Mistakes hurt your portfolio more as they compound. If you make a mistake with a long position, it becomes a smaller percentage of your portfolio as it drops. A mistaken short, however, grows larger as it appreciates.
12. If you go public with your short thesis, a company can attack you in many ways: file a lawsuit (Fairfax), complain to regulators (who occasionally investigate) (MBIA, Farmer Mac), tap your phone (Allied Capital), etc. Also, expect to get flamed on message boards and in the media. Many people view short selling as evil and un-American

Conclusion (in 3/09): "we'll again repeat that, especially in this environment, **for most people, we think shorting stocks is a very bad idea**."

Five Reasons to Short (1)

1. If you're very good at it, you can make money over time
2. A necessity if you're going to be in the hedge fund business
   - Most investors won't pay hedge fund fees for a long-only fund
3. Having a short book allows me to invest more aggressively on the long side, both in terms of overall portfolio positioning, individual position sizes, and willingness to take risks in certain stocks. Here are some examples of what I mean:
   - I wouldn't be comfortable taking my fund's long exposure up to 100% in the current market if it didn't have meaningful short exposure;
   - I wouldn't have held onto my position in Netflix as it's risen from just above $50 to more than $360 over the past year if our fund wasn't short a number of similarly volatile, speculative stocks;
   - I wouldn't hold such a large position in Howard Hughes, another huge winner for us, if my fund weren't short St. Joe, which is also closely tied to the real estate/housing market; and
   - I'm not sure I would feel comfortable owning economically sensitive stocks like Hertz and Avis if my fund weren't short many stocks that I expect would do very poorly if the economy weakens.

Five Reasons to Short (2)

4. A short book typically pays off just when you need it most, during severe market declines, providing cash – and the psychological boost – to invest aggressively on the long side when it's most attractive. It also stems investor redemptions, which is effectively another source of cash.
   - This is exactly what happened to me in 2008 and early 2009. After inflicting losses as the market rose from early 2003 through October 2007 (the same length of time as the current bull market), my substantial short book cushioned the downturn – my fund was down approximately half the market in 2008 – and allowed me to invest aggressively on the long side, which translated into big gains after the market bottomed in March 2009.
5. I sleep better at night with insurance. At the beginning of every year, I write a check for homeowner's insurance and at the end of the year, when my apartment hasn't suffered from a flood or fire, my insurance expires worthless and I have to buy it again. Is it a mistake to buy insurance that turns out to be worthless almost every year? Of course not.

Carnage in the Short Sector Today

- Viewing shorting as insurance is fine – as long as it's cheap
- But it hasn't been cheap – there's been carnage in the short sector since March 2009 – worst of all in 2013
- The average short-only fund is down 15% YTD through October
- Some short-only funds are closing
- Some hedge funds are starting long-only funds
- Many hedge funds are reducing their short exposure, often substantially

What Short Sellers Are Saying Right Now

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- "Being bearish in the bull market has been, thus far, a mug's game and a hedge against profits." – Doug Kass
- "We've also taken our lumps this year on the short side (and since March 9, 2009) so we know how you feel. For what it's worth, we agree that this is the best environment to find shorts and we are seeing some incredible opportunities. We haven't seen a variance like this between our longs and shorts since early 2008. So, while I feel like I'm covered in battle wounds and have blood dripping out of my eye balls at the end of each day, I am confident we will be rewarded for staying the course." – A friend
- "I don't have the antidote to your pain. We've been bludgeoned by this melt-up as well. It's unbelievably unpleasant. I've never seen such widespread capitulation among seasoned short sellers. Many are out of business. This stretch is worse than the internet bubble for me. It's constant pain across my entire short book, whereas the internet was isolated to one industry – and then you got relief when the bubble burst." – Another friend

Summary: I Have Conflicting Thoughts on Shorting Right Now

I have two strong feelings about shorting right now:

1. It's a horrible business, it's cost me (and my investors) a fortune over the past 4½ years, I wish I'd never heard of it, and every bone in my body wants to cover every stock I'm short and never short another stock again; and
2. In my 15-year career of professional investing, the only other times that have been as target-rich in terms of juicy, obvious shorts are late 1999/early 2000 and late 2007/early 2008 (and we all know how those ended…).

So which feeling am I going to follow? I don't know, but this I know for sure: the only other time I felt like covering every short and becoming a long-only manager was October 2007. At that time, I went through my short book, stock by stock, and said, "OK, am I willing to cover MBIA at $70? Hell no, not a single share! Allied Capital at $30? Hell no, not a single share! Farmer Mac at $30? Hell no, not a single share!" And on it went… I couldn't bring myself to cover a single share of any stock I was short – they were all "trembling-with-greed" shorts.

And that's exactly how I feel today. I look at the stocks I'm short – all of which I think are absurdly overvalued and sure to collapse – and feel intensely that covering them now would be the most boneheaded capitulation trade of all time.

That said, unlike in 2007, I don't have the same foreboding feeling that there's a good chance that the world will fall apart in the next year or two (though it's possible), which makes being short that much harder…

Sources of Good Short Ideas

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- Other short sellers
  - Cultivate relationships, build networks, trade ideas
- Attend investing conferences
  - Value Investing Congress twice a year (next one in Las Vegas April 2-4)
  - Robin Hood Investors Conference
  - Ira Sohn Conference
- Value Investor Insight
- ValueInvestorsClub.com
  - Can access ideas as a guest with a 30-day delay
- Seeking Alpha
- SumZero
- Citronresearch.com
- Stock screens
- Newspapers, magazines, business television
  - Look for the most hyped nonsense

Lesson: Be Diversified and Try to Match Long and Short Positions

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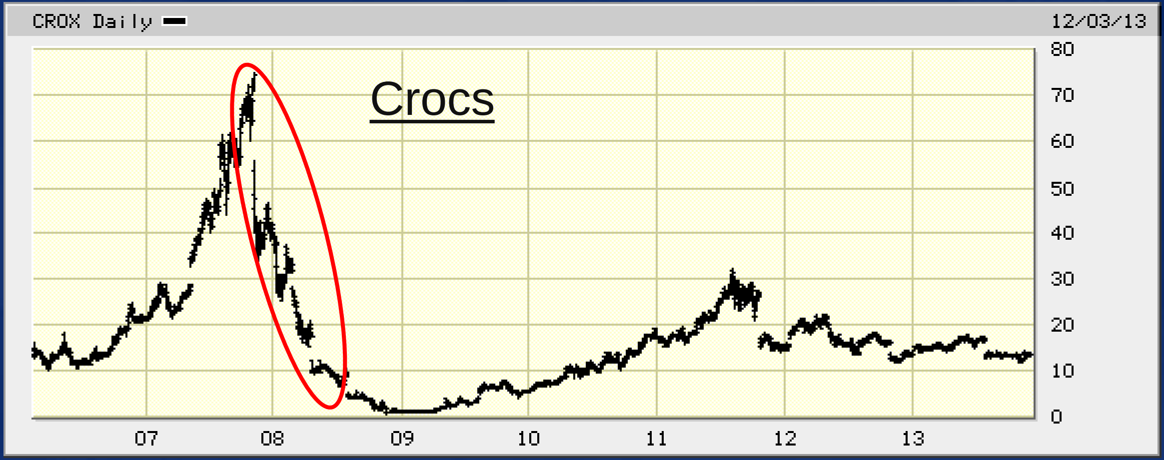
- Be diversified
  - Until recently, I was managing my short book like I manage my long book, but half the position size; thus, on the long side I had 12-15 5-6% positions and on the short side I had a dozen positions averaging 2.5%
  - I learned the hard way that a 2.5% short position is, in most cases, too large; if such a position goes parabolic, as many have done this year, it's very painful and forces you to cover to manage risk
  - Today I have 28 positions averaging 1.1%, only one of which is larger than 2.5%
- Try to match long and short positions
  - There's a serious mismatch between a long book focused on stocks like Berkshire Hathaway, AIG, Procter & Gamble, Microsoft, and ExxonMobil (I own the first two), and a short book focused on smaller, more volatile, heavily shorted, battleground stocks
  - These stocks tend to be the most overvalued and have the potential to fall the furthest – often, I believe, 100% – but they can also rise the most during periods of excess liquidity and complacency
  - Owning riskier (and heavily shorted) stocks like Netflix and Deckers has offset some of the pain on the short side this year
  - If you have a large-cap, low-beta long book, look for similar shorts

Be Patient

- Be patient
  - I've been reasonably successful over the years in being able to identify hugely overvalued stocks, but have been less successful in getting the timing right
  - In such cases, I correctly foresee what's going to happen in a year or two, but highly promotional management, as always cheered on by Wall St., dupes investors into ignoring huge red flags – and the stocks run up a lot in the short term
  - I've certainly gained a greater appreciation for the power of short-term stock price momentum and am going to make more of an effort to be patient, stay out of the way of freight trains on the way up, and do what the best short sellers do: make money by *adding* to shorts that are working *on the way down*
  - Examples:
    - Lehman Brothers
    - Crocs



Stocks Usually Follow Earnings

- Even the most well-publicized, airtight case that a company is, for example, committing blatant accounting fraud, bilking its customers, is dangerously underreserved and overlevered, etc. is usually not enough to cause the stock to decline materially
- As long as a company continues to report growing earnings, it's generally safe to assume that its stock will continue to rise as well
- Examples today: Questcor, World Acceptance, StonMor Partners
- Historical Examples: Allied Capital (David Einhorn) and MBIA (Bill Ackman)
  - Bill Ackman published a devastating 66-page report on 12/9/02 entitled *Is MBIA Triple A?* and in subsequent years he continued to warn investors, ratings agencies and regulators about the company and the danger it was causing in the financial system
  - But nobody cared because the company continued to report strong earnings, so the stock doubled – until the financial system collapsed, as did MBIA's earnings and stock price

Beware of the "Beat N' Raise" Game

- Be careful of companies successfully playing the "beat n' raise game"
  - Every quarter they beat their earnings estimates and raise guidance
  - There is no price a stock can't go to, especially if it's a high-quality business
  - Examples (none of which I'm short): LinkedIn, Michael Kors, TripAdvisor, Priceline

Look for Companies That Have Stumbled, But the Stock Is Still Expensive

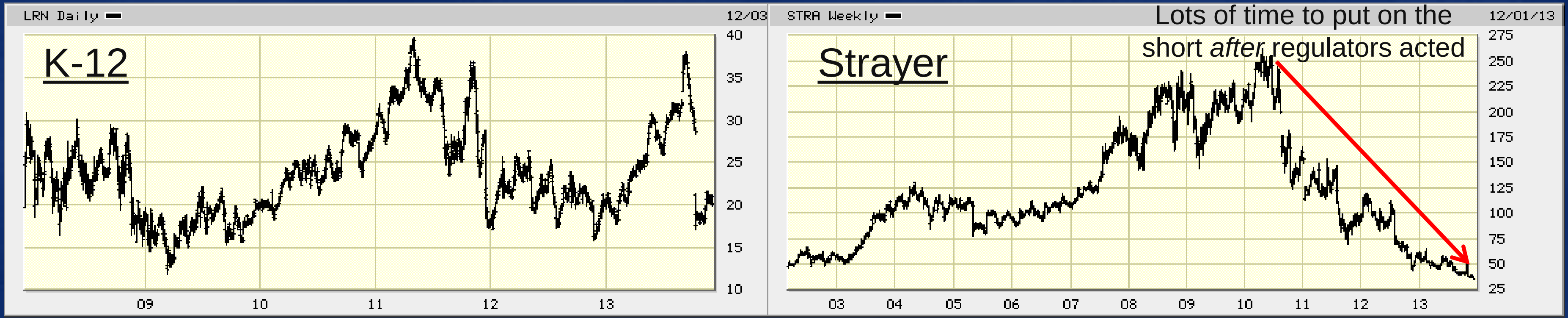
- Instead, look for companies that have stumbled in the "beat n' raise game"
  - The first stumble is usually the company only matching estimates (or beating via artificial means such as a lower tax rate) and failing to raise
    - Often the stock won't decline on this
  - The next step is to miss and lower; sometimes the stock doesn't even fall on this!
  - Examples: Green Mountain, Krispy Kreme, iRobot, World Acceptance

Look for Obvious Bubbles, Frauds and/or Promotions

- There's always room for obvious bubbles, frauds and/or promotions
  - But size them small!
  - Examples: 3D Systems, ExOne, InterOil, Opko

Waiting for Regulators and/or Auditors to Act Is Often a Sucker's Game

- Shorts often get clobbered waiting for regulators to take action
- It's usually better to wait until after regulators have acted because often the stock is only down a small amount initially because the company and analysts are minimizing the impact
- Examples:
  - Lumber Liquidators (see next slides)
  - K-12 (I think the recent miss that cut the stock nearly in half was in part due to steps regulators have taken to rein in the company)
  - For-profit colleges like Strayer



Overview of Lumber Liquidators

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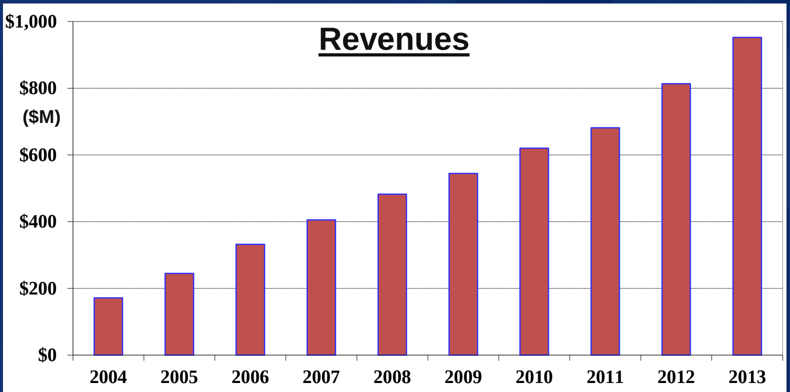
- Lumber Liquidators is the largest specialty retailer of hardwood flooring in North America, with 305 locations and run-rate revenues of $1 billion
- Founded in 1994 by current Chairman Tom Sullivan

Lumber Liquidators's Stock Has Risen More Than 6x in Less Than Two Years

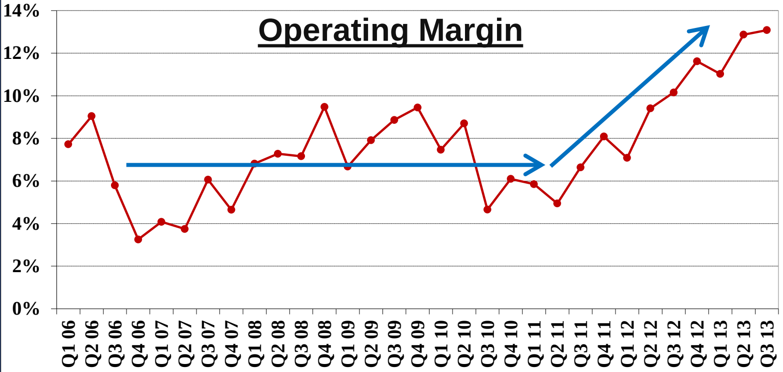
Source: BigCharts.com.

Lumber Liquidators Has Grown Rapidly in the Past Decade, Especially in the Past Two Years

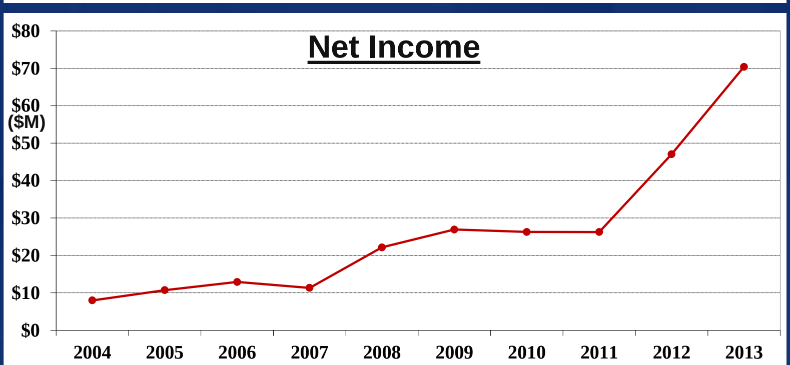
- Revenue growth of 22% annually for nearly a decade:
- In Q3 '13, revenues, SSS, and EPS grew 25%, 17%, and 58%, respectively
- In 2014, analysts project revenue growth of 17% and EPS growth of 26%



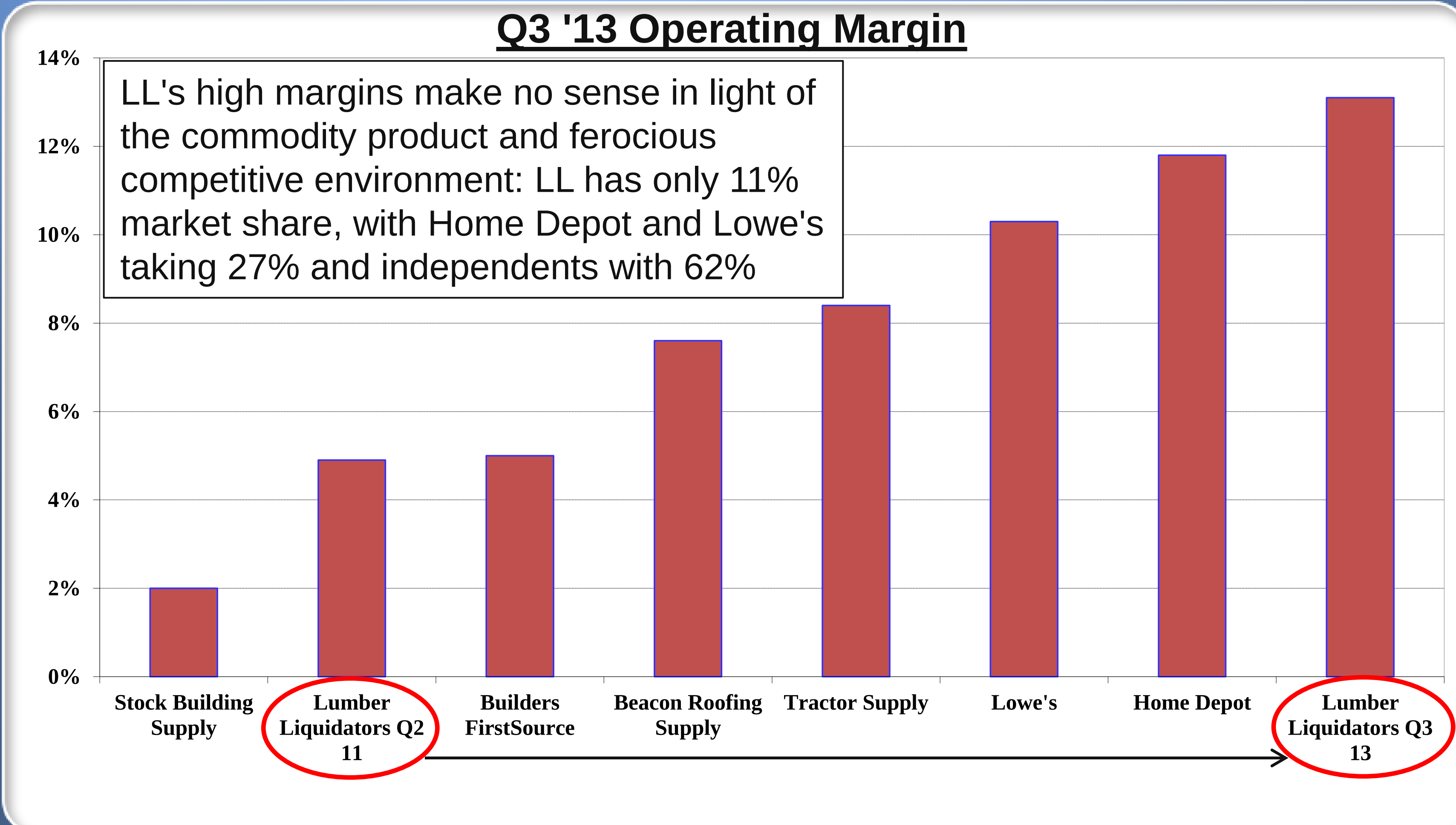
- Operating margins have increased from 4.9% to 13.1% in only nine quarters:



- Profits have skyrocketed thanks to strong revenue and operating margin growth:



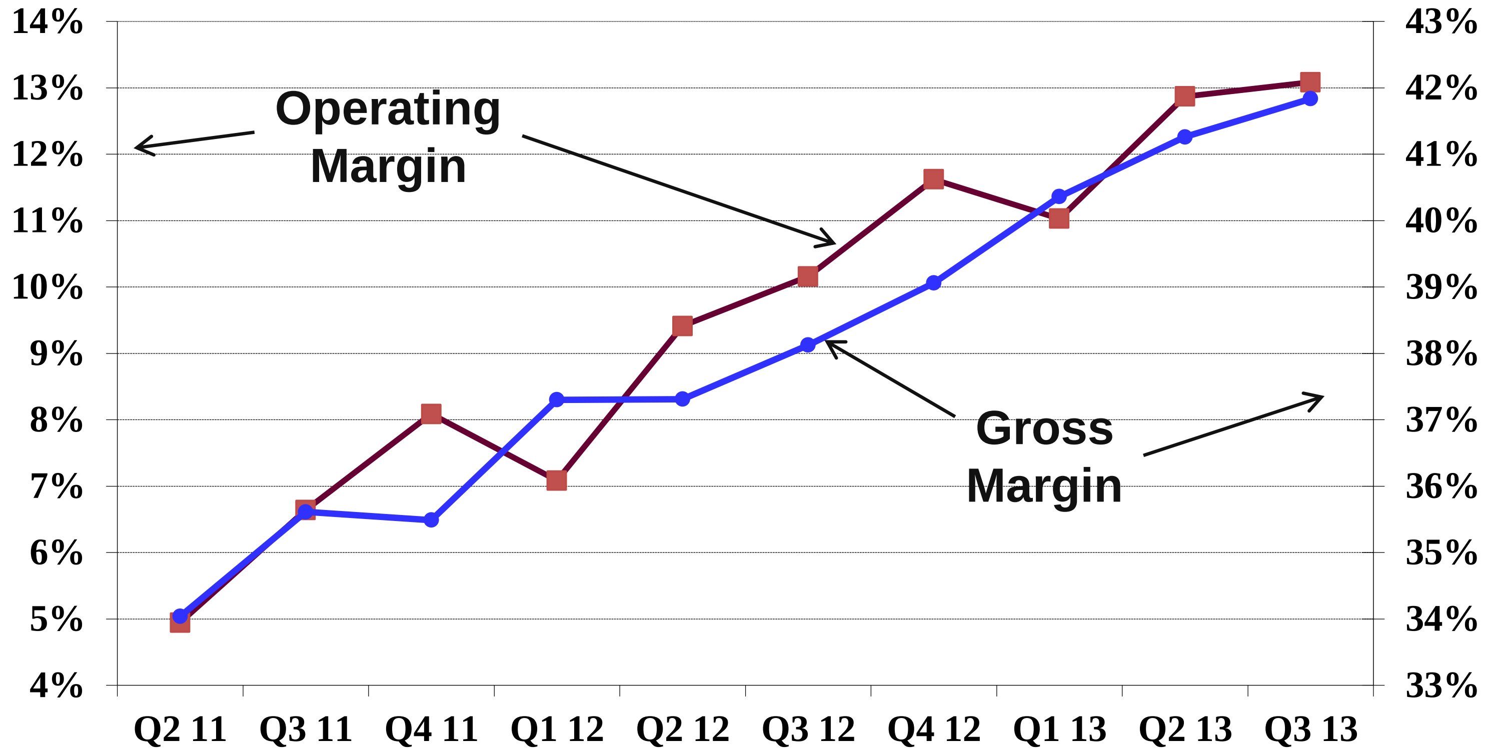
LL's Operating Margin Has Risen to an Unusually High Level, Exceeding All of Its Peers



Source: CapitalIQ.

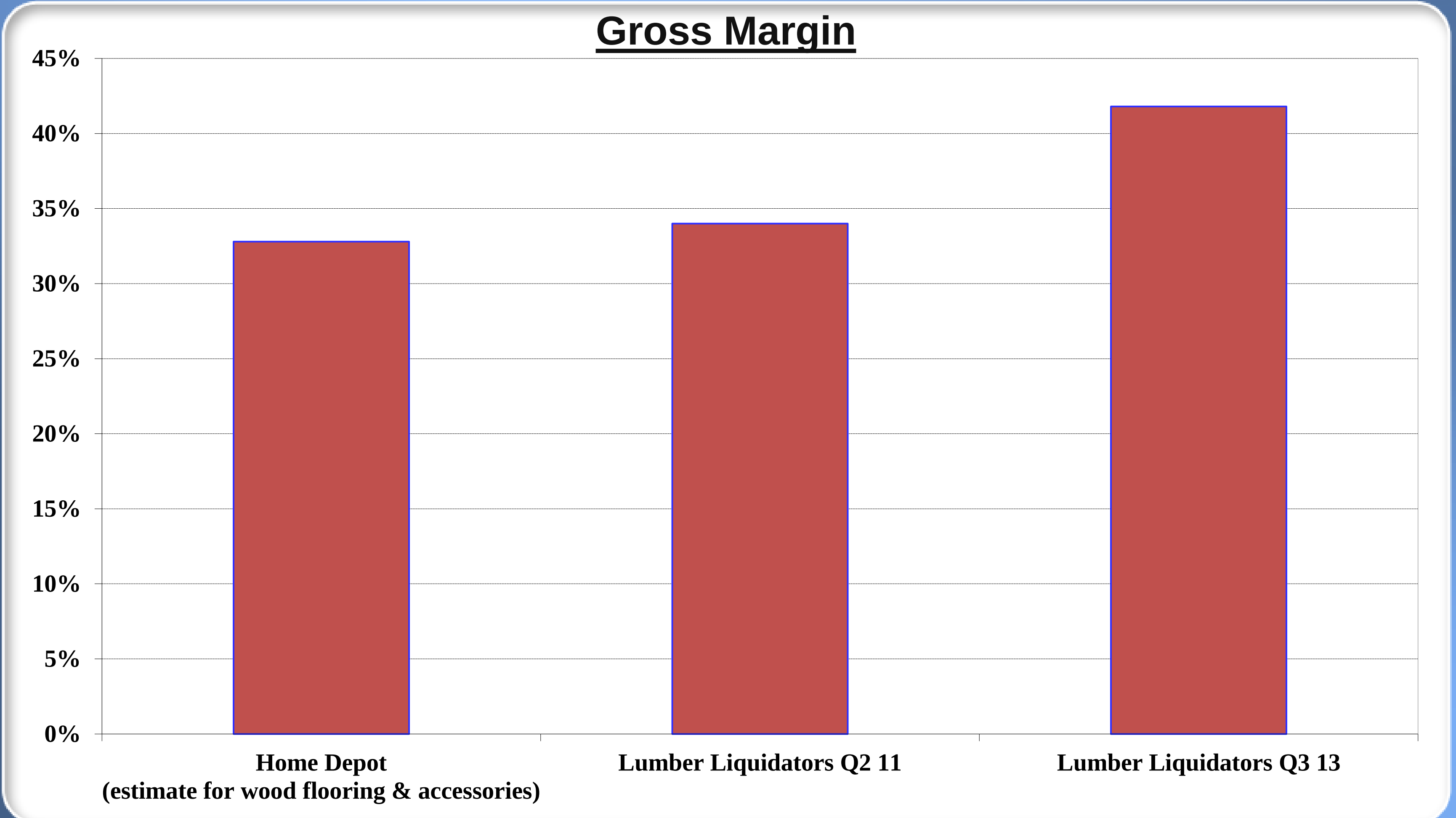
LL's Operating Margin Expansion Has Been Driven Almost Entirely By Gross Margin Expansion

Of the 820 bps of operating margin expansion from Q2 11 to Q3 13 (4.9% to 13.1%), 780 bps of it is due to gross margins increasing from 34.0% to 41.8%



Source: CapitalIQ.

LL's Gross Margin Two Years Ago Was Comparable to Home Depot's – But No Longer



Source: Interview with Home Depot store manager, who said wood flooring and accessories had 24% and 72% gross margins, respectively. Applying LL's percentages (18.5% moldings and accessories), the comparable blended average for Home Depot is 32.8%.

How Has Gross Margin Risen?

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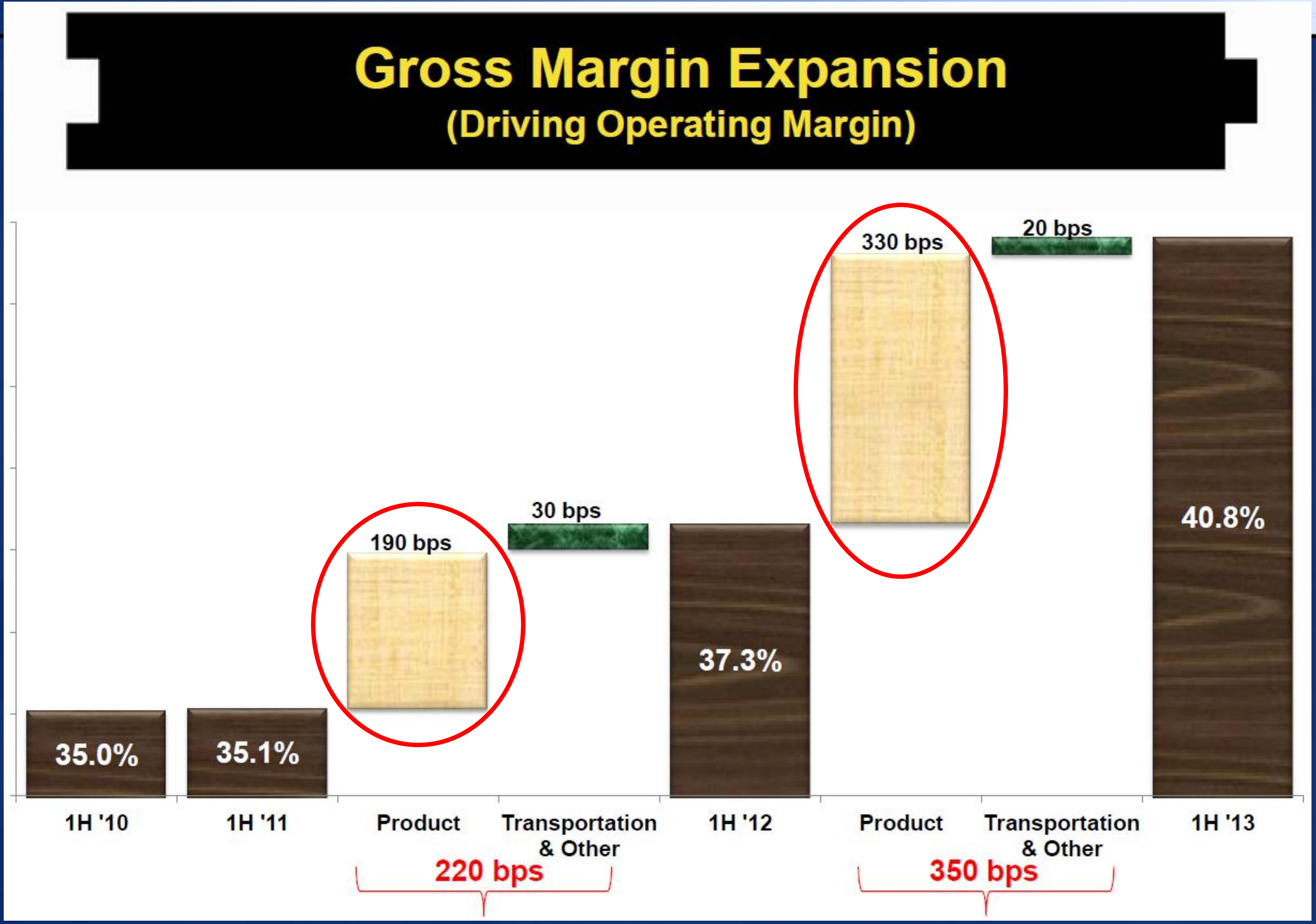
- On the Q3 13 conference call, LL CFO Daniel Terrell said: "Our third quarter average sale was $1,745, up [7.1%] from $1,630 in 2012 due to an increase in average retail price per unit sold, which benefited from a net increase in the sales mix of premium flooring products, a 180 basis point increase in the sales mix of moldings and accessories [from 16.7% to 18.5%] and stronger retail price discipline at the point of sale."
- Later, he added: "Our gross margin over the past two years has benefited from a portfolio of initiatives working individually and in combination to deliver cumulative multiyear benefit…We aggregate gross margin drivers in three primary categories, all of which contributed to third quarter expansion. The product margin drove 300 basis points due to shifts in our sales mix, including an increase in moldings and accessories, <u>lower cost of product due to sourcing initiatives</u> and higher like kind ASP, not due to retail price increases, but a result of greater retail price discipline at the point-of-sale." (emphasis added)
- I believe that a substantial fraction of LL's gross (and operating) margin expansion is due simply to buying the same products for less.

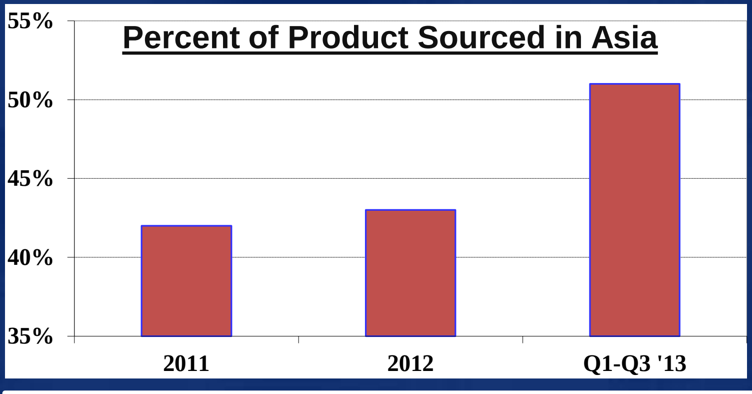
Reduced Product Cost Accounts for Nearly All of LL's Gross Margin Expansion

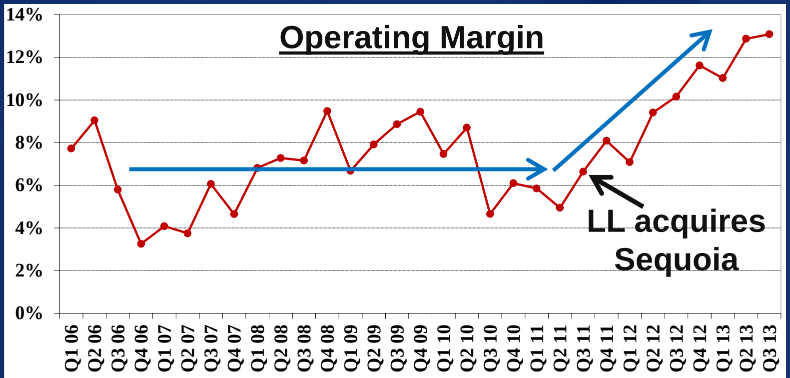


Source: Company presentation, 8/14/13.

Another Explanation for Why LL's Margins Have Skyrocketed

- Robert Lynch became President of LL in January 2011 and then CEO a year later. Many attribute the company's improved performance, especially margin increases, to his leadership, but I think another event two years ago also played a critical role
- In late 2011, LL paid $8 million to acquire Sequoia, which is based in Shanghai, for its "quality control and assurance, product development, claims management and logistics operations in China. We believe our cost of product was reduced, primarily in 2012, due to both the net cost reduction of owning those services and the benefits of working directly with the mills." – LL 2012 AR
- Since this acquisition, the percentage of product sourced in Asia has risen from 42% to 51% and margins have skyrocketed:





How could a tiny $8 million acquisition have such a big impact??? It's not like directly sourcing wood from mills in China is some great secret, unavailable to Home Depot, Lowe's and others…

Source: Company filings.

I Believe That a Meaningful Portion of LL's Margin Expansion Is Due to Buying Illegal Wood

- On October 9th, the Environmental Investigative Agency, a London-based nonprofit that conducts "undercover investigations, including audio and video recordings, to expose environmental crime", released a 64-page report, *Liquidating the Forests: Hardwood Flooring, Organized Crime, and the World's Last Siberian Tigers* (http://eia-global.org/news-media/liquidating-the-forests), which "details the organized crime of illegal timber harvesting in Eastern Russia, and tracks the wood across the border into China, through factories and warehouses, to its ultimate destination in showrooms around the world."

- "During a multiyear investigation by the EIA, Lumber Liquidators, the largest specialty retailer of hardwood flooring in the United States, emerged as the strongest example of a U.S. company whose indiscriminate sourcing practices link U.S. customers to the destruction of critically endangered tiger habitat and forests in the RFE [Russian Far East]. While making record profits in recent years, Lumber Liquidators has turned a blind eye as its purchases have fueled rampant illegal logging in the region."

A <2 Minute Excerpt of EIA's 11-Minute Video

Source: EIA (posted at: www.youtube.com/watch?v=UKqwMH2N0vc or simply Google "EIA Lumber Liquidators video")

Is the EIA Report Correct – And If So, So What?

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- The EIA report is meticulously researched and documented – it's an extremely impressive piece of investigative work
- The story is consistent with everything we know about Russia and China: the Wild West of capitalism, widespread corruption, little rule of law or concern for environmental issues, etc.
- Both EIA's evidence and common sense indicate that the EIA report is directionally correct – but the devil is in the details: how widespread is the illegal logging in Russia, how many mills in China are trafficking in illegal wood, and how compromised is LL's supply chain?
- My best guess is that this is a big problem, not a small one
- But even if I'm right, so what? Lots of companies are doing lots of even more nefarious things and regulators/authorities do nothing
- What's the catalyst?

Federal Authorities Raided LL's Headquarters Two Months Ago

- On September 26th, agents from the Department of Homeland Security's Immigration and Customs Enforcement and the U.S. Fish and Wildlife Service raided LL's headquarters, executing sealed search warrants "which relate to the importation of certain of the Company's wood flooring products"
- LL hasn't revealed any further information other than to say: "We are continuing to cooperate fully with the authorities to provide them with the requested information and there is no update or additional information pertaining to the request that we can provide at this time." (Q3 '13 conference call, 10/23/13)
- Normally a stock falls sharply and stays depressed with news like this – but in this environment (and in light of LL's blowout Q3 earnings), the stock is near its all-time high

How I Think It Will Play Out

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- I do <u>not</u> think federal authorities are likely to impose a meaningful fine
- I think LL will successfully claim that it didn't know it was buying illegal wood (unless company executives were very indiscrete in their emails and documents)
- Like Gibson Guitar (see appendix), LL will probably pay a small fine a year or two from now
- BUT – this is key – LL will have to ensure that it is no longer buying illegal wood
- While the largest mill supplying LL only accounts for 4% of LL's hardwood purchases, I think it is likely that a meaningful percentage of the 51% of LL's wood sourced in Asia is from Chinese mills that are trafficking in illegal wood
- Thus, the raid by federal authorities – even before any resolution is announced – is likely to disrupt LL's supply chain and materially impact margins

Lumber Liquidators's Stock Is Priced for Perfection

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- Stock price (12/3/13 close): $96.88
- Market cap: $2.7 billion
- Cash: $84 million
- Debt: $0
- Enterprise value: $2.6 billion
- TTM EPS: $2.53
- 2014 est. EPS: $3.49
- P/E (trailing): 38x
- P/E (2014 est.): 28x
- EV/EBITDA (trailing): 21x
- TTM revenues: $954 million
- P/S (trailing): 2.8x

Any disruption to Lumber Liquidators's supply chain and/or margins could result in the stock being cut in half.

My Two-Year Price Target Is $53

- Sales in 2015: $1.35 billion (16% annual increase in 2014 and 2015)
- Operating margin: 9% (give back half of the 830 basis point increase in the last nine quarters and go to 9%, still far above LL's long-term average)
- Tax rate: 39%
- Diluted shares outstanding: 28 million
- Equals EPS of $2.65
- P/E multiple of 20 (generous if earnings are flat for two years and margins contract)
- Equals share price of $53

Appendix

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What LL Says

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<u>CEO Robert Lynch, Q3 '13 conference call, 10/23/13</u>

"I can assure you of our commitment to uncompromising integrity and ethical business conduct across all areas of Lumber Liquidators' operations. We expect and require the same with our suppliers. Working together, we strive to advance responsible forest management. The nature of our supplier relationships within our direct sourcing model allows us to develop and produce the highest quality merchandise in the broadest assortment at industry-leading value. We believe these direct relationships are unique in our industry and provide us with a competitive advantage.

We work collaboratively with our suppliers, from planning to payment, and expect them to stand by their promises and commitments as we do. We are sought after by mills all over the world and we have a supplier due diligence process designed to identify long-term relationships that can provide sustainable and growing supplies of our product. Many mills are disqualified during this on-boarding process. Once we establish a mill relationship, we monitor and enforce our specifications and practices through more than 60 employees dedicated to quality control and assurance located on the ground in the U.S., Canada, China and South America.

We invest significant time and resources to safeguard quality and enforce product compliance and we terminate relationships with suppliers we believe are not adherent to those standards. As a result of these processes, we diversify our sourcing across more than 100 suppliers, this affords us flexibility in making changes to meet consumer trends or if we find that the supplier is not willing to comply with our policies.

It is important to note that no single mill provides more than 4% of our hardwood purchases and no single hardwood product represents more than 1% of our sales mix."

However, in a document entitled LUMBER LIQUIDATORS' COMPLIANCE WITH CALIFORNIA TRANSPARENCY IN SUPPLY CHAINS ACT, Lumber Liquidators reveals that: "<u>We do not at this time engage third party auditors or verifiers to evaluate supplier compliance with our standards</u>." (emphasis added)

LL's Response to My Presentation

LL stock fell 12% the day of my presentation, which led the company to release this statement:

"Mr. Tilson did not contact the company in compiling his presentation and we have never met with him to discuss our business. Mr. Tilson's presentation is based entirely on his own speculation and the contents of a report released almost two months ago which we had previously stated contained numerous inaccuracies and unsubstantiated claims. Lumber Liquidators is committed to uncompromising integrity in how the Company operates, across all areas of the business. We have policies and procedures in place for the sourcing, harvesting and manufacturing of all of our products, monitored by professionals located around the world. We support the protection of the environment and responsible forest management, and we invest significant time and resources to safeguard quality control and compliance. As a result of our processes, we diversify our sourcing across more than 100 suppliers, which affords us the flexibility to make changes to meet consumer trends and move business away from any supplier unwilling to comply with our policies. If we find that any of the Company's suppliers are not adhering to our standards, we will discontinue sourcing from those suppliers. It is important to note that no single mill provides more than 4% of our hardwood purchases and no single hardwood product represents more than 1% of our sales mix."

My Response to LL (1)

Lumber Liquidators asserts that the EIA report "contained numerous inaccuracies and unsubstantiated claims", but has yet to provide even one fact to rebut the report, which I found to be an extremely impressive piece of investigative work – and 100% consistent with everything we know about the wild-west business environment in Russia and China: widespread corruption, weak rule of law, little concern for the environment, etc.

Federal authorities obviously think the EIA report is credible, as agents from the Department of Homeland Security's Immigration and Customs Enforcement and the U.S. Fish and Wildlife Service on September 26th raided LL's headquarters, executing sealed search warrants "which relate to the importation of certain of the Company's wood flooring products."

Lumber Liquidators's only response has been to say (on the Q3 earnings conference call), "We are continuing to cooperate fully with the authorities to provide them with the requested information and there is no update or additional information pertaining to the request that we can provide at this time." The company's silence speaks volumes.

Lumber Liquidators's second line of defense appears to be that even if the EIA report is correct, it focuses on only one supplier, which the company can simply stop sourcing from with minimal disruption since "no single mill provides more than 4% of our hardwood purchases and no single hardwood product represents more than 1% of our sales mix."

I'm skeptical that this is an isolated problem limited to one rogue supplier. Rather, the combination of a) the evidence in the EIA report, b) the unusually rapid increase in Lumber Liquidators's margins to unprecedented levels immediately after acquiring a Chinese supply chain company, and c) the hugely corrupt business environment in both Russia and China lead me to believe that Lumber Liquidators has a big problem on its hands. Though I can't prove it, the evidence I see, combined with common sense, makes me think it's highly likely that what EIA has uncovered is a pervasive problem across Lumber Liquidators's Chinese supply chain.

My Response to LL (2)

My response (continued):

Since the raid, I assume that the company is scrambling to show the authorities that whatever problems are in their supply chain are isolated cases, they didn't know about it, etc. But keep in mind that the authorities raided Lumber Liquidators based on the EIA report, so they're not going to be easily fooled by some spin and token actions. Rather, I think Lumber Liquidators right now has no choice but to very quickly clean up its act to avoid major sanctions by the authorities.

Specifically, I think Lumber Liquidators will have to: 1) immediately stop sourcing from suppliers they even suspect are trafficking in illegal wood; 2) find replacement suppliers; and 3) ensure their entire worldwide supply chain is pristine. Doing all of these things is likely to be very costly and disruptive to the business – not to mention management being distracted by having to deal with the authorities for the foreseeable future.

These things might not matter if the stock were cheap, but it's not: after a 7x run-up in less than two years, it trades at 40x trailing earnings and 22x trailing EBITDA.

My two-year price target is $53 (and I think I'm being generous) based on the following back-of-the-envelope math:

Sales grow 16% annually in the next two years, as analysts expect (resulting in revenue of $1.35 billion)

Operating margins give back half of the 830 basis point increase in the last nine quarters and fall to 9% (still far above the long-term average)

The market responds to this by assigning the stock a 20x P/E multiple

Result: $1.35B x 9% - 39% tax rate / 28M shares = $2.65 EPS x 20 = $53

Another Short Thesis

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David Peligal, Analyst, Grant's Interest Rate Observer

"The bullish Lumber Liquidators' story revolves around the potential opportunity for the company to open 600 stores in the United States over the next couple of years and to take market share from independent floor-covering retailers…

Now it's true that new stores cannibalize old stores, but let's make the generous assumption that a mature LL store can generate $3.5 million of revenues per year. Furthermore, assume LL can open a total of 600 stores, and that total revenue at some point in the future will be $2.1 billion (600 stores times $3.5 million per store). Say, in addition, that LL can take share from independent retailers and that operating margin climbs to 14%. You would then have $294 million in earnings before interest and taxes ($2.1 billion in future revenues times a 14% margin).

Because, at this indeterminate point in the future, LL will have become a mature retail concept, apply a multiple of 14. You get about $2.6 billion of value, or perhaps $2.4 billion, as the stores don't just build themselves."

Source: *Illegal Products Could Spell Big Trouble At Lumber Liquidators*, Xuhua Zhou, Seeking Alpha, 6/20/13.

The Lacey Act

- The Lacey Act of 1900 prohibits trade in wildlife, fish, and plants that have been illegally taken, transported or sold
- It was amended in 2008 to include anti-illegal-logging provisions
- It carries criminal penalties of up to $500,000 per violation
- The most relevant prior use was against Gibson Guitar, which the United States Fish and Wildlife Service raided in 2009, accusing the company of illegally importing hardwoods from Madagascar
- The case was settled on August 6, 2012, with Gibson admitting to violating the Lacey Act and agreeing to pay a fine of $300,000 in addition to a $50,000 community payment

A Formaldehyde Problem?

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- A short seller bought three samples of flooring LL imported from China, had them tested for formaldehyde, and discovered that one was tainted with dangerous levels of formaldehyde:
  - "I recently conducted independent lab testing -- engaging Berkeley Analytical, an IAS accredited testing laboratory -- on a sample of Lumber Liquidators house brand flooring ("Mayflower" brand), and the results that came back weren't pretty: Over 3.5x the maximum legal level for formaldehyde. (This product was purchased retail from a Southern California retail store.) Fully understanding the importance of this finding, we submitted samples from the same package to a second laboratory, this one the "gold standard" lab for the National Wood Flooring Association, NTA. This second lab confirms the product is in violation of the legal limit for formaldehyde."
- By itself, this proves nothing – but tainted products from China are so common that I wouldn't be surprised if this turns out to be a big problem for LL
- For more, see two articles by Xuhua Zhou: *Illegal Products Could Spell Big Trouble At Lumber Liquidators* (http://seekingalpha.com/article/1513142-illegal-products-could-spell-big-trouble-at-lumber-liquidators) (6/20/13) and *Lumber Liquidators - Management's Silence And Broker's Rebuttal May Validate The Worst Fear*, (http://seekingalpha.com/article/1517322-lumber-liquidators-managements-silence-and-brokers-rebuttal-may-validate-the-worst-fear) (6/24/13)

A Formaldehyde Scare in China

- "A&W, Anxin Weiguang Flooring, was a leading hardwood flooring company in China until February of 2012 when a consumer advocate broke the news on the Internet that A&W branded engineered hardwood flooring products do not meet regulatory formaldehyde emission standards. For investors who are unfamiliar with formaldehyde, it is listed as a known carcinogen in June of 2011 by the National Toxicology Program. In addition to being a known human carcinogen, formaldehyde is also shown to cause childhood asthma and female reproductive issues. A&W is a major Chinese flooring company counting Carlyle as one of its investors. Media nicknamed the issue "toxic flooring gate" and drew an incredible amount of attention from consumers. Among the allegations, the advocate detailed A&W branded engineered hardwood flooring products used in certain condominiums developments significantly exceed the regulatory limits and such flooring products were sourced directly from A&W. The issue turned into a major controversy forcing China Vanke, the largest residential real estate developer in China, to re-test all the flooring products sourced from A&W. After comprehensive testing of the flooring products in question, Vanke identified at least one of its developments where the formaldehyde emission level of the flooring products was noncompliant. The incident caused significant public concerns and subsequently, A&W experienced a drastic sales slump and almost went bankrupt as a result of the incident."

Source: *Illegal Products Could Spell Big Trouble At Lumber Liquidators*, Xuhua Zhou, Seeking Alpha, 6/20/13.

Visits to Five Chinese Suppliers to LL Reveal Very Poor Working Conditions

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- Workers at all but one supplier reported that they weren't paid extra for overtime and that they didn't receive social insurance, both of which are required by Chinese law
- The work environments in some cases resembled sweatshops, with strong odors, dusty air and poor lighting
- Sample pictures:

LL's Customers Give the Company Terrible Reviews on Major Ratings Web Sites

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- About.com gives LL a 1.3 rating (out of 5; 44 reviews)
- Resellerratings.com gives LL a 0.17 rating (out of 10; 96 reviews)
- Consumeraffairs.com gives LL a 1.2 rating (out of 5; 78 reviews)
- Mythreecents.com gives LL a 1.1 rating (out of 5; 75 reviews)
- Pissedconsumer.com had 75 complains for LL, 10x the number of Home Depot per dollar of revenues
- The only site I could find with good reviews for LL was Google (4.5 of 5 stars), but as Xuhua Zhou notes:
  - "The Google reviews are notoriously known to be subject to easy manipulation. The issue got so severe that Google itself had to issue a warning to SEO and businesses to avoid fake reviews. In the case of Lumber Liquidators, the reviews on Google Shopping are especially suspicious. Investors should take time to scroll down a number of pages and actually read the reviews. Most of the reviews came from Online Shopper (I do not think many consumers who purchase LL products do so exclusively online). And almost 96% of the reviews or 3168 of them came from a single source, Bizrate."

Source: *Lumber Liquidators - Management's Silence And Broker's Rebuttal May Validate The Worst Fear*, Xuhua Zhou, Seeking Alpha, 6/24/13.

Both LL's Founder/Chairman and CEO Have Been Heavy Sellers of the Stock This Year

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Founder/Chairman Tom Sullivan

May 2013: Sold 200,000 shares for $16.5 million

August 2013: Sold 100,000 shares for $10.2 million

Total sales: $26.7 million

Remaining holdings: 609,000 shares

CEO Robert Lynch

May 2013: Exercised and sold 80,000 shares for net proceeds of $5.0 million

May 2013: Sold an additional 24,500 shares for $2.1 million

July 2013: Exercised and sold 50,000 shares for net proceeds of $3.5 million

Total sales: $10.6 million (total cash compensation in 2012: $1.2 million)

Remaining holdings: 34,216 shares

- Lynch appears to have sold every share he can (his remaining holdings haven't vested yet)