Value Investor INSIGHT
The Leading Authority on Value Investing
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Play Your Game

Investors, just like the companies they follow, can veer off course by pushing beyond what made them successful in the first place. Here's an update on money-manager Jim Roumell's journey back from the investing wilderness.

INVESTOR INSIGHT

Jim Roumell
Roumell Asset Management

"Charlie Munger said it best, 'The single most important thing is to know where you are competent and where you are not.'"

Editor's Note: *Jim Roumell had a clear and well-defined strategy when he started Roumell Asset Management at the end of 1998: Search for mispriced deep-value opportunities among sub-$500 million market cap companies, where his strengths in "shoe-leather" research could give him an investment edge. It worked. Over fifteen years he delivered market-trouncing returns and by 2013 assets under management rose above $300 million, not far from what he originally considered his strategy's full capacity.*

Things then went somewhat off the rails. He staffed up to grow the firm. He thought it was important to invest in what would be considered higher quality companies. He decided he could manage significantly more money, and hired a marketing firm to more aggressively get the word out. All that didn't work. Performance over the next three years nosedived and a material portion of the firm's assets walked out the door.

At the beginning of 2016 he went back exactly to playing his original game. For the firm, he needed to repair the track record. For himself, he needed to prove the prior three years – not the 15 that came before it – were the anomaly. We spoke recently with Roumell about this journey back from the investing wilderness and where it takes him from here.

Describe the key realizations you came to that led to the rebooting of your strategy in 2016.

Jim Roumell: A lot of it really just came down to recognizing who I am as an investor and what I'm good at. Charlie Munger said it best, "The single most important thing is to know where you are competent and where you are not. The human mind tries to make you believe you are smarter than you are."

What I think I'm pretty good at is identifying very small, off-the-radar companies that may be mispriced and then doing the investigative journalism, if you will, to arrive at insights that can give me an edge over other investors. It's not going to be in identifying why this high-margin, high-ROE company is even better than the market thinks it is. It's not in trying to figure out if Cisco should trade at an 18x P/E multiple rather than at 15x. And it's certainly not in pushing myself out of my comfort zone to make my business more "scalable."

When we first spoke [*VII*, April 30, 2009] you described my portfolio as being rather "quirky," which was perfectly fair. I've had most of my success investing in well-capitalized but out-of-favor companies that may be difficult to analyze because of what they do or their mix of assets. They typically don't screen well and there's an unusual amount of uncertainty about their prospects. If the data points are fairly straightforward, the business is relatively stable, and there are a large number of people pricing the security, I just don't believe I'm going to add meaningful value.

The situations I target match up very well with what I think are my research strengths. I'm comfortable in creating and maintaining relationships, so over the past 35 years have developed a wide and continually growing range of contacts who are usually willing and able to help me understand just about any business I'm looking into. I do not treat relationships as "transactional" – my network is built around people I genuinely enjoy spending time with and I hope that's the case on their part, too.

Give an example of a classic type of idea that attracts you.

JR: One good one still in the portfolio today is Enzo Biochem [ENZ]. This is something we'd owned before and came back into less than a year ago at a cost basis of around $2.30 per share. There are 48 million shares outstanding, so the market cap at the time was roughly $110 million, $50 million of which was in cash, with no debt. So we basically had to figure out what we were getting business-wise for $60 million.

The company has three main assets. The first is a clinical lab-testing business, like those of Quest Diagnostics and LabCorp, but with a narrow geographic footprint in New York, New Jersey and Connecticut. The next asset is a products business, where they actually sell test kits, primarily for women's health, that are used in their labs and sold to third-party facilities as well. This segment also got emergency authorization last Spring to start selling Covid active-virus and antibody tests that they had quickly developed. The third asset is a small therapeutics business, consisting of two drugs that have passed phase-two clinical trials and are continuing through the trial process.

It's a long story, but Enzo has been in kind of a perennial battle with shareholders. The board and management has tended to be uncommunicative and basically deaf to shareholder concerns. We're currently actively involved in working to change various aspects of that, but motivating it all is our view that the assets here are worth a lot more than the market recognizes. There's no sell-side analyst coverage.

Run-rate annual revenue coming from the lab and products businesses is currently around $115 million. Covid test sales have provided some tailwinds, and it's of course unclear how long that will last. But the lab business, based on what Quest and LabCorp typically pay to buy up such businesses, we think is worth 2-4x revenue. Products' businesses like Enzo's are typically bought and sold for at least 2x revenue. To be conservative, we use 2x revenue for both businesses, which would indicate a value of around $230 million. Add in the $50 million in cash and that results in a market value of $280 million, or close to $6 per share. That ascribes no value to the pipeline therapeutics. The stock today trades at $2.90.

This kind of checks the boxes for us. Great balance sheet protecting us on the downside. What we think is a deeply discounted stock price. There's high uncertainty, in this case focused around corporate governance, which is horrendous but we believe is finally poised to change. It's a business we've known for some time, but very few people are paying attention to it. It may not be a smooth ride, but we think one worth taking.

You've written recently about a further evolution in your strategy, this time around position sizing. Explain the genesis of that and what you're doing differently.

JR: We recently decided to increase our level of portfolio concentration, taking full equity positions from 3% to 6% in size to more like 5% to 10%. The genesis of that was hearing from investors that they invest with us to find small out-of-favor stocks and spend the time and effort involved to figure out if those stocks are mispriced. If we do that well – and our investors are counting on us to do that well – why not express our conviction through bigger positions?

As the conversation went further, I realized that the primary reason I managed the portfolio the way I did was because the majority of my net worth was in it. It obviously makes sense that portfolio managers should have skin in the game, but my having more than 50% of my total net worth in the portfolio put me in a very different place risk-wise than my investors who only had maybe 5% to 10% of their money with me – money that was specifically earmarked to invest in small off-radar stocks.

To get in better alignment from a risk perspective – while still having plenty of skin left in the game – I've committed to keeping one-third of my net worth in the fund. We'll keep cash on hand for liquidity purposes, but not let the cash level reflect market timing to any great degree. Our top ten positions now average 7-8% each of the portfolio. It all makes more sense for how we invest, and it's actually been quite liberating for me to act more fully on conviction when I have it.

ON ALIGNMENT:

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Describe the broader investment case for your portfolio's largest current position, GSI Technology [GSIT].

JR: We first came across GSI in 2016 not long after it acquired an Israeli software company called MikaMonu. Like a lot of our companies it was cash-rich, and the acquisition had the potential to transform it from a declining maker of SRAM [Static Random Access Memory] chips to an important player in the emerging area of what are known as Associative Processing Unit [APU] chips used in artificial intelligence applications. The legacy business still generated plenty of cash to fund investments in the future, and the payoff in AI-related chips, while pretty speculative, was potentially very big.

We underestimated the time necessary to bring the APU chip to market, but we believe the first-generation Gemini-I chip the company has developed is now ready for prime time. And given the various assets the company has, we don't believe the market is ascribing nearly the value to it that it should.

The company's market cap at the current $7.35 share price is around $175 million. Starting with the easiest to value assets, we subtract from that $62 million in cash and Treasury securities on the balance sheet. GSI owns outright its Sunnyvale, CA headquarters, which we value at $13 million. The legacy SRAM business has been repurposed away from commodity consumer end markets and is now on more solid footing selling chips with $20,000 to $30,000 average selling prices to defense and aerospace customers. We value this business at 1x to 1.5x revenues, which at the midpoint of that range would make it worth about $63 million. There's no debt, so net all that out from the market cap and there's an implied value for the APU business of less than $40 million.

The big question then is what the Gemini chip business is worth. I'll try not to overwhelm you with too much detail, but the Gemini APUs are designed to execute memory and processing functions in parallel fashion, which allows them to deliver faster search outcomes, with a scalable architecture that uses dramatically less power. This is extremely important in artificial-intelligence applications, where you're looking to draw inferences from databases that have billions of pieces of information. The company expects early, prominent applications in such areas as facial recognition, drug discovery and online search.

We were excited to see that Gemini was selected for beta-testing by the Weizmann Institute of Science, Israel's leading research university, and that relationship is expected to expand. The new chips are just now coming to market more broadly, so we're not likely to see sales ramping for them until into 2022.

We could imagine the research and analysis here getting pretty technical pretty fast. How did you get sufficiently up to speed on the nuances of all that?

JR: The idea was actually brought to our attention by a very successful technology entrepreneur in Israel who has helped us a great deal in getting comfortable with both the people and the technology. We have another contact in the U.S. we've known for years who's knowledgeable about the memory-chip business and participated on several of our calls with the company. You can also find good Wall Street research, not on GSI specifically, but on APU chips in general and their potential as artificial-intelligence applications multiply.

I'd also say after getting to know the company's management over the past five years, we believe them. Insiders own roughly 35% of the shares and have at every step of the way laid out very credibly what they're doing and why. It's always at least partly the case in ideas like this that we're making a bet that the people running the company will deliver. And remember, we believe we're pretty protected on the downside by other assets of the company and by the fact that we're not paying that much for the Gemini option.

So what could the new chip platform be worth? We obviously don't know exactly, but there have been a number of acquisitions of AI chip companies that we believe are relevant. Probably the most comparable is Intel's purchase in 2016 of a pre-revenue AI-chip competitor called Nervana, for $400 million. GSI makes the case that its technology is superior to Nervana's, and I've asked management outright what they'd do if offered $400 million for the Gemini platform. I realize they wouldn't likely tell me any different, but I believe them when they say they wouldn't take it. For something that we think is valued at less than $40 million by the market today, that's very nice to hear.

I'd add here that we believe GSI will ultimately get sold to a larger chipmaker with marketing heft and plenty of resources to expand in what should be a dynamic part of the AI ecosystem. I would expect us to be in this until that happens.

Any parting advice for investors out there rethinking – as they should from time to time – how they do things?

JR: I remember in 2015 just being so angry that I'd allowed what happened to happen and that I'd messed up the record I'd worked so hard to build. It's all on me, but I had listened to people and went down some paths even though the whispers in

INVESTMENT SNAPSHOT

GSI Technology
(Nasdaq: GSIT)

Business: Designs, develops and markets static random-access memory [SRAM] and artificial intelligence chips used in security, defense, drug-discovery and other applications.

Share Information (@2/26/21):

Price	**7.34**
52-Week Range	4.75 – 8.74
Dividend Yield	0.0%
Market Cap	$174.7 million

Financials (TTM):

Revenue	$28.6 million
Operating Profit Margin	(-69.4%)
Net Profit Margin	(-71.2%)

Valuation Metrics
(@2/26/21):

	GSIT	S&P 500
P/E (TTM)	n/a	43.7
Forward P/E (Est.)	n/a	22.5

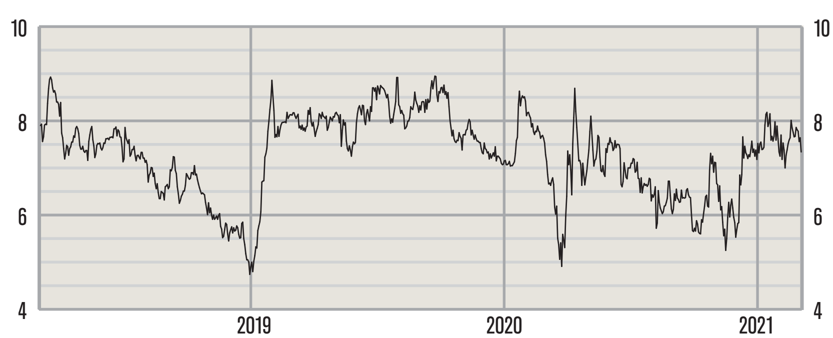
Largest Institutional Owners
(@12/31/20 or latest filing):

Company	% Owned
Roumell Asset Mgmt	5.6%
Dimensional Fund Adv	3.9%
Renaissance Tech	3.7%
Vanguard Group	3.6%
BlackRock	3.6%

Short Interest (as of 2/15/21):

Shares Short/Float	1.0%

GSIT PRICE HISTORY



THE BOTTOM LINE

Jim Roumell often looks for companies with emerging business lines that appear to have far greater potential than the market appears to be recognizing. In this case be believes the market is valuing the company's new line of processors for artificial-intelligence applications at less than $40 million, maybe 10% of what it would be worth in a buyout.

Sources: Company reports, other publicly available information the back of my head were telling me otherwise. You choose to ignore those whispers at your peril.

But all is well. I'm back where I should be, doing things in the way I truly enjoy, and it seems to be working. I have no doubt I'll hit any number of bumps along the way, but I'm pretty confident it won't be because I strayed again from what I think I do well. VII

Disclosure

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended, and the reader should not assume that investment in the securities identified and discussed were or will be profitable.

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