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October 25, 2016

Dear Fellow Investors,

Warren Buffet has been quoted as saying, "I would much rather earn a lumpy 15 percent [return] over time than a smooth 12 percent." This is certainly how we approach investing at Greenhaven Road. This implies both up quarters and years, as well as down quarters and years. We are fortunate that we had an up period in the third quarter of 2016, but that will not always be the case. The fund posted a 9% gross return for the third quarter, bringing us to 12% for the year. Please check your individual statements, as net returns, which are ultimately what matters, will vary due to investment class and investment date. Since inception over five years ago, day one investors have earned 117% net after fees and expenses vs. 95% for the S&P 500 and 73% for the Russell 2000. This quarter was notable for the lack of volatility in the markets. The S&P 500 went more than 40 days without a move of greater than 1% in either direction. While volatility can be painful, it is ultimately the value investor's friend since it creates opportunities. When volatility rears its head again, we will embrace it and try to benefit from the opportunities it presents.

The lack of market volatility and low risk-free rates of return, as evidenced by negative yielding government bonds, has created a tricky environment to invest in. For me, the most attractive companies to invest in are those with high free cash flow yields and sustainably growing businesses. There is a large margin of safety when a company is generating one-quarter or one-fifth of their market capitalization each year in cash. Management has a lot of flexibility and can reinvest in the business, buy back shares, or pay a dividend. Unfortunately, in a low volatility world and low-yield environment where every investor has basic quantitative screening tools available to them, growing companies with high free cash flow yields just do not exist. Yield-hungry investors and ETFs/index funds have bid up the prices of stable cash-producing companies to the point where there is no margin of safety, and, in fact, everything has to go right for the investment to yield attractive returns. When we are several years into an economic recovery, paying 30 times cash flow for even the highest-quality companies is not an appealing option in my mind.

What are we to do? One option would be to try and time the market – we could just accumulate cash and wait for a correction. However, I would argue that timing the market is virtually impossible to do well or consistently. Valuations are not that stretched relative to the prevailing interest rates. The Nasdaq returned 21% per year from 1991-1995 in a period during which the United States had a recession. The prevailing wisdom at the time said that the returns were dramatically above historical returns and were thus not sustainable. Yet, investors who waited for the correction missed another quadrupling of their money over the next four plus years before the market "topped out" in 2000. The point here is not that we must continue to invest because we fear missing out. The point is that timing the market is very difficult and sitting in cash is effectively accepting zero return. Our cash level has been rising as new capital has come into the partnership, but because we are small and nimble, there should be investments that are more attractive than cash.

Fortunately, we do not have to own the market as a whole. Sheryl Sandberg, the COO of Facebook, wrote a beautiful essay (dealing with the loss of her husband and the challenges of raising her children without him and continuing her life) in which she recounts a conversation with a friend where she kept saying how much better life would be if her husband was still alive. Eventually her friend made a statement that resonated with her, "...option A is not available. So let's just kick the shit out of option B." This phrase went on to become a rallying



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cry within Facebook for less serious matters than raising children, and the expression resonates with me when considering how to approach the current investing environment. We can bemoan the lack of high free cash flowing opportunities and curse the yield chasers who bid them up – or we can adapt and “kick the shit out of option B.” I think Murray Stahl from Horizon Kinetics articulates plan B best in his must-read series on indexation:

“The beauty of the markets, though, is that when one door closes, another opens – for the tide of money to flow into one particular direction, it must drain from somewhere else. That somewhere else means the securities not caught up the indexation vortex. Those securities are relatively invisible: they are not being evaluated or priced actively; the efficient market has passed them by. These are the idiosyncratic securities, available for individual inspection and purchase that we believe have obviously favorable expected outcomes, not obviously unfavorable outcomes. They are artisanal selections, so to speak, curated, and the once traditional fare of the active manager.”  
(Full series available at [horizonkinetics.com](http://horizonkinetics.com))

In my shorthand, I now refer to option B as invisible companies. I think that term best describes where and how we have been investing for the past six months – spinoffs, the pink sheets, nano caps, etc. They are the current plan B. The result of pursuing plan B should be the same as day one - a portfolio half invested in high-quality companies with very long holding periods and the other half in special situations which are often “invisible” companies.

### **STABLE PATIENT CAPITAL ALLOWS PURSUIT OF INVISIBLE COMPANIES**

In a world where information flows easily and companies are restricted from sharing information selectively, real advantages for investors are hard to come by. Our fund has a couple, by virtue of our setup. Our small size means that we can invest in a \$150M market capitalization company and still have the investment impact returns in a way that a \$5B fund cannot. The second advantage is the stability of our capital allows us to pursue everything from the largest most liquid companies to small companies that “trade by appointment.” We are built to invest in invisible companies if we choose. Even as we have grown to 50+ limited partners, my family group still represents 20% of the capital, and the Royce family and Stride Capital will eventually become the largest investors as they continue to invest each month. My family, Royce, and Stride create a very strong foundation. In addition, the majority of new investors have committed to the long-term class with a three-year lock-up. The net result is that I believe that we have exactly the type of investor base we need for the style of investing we are pursuing. We can sacrifice liquidity for a portion of our investments if the return potential justifies it, something we could not prudently do with daily, monthly, or even annual liquidity.

### **LESSONS FROM THE PRACTICE COURTS – DON’T WATCH THE BALL**

One of the challenges of “invisible” companies is that their strength is often not revealed in their financials. These are companies that do not “screen” well. How do we find companies that don’t screen well? Besides looking under a lot of rocks? I know a number of our investors are tennis players – so let’s use a lesson from the tennis courts. This summer, my wife (who takes her tennis very seriously) had a big match which I really wanted to see, so I made a field trip. Her match turned into a slow, grind-it-out affair. Over time, I started to watch a lesson the pro was giving on the next court. This was not a kids’ lesson where the pro spends time on how to hold



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the racket or getting the children to watch the ball. This was three players who have “been to nationals,” which is USTA code for “serious players,” with an even more serious coach playing out points simulating a match. Every tip the pro gave was about watching the set-up of the opposing player. Really good tennis players are watching so much more than the ball. The pro can tell from an opposing player’s knee bend and racket position if a lob is coming or if a hard shot is on the way, and starts to move before the shot is hit. Really good tennis players can tell from the toss of a serve where the ball will be hit – wide or up the middle. Think of the difference between the tennis player who can tell by the toss where the ball is going vs. the player who is figuring out the destination as the ball speeds over the net. I would rather be the player who can anticipate the next shot before it is even hit than the player reacting as the ball sails over the net.

The search for invisible companies is in part about the ball (earnings, revenue, etc.), of course, but the set-up is perhaps even more important. What is the insider ownership? What are the incentives for management? What is the competitive landscape? What is management’s track record? Who are the shareholders? What is the margin profile for the business? Is there operating leverage? What parts of the business are growing? What parts of the business are shrinking? What has changed such that historical financials are misleading? How are the “visible” comps valued? Why is the company invisible? Is there a path to greater visibility? The set-up matters; we are trying to invest before all of the results show up in the historical financials and before companies screen well for others.

## **NEW INVESTMENTS**

This past quarter we made two new investments, both of which can be classified as “invisible” with interesting set-ups. There is a long, detailed write-up at the end of the letter, but given the following fact pattern, I think we can all agree Gaia (GAIA) is largely invisible. GAIA is covered by just one sell side analyst who did not published for several months. The company has changed its name and its sub-\$150M market capitalization makes it largely not investable for large funds. This year, Gaia sold its two largest divisions, changed CEOs, bought back 40% of the shares in a tender offer, and until last month had a PDF with the words “place holder” come up when you clicked on their investor presentation. There are plenty of invisible companies, so why Gaia? What is the set-up? As outlined in the write-up below, 75% of Gaia’s market capitalization is covered by cash and real estate, the company could be profitable today if it chose to grow more slowly, and it is acquiring customers at one-third of their lifetime value in a large and growing market. Gaia is 38% owned by its CEO, who previously built a Fortune 500 company. It can grow 50%+ per year, has a fully funded business model, and generates 80%+ gross margins. This has not been a profitable investment to date, but based on the growth opportunity ahead combined with the “downside protection” that the balance sheet provides, I like the set-up and think significant appreciation is possible.

The second “invisible” opportunity we pursued was to be both long VMware and short VMware. Generally speaking, being long and short the same company would only make the broker a handsome return. How and why did the fund do this? Context is helpful. Dell is a private company, and they are in the process of buying EMC, a public company that owns 80% of VMware, another public company. To finance the transaction, Dell could not pay EMC shareholders 100% in cash, so they gave EMC shareholders \$24.05 per share in cash and .11 DVMT shares per EMC share. DVMT is a newly created tracking stock meant to track the performance of EMC/Dell’s ownership of VMware. Dell effectively had to let EMC shareholders retain some of their VMware ownership



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through the tracking stock. The main difference between the publicly listed VMware and DVMT is that if Dell faces bankruptcy, DVMT will be impaired, so there is Dell credit risk associated with DVMT and not with VMware. But Dell's earnings and bond prices indicate that bankruptcy is not a near- or medium-term concern. We bought the DVMT shares when they were trading on the pink sheets as "when issued" shares – meaning that they would eventually turn into DVMT shares on a given date – and also shorted a proportional amount of DMVT shares. At the time we made this investment, the difference in price between our "invisible"-when-issued DVMT shares and the economically equivalent VMware shares was approximately 40%. One reason the discount may be so large is that Dell carved out the ability to buy back tracking stock shares over time, so they had no incentive to "talk up" the shares or opportunity.

This investment is referred to as a "pair trade" and we are effectively not exposed to the VMware business and are indifferent to its price (we are also short VMware). Rather, we will benefit if the "tracking stock" discount gets smaller, which implies a convergence in the price of VMware and DVMT. It is not clear there is an "appropriate" tracking stock discount overall, but the Liberty tracking stocks and others typically have a 15-25% discount. So yes, this stock was largely invisible (pink sheet, when issued, tracking stock) but it was also a 40% discount to the publicly traded, visible comparable. This investment is not directly correlated to the overall market and does not rely on earnings growth or multiple expansion to be profitable. I prefer it to cash. I like the set-up here as well, and time will tell if we are rewarded.

## TOP 5 POSITIONS

Careful readers will note a few changes in Greenhaven's top five holdings, driven by two factors. One is that we exited our position in Diamond Resorts as the purchase by Apollo was consummated. It should also be noted that Halogen Software and Interactive Brokers are still in the portfolio; we have not sold a single share. They are currently outside of the top five because of fluctuations in prices and incremental purchases of other companies. Our current top five positions are as follows:

**Fortress Investment Group (FIG):** The thesis remains the same: the market is undervaluing the quality of the management fees and ignoring the cash and investments on the balance sheet. This year, the company tendered for shares and paid a "top off" dividend of more than 4%. The largest shareholders are the employees. The set-up remains constructive on this sub-\$5 stock. With more than \$3.50 in cash, investments, and embedded incentive fees, there is significant downside protection. There is also a stable base of \$70B in fee-paying assets. There have been headwinds in the price performance of permanent capital vehicles, which have made raising additional capital a challenge, but the prices are recovering as are the publicly traded private equity holdings such as Nationstar Mortgage and OneMain Financial.

**Gaia (GAIA):** This is covered in detail at the end of the letter.

**Lindblad Expeditions (LIND / LINDW):** The Lindblad Expedition warrants were discussed in detail in the last letter. We have added common shares to the fund as well because they have decreased in price. Part of the investment thesis is that investors were not looking out to 2017 and 2018. A recent Deutsche Bank initiation report was the first I have seen to model 2018 – one of us will be proven to be wrong, since our outlooks for the company are quite different. Lindblad Expeditions will be increasing capacity by more than 40%, adding land-based tours from its Natural Habitats acquisitions, and could grow its Cuba business over



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time. Deutsche Bank thinks all of this will lead to decreased profitability and still has a \$9.50 price target. If we apply the Deutsche bank multiples to my numbers, their price target would be close to double.

**Radisys (RSYS):** This is a situation where the company is becoming less “invisible” over time. At the time of investment, there were no sell side analysts; now there are two. The opportunity exists because low-margin hardware business declines were masking software business growth. RSYS shares have more than doubled from our original purchase prices as management has executed well, selling to large customers such as Verizon. It remains a logical acquisition target for larger growth starved companies such as Cisco.

**IDW Media (IDWM):** IDWM shares have appreciated materially since we purchased this pink sheet company. There is a cash-flowing brochure business that has underwritten the growth of a high-margin entertainment division, which is reaching scale with comic books (#4 seller), games, and, most importantly going forward, television shows. They currently have two series that will air this year: “Wynonna Earp” on Syfy and “Dirk Gently,” starring Elijah Wood, on BBC America. This is a scrappy team with high insider ownership that is at an inflection point in the business. If they have continued success in television, an acquirer will likely appear.

## SHORT POSITIONS

We continue to have a very small number of short positions. Given current nosebleed valuations and lack of growth prospects on many consumer goods companies, it is possible we will increase the number of shorts as the year progresses. The two primary short positions the fund currently holds are Tesla (TSLA) and Lands’ End (LE), for similar reasons. Tesla is a cult stock that needs continuous access to the public markets to finance a broken business model. The unit economics are broken, and Tesla loses money on each car sold. The likelihood of delivering the Model 3 on time with 20% margins as advertised is very, very, very low. The competitive landscape is intensifying with the Chevy Bolt and a slew of other electric cars entering the market. I have yet to hear a justification for the Solar City acquisition that makes any sense for Tesla shareholders (other than Elon Musk, who is also a Solar City shareholder). Elon Musk has some incredible accomplishments, but at current valuations, Tesla is a stock built on what I would argue is a vulnerable myth of his unquestioned genius. To date, the short is moderately profitable, but we have tried to short the stock before with little success – so time will tell. The markets will fund Elon’s broken model... until they won’t.

Lands’ End has a leadership problem like Tesla, just a different kind of leadership problem. Lands’ End is a spinoff from Sears, which has a hedge fund manager as a CEO; this seems to work as well as a retail manager running a hedge fund. In the case of Lands’ End, there is \$280M of net debt for a company that generated less than \$10M in adjusted EBITDA (down 75%) in the first six months of the year (before the quarter the CEO stepped down). More importantly, when we initiated the short position, they had a CEO who hailed from Ferrari and Dolce & Gabbana, living in New York City and commuting to Wisconsin. Aside from the likely “fit” issues of the Italian CEO commuting to Wisconsin, she was trying to dramatically increase the fashion profile of the dowdy Lands’ End (I can say that because I am dowdy myself). The company was launching new lines emphasizing slimmer clothes and stiletto heels, having expensive fashion shoots, and establishing a Fashion Week presence – a long distance from the canvas boat bags and Midwestern flair the company is known for. This strategy seemed highly unlikely to succeed, and is perhaps best described as a head scratcher. As of now we don’t know the final results, but at the end of September, the CEO resigned and now the company is being led on



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an interim basis by co-CEOs, another set-up that rarely succeeds. The shares have sold off, but we remain short Lands' End.

The fund is also short a company that is losing its largest contract and has displayed little ability to manage through the process. Management continues to spin tales of how they will replace lost revenue. Once again, time will tell.

## **ANNUAL MEETING**

For those of you who missed the annual meeting, I thought it was a wonderful event. It was a highlight for me to have attendees younger than 10 years old and older than 80 years old. We also had attendees from multiple states. It was the first time that I met in person with several of the LPs, including one who lives 10 miles from my house. It was also a great excuse to get together and allow folks to meet the Stride team and Chuck Royce. I was nervous that the crowd would run out of questions too quickly and we would go to dinner before the food was ready. I should have known better. Folks who find their way to Greenhaven Road are an independent thinking lot with views on where the world is headed, and they like to have their assumptions tested. We will make a ton of changes for next year, including picking a date and location further in advance. For those Limited Partners who were not able to attend, the brief presentation and a small gift should be finding their way to you shortly. If you have any questions, I am happy to discuss them via email or telephone. The benefits of a small partnership extend beyond the ability to invest in smaller companies – please reach out if you want to connect.

## **BROADENING THE FUND'S INVESTOR BASE**

The patient style of investing the fund engages in requires an aligned group of limited partners with aligned terms. The fund is not right for everyone. Creating this type of limited partner base was intentional. I often say that Greenhaven Road is not sold, it is bought. The investing approach and fee structure resonate with a small portion of the population – for those people, the decision to invest seems to feel natural and obvious. The fund also tends to not appeal to great swaths of the investing community, including a group called funds of funds. These are funds set up to specifically invest in other hedge funds and private equity funds. The stereotype of a fund of funds is “hot money” that will be redeemed when returns lag for any period, which they inevitably will. Earlier in the year, I was approached by a fund of funds and I was somewhat dismissive and politely tried to say, “Greenhaven Road is probably not right for you,” but received a great email back. The principal said, “I have read your letters, just like you are not a typical hedge fund, we are not a typical fund of funds – are you sure you don’t want to talk?” The email was a great reminder that just how wonderful companies can be hidden in all corners of the markets, great limited partners can be as well. We now have our first fund of funds that has joined the partnership. I never thought I would be excited by that, but I am. I think they are a great addition.

## **TRANSITION TO SS&C COMPLETE**

We spent the last quarter completing our administrative transition to SS&C. For the course of the quarter, we ran our old administrator Halpern and Associates in parallel with SS&C to make sure the transition was as smooth as possible. Halpern remained extremely helpful and I am appreciative of their five-plus years of service. One of the benefits of being on the SS&C platform is there can be a tighter integration between the administrator and our bank account, which we will be shifting this quarter to Northern Trust, a partner bank of SS&C. With this



transition, SS&C will have the oversight to approve all outbound wires as well as see real-time information for new subscriptions. From an internal control perspective, this makes all the sense in the world. This will affect where money is wired going forward, and we will share the new instructions accordingly for those of you who wish to continue contributing. As someone with the vast majority of his liquid net worth in the fund, the additional controls are welcome and will put us on par with institutions with far greater AUM.

## **OUTLOOK**

I continue to believe that our economy will muddle along and interest rates will likely rise. As discussed in the letter, with current valuations, there is not a lot of low-hanging fruit, but we don't need a lot to be successful. Greenhaven Road's strategy needs four to six good ideas a year. As of the start of the current quarter, we are acquiring as many shares as we can of a small Canadian company with 97% customer retention, a large competitor leaving the industry, and a potentially large customer just acquiring 10% of the company. I will lay out the opportunity in greater detail when we have acquired a "full position." This is not a perfect company, but it's certainly nearly invisible with a very attractive set-up. Companies like this make me optimistic that over time, like Sheryl Sandberg, we can kick the shit out of option B. Thank you for the opportunity to grow your family capital alongside that of mine.

Sincerely,

A handwritten signature in blue ink, appearing to read "Scott A. Miller", is written over a light blue horizontal line.

Scott Miller



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## **Gaia, Inc. (GAIA) – (\$7.75)**

Gaia is certainly an invisible company. Why do I say this? For starters, the presentation on their investor relations website until last month simply linked to a blank document entitled “Place holder.” The company did not even broadcast audio or slides for the sole investor conference they held this year. GAIA is covered by only one sell-side analyst that published infrequently. As if trying to be forgotten, the company even changed its name this summer (from Gaiam).

### **Background and History**

Ultimately, Gaia is a “trust me” story, and the person telling the story is Jirka Rysavy. Rysavy is not a 30-year-old Unicorn CEO with great PowerPoint skills, limited skin in the game, and no history of execution. Rysavy was a competitive runner in Czechoslovakia before immigrating to the United States in 1984 virtually penniless. He founded Corporate Express, an office supply company rollup that used a combination of efficiencies and reduced catalogs to increase inventory turns and make the cutthroat office supply industry a profitable one. In fact, it was so profitable that Corporate Express became a Fortune 500 company. His successes, as well as his alternative lifestyle, are summarized well in the following article: (<http://fortune.com/2008/06/17/the-strange-origin-of-staples-big-deal/>).

Rysavy has a strong entrepreneurial streak. In addition to founding Corporate Express, which was eventually sold to Staples, he also founded a natural food store, which eventually became Wild Oats and was bought by Whole Foods. He also founded a publicly traded business known as Gaiam that realized more than 90% of its business through the “branded products” segment, essentially yoga-related items such as pants, mats, and other yoga lifestyle products. After branded products, travel was the second largest component of the business, and there have been a few odds and ends including a solar-related business that was spun off, and a yoga DVD business that was sold (not without a multi-year lawsuit by the buyer). Additionally, over the last three years, there has been a small but growing video streaming business. The vast majority of Gaiam shareholders owned Gaiam because of the promise of growth and profitability in the branded products division. The old conference calls logs feature a steady drumbeat of apologies for losses in the video streaming business and a pledge to effectively grow more slowly to reduce the losses.

### **TRANSFORMATIVE TRANSACTION**

In the second quarter of this year, Gaiam announced a series of transformative actions. The company sold its large branded business for \$167M and its travel business for \$12M, leaving the former runt of the litter – the video streaming business (Gaia) – behind with a large pile of cash. The company promptly announced a tender offer (for almost half the company) at a 34% premium to the year-to-date average trading price of the stock. The tender was not fully subscribed, but in July, Gaia did buy back 40% of the company in one fell swoop. Understandably, a beleaguered shareholder base interested in branded products and not video streaming voted with their feet and sold their shares back to the company at prices they had not seen in years.

### **ACTIONS SPEAK LOUDER THAN WORDS**





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As part of the tender offer, the founder Rysavy indicated he would not sell any of his shares; upon conclusion of the tender offer, he effectively owned more of the smaller company, increasing his ownership from 24% to 38%. He also went from Chairman to an operating role and has become the CEO of the video streaming business. In essence, Rysavy has sold off the businesses that other owners were focused on, and doubled down on the small “unprofitable” business, which seems to be a strong indication that he believes the streaming business has real potential. At current prices his 38% stake in the company is worth more than \$40 million.

## **SILENCE IS DIFFICULT**

In the investment profession, we are trained to look for gaps or holes in a story. Management will rarely identify the fatal flaws of their own business. Instead there is a centuries-old tradition of spinning the positives to shareholders and hoping to buy enough time to fix the weaknesses of a business. The management team of Gaia is not making it easy for investors to connect all of the dots.

At the time of the tender offer, management did a “non-deal” roadshow where nobody was given a physical presentation. Instead participants were given iPads to view the presentation. There is no PDF on their website and no “copies” of the presentation were distributed. In addition, the deal to sell the branded business closed on July 1 while the quarter ended on June 30. The net result is that the earnings through June 30 were “messy.” The company did not make any effort to explain the earnings numbers or to normalize them. This includes making adjustments for a lower share count (15M vs. 24M) and higher cash balances (\$60M+ vs. \$6M). The company is clearly not putting a promotional spin on their results or prospects.

One plausible reason for the company’s silence is that the dots just don’t connect. If that is the case, one should not own the shares. If Rysavy had tendered even a portion of his shares, that would be my conclusion. However, he did not tender. If not tendering shares is doubling down on the idea of video streaming, leaving the Chairman role to become the CEO is a step towards tripling down. Could there be other rational reasons for silence? Three of them come to mind.

The first is that if the business plan is fully funded, and there is excess cash because the tender was not fully subscribed, it is in Rysavy’s interest to avoid doing anything to boost the share price so he can buy more.

A second reason could be the recent litigation the company has endured. In 2013 Gaia sold GVE entertainment for \$51M. The sale included Vivendi Entertainment, which the company had purchased in 2012, as well as distributed content from companies such as WWE, NFL, Hallmark, National Geographic, and Discovery. The sale of GVE led to extensive litigation and ultimately a \$10M payment from the company to the purchaser of the company, Cinedigm. The lawsuit centered around representations the company made during the sales process. One interpretation of the company’s reluctance to put information in an investor presentation or discuss the information on widely available conference calls is a desire to avoid future litigation.

A third explanation that has been offered by longer-term shareholders is that management prefers to under promise and over deliver. During this time of transition, their silence is in line with their lack of promotion.



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## WHAT IS THE BUSINESS? VIDEO STREAMING

Now that we have the investment set-up, let's look at the business. Gaia refers to itself as a conscious media company. Similar to Netflix, content is delivered via streaming over the internet. Gaia's content is far more niche than Netflix and ranges from streaming yoga classes to guided meditation, to nutrition, to parenting, to the paranormal. In the words of one member:

*"Gaia is an incredible portal into the realms of the esoteric. Everything from meditation and astrology to ancient civilizations and the paranormal, it's all in one place. I'm able to expand my perspectives every day at home, plus it makes for great conversation with my friends. Thanks Gaia, keep fighting the good fight!"*

In a world of hundreds of cable channels, Gaia's content in many ways is so niche it does not even merit a cable channel. However, given the streaming technology, there is a vibrant and viable business with a real value proposition here. For example, if you live nowhere near a yoga studio, online classes are actually pretty attractive. Information on holistic nutrition and conscious parenting could easily be worth more than \$10 a month to a parent. If you are a follower of one of the Gaia gurus, all of their historical content and all of their new content in one place is quite a resource.

In terms of how it works, the "stars" of Gaia are paid on the number of subscribers they attract to the platform. This is a low-cost customer acquisition strategy which aligns the gurus with the platform and provides reasons to retain gurus on the platform.

## DOWNSIDE PROTECTION

Besides an owner of 38% of the company who has chosen to be an operator, what do we have? What are we buying and what are we paying for it at these prices?

There are four primary assets of the company.

- 1) \$60M+ of cash. The company has been reluctant to state exactly how much cash would be available after settling the escrow conditions on the sale of its businesses. In the non-deal roadshow before the tender offer was complete, the company indicated they would have \$60M. Given that the tender offer was short by \$17M, this would imply \$77M. On the earnings call, they reiterated at least \$60M.
- 2) A building that is less than 20% occupied by Gaia. Management estimates a value of at least \$20M for the building. In 2015 the video streaming segment recorded \$1.9 million in rental revenue related to the portions of the building it did not occupy, and the majority of that was from third parties that presumably negotiated arms' length leases. The company paid \$18M for the building almost 10 years ago. It is 150,000 square feet on 12 acres with a cafeteria and a gym outside of Boulder, Colorado. Based on the income and location, the management estimate appears reasonable.
- 3) A media library with more than 7,200 hours of content. The company currently is paying approximately \$5,000 per hour of content. At a conservative value of \$2,500 per hour, the library would be worth \$18M.
- 4) 170,000 current video subscriber customers. Given the lack of disclosure about churn rates and types of customers, putting an exact value on existing subscribers is difficult, but it should be north of \$100, which is 10 months of revenue associated with a subscriber.



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<b>Assets</b>	<b>Value</b>
Cash	70,000,000
Building	20,000,000
Media Library @ \$2500 per hour	18,000,000
Subscribers (170K @\$100 per)	\$ 17,000,000
<b>Estimated Value</b>	<b>125,000,000</b>

Our shares were bought at a market capitalization of \$120M, meaning that 75% of the market cap is covered by cash and a building. Thus we were paying \$30M for 7,200 hours of content and 170,000 subscribers. On the face of it, a reasonable proposition – but to get at all excited you have to believe that the model works and the business can grow profitably.

### **HOW THE VIDEO STREAMING BUSINESS WORKS**

The basic model is to pay up front to acquire customers and then collect revenue over the coming months to more than recover the cost of acquisition. In essence, the company must acquire customers for less than their lifetime value. The person with the most knowledge on how the business works is the CEO and largest shareholder and again he has not connected all of the dots for minority shareholders, but this is what he has said about acquiring customers:-

*“We have a discipline. We don’t really ever go as we trend the lifetime value, which is kind of retention multiplied by our cash margin, is not based on revenue like most other people who we calculated based on our cash margin which let’s say it’s about 80% right now. And we never spend more than half of the cash – customer value and we spending actually spending much less, and some of the better channels are actually more like now 25%, 30%. So it’s – that’s kind of why you can go faster you spend a little more, so we kind of try to manage to grow such that we can go over 100%, but we don’t plan to do that we want to be disciplined to this kind of model.”*

The margin of safety in the model is that they do not spend more than 50% of the lifetime value of a customer. A subscriber can download an app, log in directly to the website, or access the content through a variety of partners including Amazon, AppleTV, Roku, Verizon, and Comcast. The business also has negative working capital as subscribers pre-pay.

### **WHAT IS THE UPSIDE?**

The company does not provide a precise market size but gives several touchpoints. There are currently 218M streaming video customers worldwide across all services including Netflix, Amazon, Hulu, etc. The company cites Bespoke Research Group, estimating 300M video streaming customers, and Gaia research indicating that 55% of subscribers are interested and willing to pay for at least one Gaia topic. The company also stated that 60% of Netflix subscribers use other services. Netflix has grown to more than 80 million subscribers in 2016, which is up over 3X from 2012. The reality is that the value proposition for video streaming services is very high. Gaia will never get to a fraction of the total addressable market, but there are indications that it is large enough to support far more than the 170,000 subscribers the company has today. One useful reference point is that 33% of subscribers are international and the only language currently supported is English. Simply expanding into new



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languages should provide a meaningful boost to subscriber count. At one million subscribers, this business is worth multiples of today. Is one million subscribers achievable? It would be far less than 1% of video streaming customers. As proof that niche streaming platforms can be much larger than Gaia, there is a Japanese Anime streaming company that has 700,000 paying subscribers (<http://www.animenewsnetwork.com/news/2015-10-22/crunchyroll-sumitomo-announce-partnership-to-create-company-to-co-produce-anime/.94495>).

Gaia content would appear broader than Anime, covering yoga, healthy living, spiritual growth, and truth seeking and has gone from a standing start to 170,000 subscribers in three years. Given the growth in SVOD, their distribution on Apple, Amazon, Comcast, Verizon, Roku, and the increasing trend towards using streaming services, a subscriber base in the low millions is in the realm of possibility. A 7% share of that subset yields 11.5M subscribers. The business is profitable at 170,000 and worth a multiple of the current valuation at 1M subscribers.

### **GAAP ACCOUNTING – CURRENTLY PROFITABLE**

Under GAAP accounting, all of the expenses associated with acquiring new customers are expensed when they are incurred, but revenues from new customers are realized over their lifetime, which may be several years. Thus there is a mismatch between when the expense is recognized and when the revenue is received. Essentially, the more you grow in the short term, the greater the losses are. However, the company has indicated it could be profitable within 90 days if they reduced spending on advertising and chose to grow more slowly. When the video streaming business was part of Gaiam and was mainly viewed as a source of losses, there were pressures to reduce advertising, which slowed growth and reduced profitability. In Q3 2015 the company had approximately 120,000 subscribers, and video streaming was able to generate in excess of \$1M in EBITDA for the quarter. The important point here is that sufficient scale has been achieved, which means that growth from here on is optional, not required. Given that the company has almost 50% more subscribers in a business with high gross margins and high fixed costs, it is reasonable to believe that if they wanted to reduce growth and investment in content – effectively entering a steady state - Gaia could generate \$5M+ in annual EBITDA. Put another way, ex cash, ex building, ex media library, we are paying somewhere around 3X EBITDA for the option to try and grow the business.

### **WHAT COULD WE HAVE - ASSUMPTIONS**

Given the cash, the building, and the media library, our downside is somewhat protected, but to be fair a portion of the cash will be used to grow the streaming business. For this to be an asymmetric opportunity, the streaming business has to work. Can it? There are three primary assumptions that matter. The biggest assumption/variable by far is how long can the company retain customers? At \$10 per month, a customer that sticks around for 36 months is far more valuable than one who sticks around for one month. The second assumption that matters is how much will the company have to pay for a customer? The third key assumption is what will happen to content costs? Let's look at them one at a time.

**Retention:** The company has indicated that subscribers who focus on different areas of content have different retention rates. Those with the shortest retention rates are yoga subscribers, which average



about 14 months. The group with the longest retention rates is called “Seekers” and they average over three years. The company has indicated that retention metrics are improving.

**Customer Acquisition Costs:** If the company can acquire millions of customers at substantially below their lifetime value, there is an attractive and viable business here assuming they can control their other costs.

**Content Costs:** One of the largest differences between Netflix and Gaia is the content costs. For Netflix, content costs are approximately 70% of revenue. For Gaia, it is below 20% of revenue. There can be a number of reasons for this including the company acquired niche content at attractive prices and conscious media stars make a lot less than Hollywood stars. Given the lack of relative scale, the Gaia model falls apart if content ever approaches Netflix levels.

### IS THE MODEL REALISTIC?

When we model five years out, the one thing that is certain is that the model will be off. However, in the spirit of John Maynard Keynes who said that “It is better to be roughly right than precisely wrong,” we can try to connect the dots. Does the business model make sense? If our assumptions on the primary metrics of retention, customer acquisition costs, and content costs are approximately correct – can this investment be profitable? The short answer is yes.

We can triangulate between their stated customer acquisition costs, stated retention rates, and stated gross margin goals – and the model can work. Below assumes 35% attrition rates and customer acquisition costs of \$90, which is higher than historical.

ASSUMPTIONS	2015 (A)	2016	2017	2018	2019	2020	2021
ARPU	\$ 107	\$ 100	\$ 95	\$ 95	\$ 95	\$ 95	\$ 95
Year End Sub Growth Rate		30%	80%	80%	60%	25%	25%
Avg # Sub Growth Rate		30%	80%	80%	50%	30%	30%
Assumed Churn (% of Subscribers)	35%	35%	35%	35%	35%	35%	35%
Cost of Good Sold	14.1%	20%	20%	18%	15%	15%	15%
Sales and Marketing Growth (Ex Advertising)		55%	-20%	5%	7%	7%	7%
Customer Acquisition Cost	\$ 60.00	\$ 80.00	\$ 90.00	\$ 90.00	\$ 90.00	\$ 90.00	\$ 90.00
Growth In Corporate Expense	-7%	57%	0%	10%	10%	10%	10%

  

OPERATING METRICS	2013	2014	2015	2016	2017	2018	2019	2020	2021
Year End # of Subs		100,000	155,000	201,500	362,700	652,860	1,044,576	1,305,720	1,632,150
AVG # Subs		132,500	172,250	217,250	310,050	558,090	837,135	1,088,276	1,414,758
Monthly ARPU		8.94	8.33	8.33	7.92	7.92	7.92	7.92	7.92
Total Net Adds		55,000	39,750	137,800	248,040	279,045	279,045	251,141	326,483
Assumed Churn (# of Subscribers)		35,000	54,250	70,525	70,525	126,945	228,501	365,602	457,002
Gross Ads			90,000	94,000	208,325	374,985	507,546	616,742	783,485

  

FINANCIALS	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue		10,134,000	14,217,000	17,225,000	29,454,750	53,018,550	79,527,825	103,386,173	134,402,024
Cost of Goods Sold		1,400,000	2,000,000	3,445,000	5,890,950	9,543,339	11,929,174	15,507,926	20,160,304
Sales and Marketing (ex Advertising)		8,818,000	8,386,000	12,998,300	10,398,640	10,918,572	11,682,872	12,500,673	13,375,720
Advertising		4,500,000	5,400,000	7,520,000	18,749,250	33,748,650	45,679,140	55,506,789	70,513,619
Corporate Expense		3,047,000	2,838,000	4,455,660	4,455,660	4,901,226	5,391,349	5,930,483	6,523,532
Pre Tax Profit		(7,631,000)	(4,407,000)	(11,193,960)	(10,039,750)	(6,093,237)	4,845,291	13,940,301	23,828,850
Implied Growth Capex (Net ads X CAC)			\$ 3,300,000	\$ 3,180,000	\$ 12,402,000	\$ 22,323,600	\$ 25,114,050	\$ 22,602,645	\$ 29,383,439
Pre Tax Profit Ex Growth Spend				\$ (8,013,960)	\$ 2,362,250	\$ 16,230,363	\$ 29,959,341	\$ 36,542,946	\$ 53,212,289

Pre-tax profit should be a reasonable proxy for cash flow in the growth phase – and with \$60M plus in cash, the company assertion that the business model is fully funded appears reasonable.



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As the model shows, if these assumptions hold, the company will have pre-tax profits in 2019. Importantly, this is while still investing heavily in growth while expensing all customer acquisition costs up front. The pretax profit in 2021 is almost what we are paying for the stub today. If you attach a 10X multiple to it and assume the cash and building stay where they are today, it implies a value of more than \$300M or nearly triple today's value.

Obviously the actual results will differ from the model – but the point is the dots can connect. In conjunction with the actions of Rysavy selling off the other businesses, buying back 40% of the company, not tendering his shares, and assuming the CEO role, the model reveals a substantial opportunity here – and Rysavy is the one with the most information.

## **UNKNOWNNS**

There are dozens of unknowns here – from retention numbers to how the video streaming market as a whole will play out to how big of a competitive threat youtube will become? Importantly, however, Rysavy has a history of selling and exiting businesses that are not working. Thirty-eight percent of the cash pile is his, and the incentives are aligned such that if the business deteriorates, he will not squander the remaining resources. This is ultimately a bet that a successful operator and capital allocator will navigate those unknowns. With more than half the market capitalization in cash, a company that is virtually silent, and distorted financials, it is easy to pass on the investment. However, as the situation settles, the financials normalize, and the company becomes more transparent, there is the potential for a generous valuation on the video business. With the cash balance and the value of the building protecting the downside, the risk/reward is skewed to the upside. Rysavy also has a history of selling assets when he thinks he has created value. By not tendering shares, he has effectively been a net buyer of the video streaming business; if my model or the company model is even close to correct, I believe he will find a buyer for a profitable subscription business with 80% gross margins and a history of growth.



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