Western Resources: You Must Be A Contrarian Or You Will Be A Victim

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- *The tendency to favor net nets paying dividends or generating positive cash-flows results in lower returns. This is completely counter-intuitive.*
- *Because of the optionality value and the cash balance of $70 million, I believe that Western Resources should be worth at least $70 million. In my opinion, it is impossible to justify the current market capitalization of $50 million despite the burn rate.*
- *Western Resources is currently trading at the lowest valuation in its history. The net cash value was bigger than the market capitalization only in 2008. At this moment, the potash price was around $200 per ton which is similar to the actual price. However, the firm was still in the exploration phase.*
- *Back in 2008, investors would probably have said the same argument about the burn rate. In my own opinion, the fact of extrapolating the burn rate in the distant future is a mistake. Indeed, a lot of events have the potential to unlock value. A liquidation of the company, a spin-off, a takeover or improving conditions in the industry are tangible examples.*

Following the article published by Larry MacDonald in the Globe & Mail, I received interesting comments about my investment philosophy and my holdings. These comments confirmed my hypothesis that it is totally counter-intuitive for a human being to buy deficient and disgusting business. It is emotionally challenging to acquire stocks in an illiquid company burning money every quarter. Moreover, the waiting is the hardest part due to the concern that the management will burn all the cash and leave the shareholders with a worthless piece of paper. On this matter, extrapolation is intuitive while mean-reversion is not.

In his amazing book ''Deep-Value'' and in his academic study, Tobias Carlisle showed that the ugliest stocks provide incredible returns over the years. The tendency to favor net nets paying dividends or generating positive cash-flows results in lower returns. This is completely counter-intuitive. This is precisely why it is possible to acquire decent assets for free.

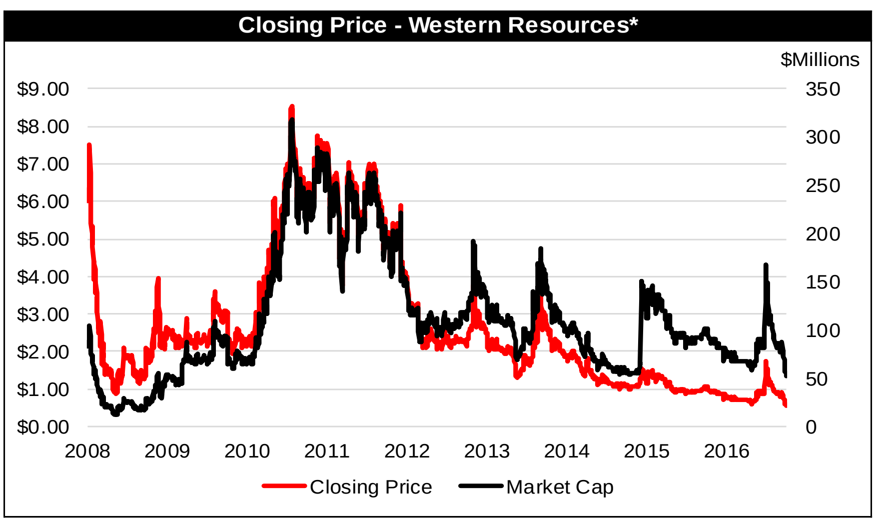
I have a tendency to believe that a stock covered by a dozen of analysts is probably priced more efficiently than an obscure stock with no coverage. Abnormally good and abnormally bad conditions do not last forever especially in the natural resources industry. This is why I started to be greedy when I discovered Western Resources (TSX: WRX).

I published a brief analysis on Western Potash when I discovered the name back in March 2016. I bought the stock at $0.95 in March 2016 and sold it at $1.58 at the beginning of February 2017. Following the plan of arrangement, Western Potash is now named Western Resources. Indeed, Western Resources acquired all of the issued and outstanding common shares of Western Potash on the basis of one Western Potash share in exchange of 0.2 share of Western Resources. The following comments of the management explain the rationale behind the reorganization.

> *As its resource properties become more advanced, Western Potash also wishes to be able to consider alternative value enhancing opportunities for those resource properties, such as joint ventures, spin-offs or business combinations […] While the Company continues to actively advance Western Potash Corp.'s 146,000 tons of capacity starter potash plant, it will explore new investment and acquisition opportunities […] Western Potash owns a world-class and successful potash project, and our new opportunities and investments will take this firm to new heights. (February 1, 2017 Press Release)*

The company has raised approximately $220 million since its initial public offering back in 2008. With its current cash balance of $70 million and almost no liabilities, it is possible to estimate that Western Resources invested $150 million in the Milestone project.

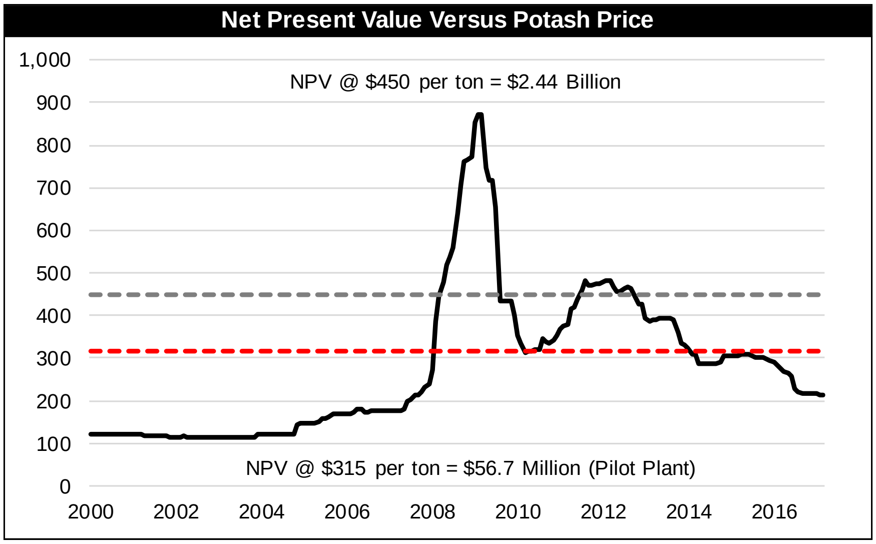
The following chart shows the share price in relation to the market capitalization. Evidently, the only moving part becomes the amount of shares outstanding that takes into account the effects of the different private placements. Western Resources was trading at the same valuation back in 2015 on a market capitalization basis. However, the cash balance was almost equal to $0.



Source: Yahoo Finance, Consolidated Financial Statements

**Adjusted to reflect the 5:1 consolidation that occurred in April 2017*

It is important to consider that a feasibility study on the Milestone project was completed at the end of 2012 and a preliminary economic assessment was completed in July 2015 for the pilot plant. The following chart illustrates the net present value of these projects in comparison to the potash price.



Source: World Bank, December 6, 2012 Press Release, July 2, 2015 Press Release

Considering the important capital expenditures required to start a new mine and the disgusting state of the potash industry, the Milestone project will not be developed any time soon. To be conservative, I will attributed a value of $0 to the $150 million invested over the past years. In other words, I will assume that Western Resources created absolutely no value since its IPO by developing its projects. Because the net present value of the Milestone project is probably negative at the current potash price, I will attribute a value of $0 to this asset. I will apply the same reasoning to the pilot plant. The following table shows these assumptions.

Western Resources - Intrinsic Value		
Assets	**Face Value**	**Current Value**
Exploration & Developement	$150 Million	$0
Milestone Project	NPV @ $450 = $2.44B	$0
Pilot Plant	NPV @ $315 = $56.7M	$0
Cash Balance	$70 Million	$70 Million
Optionality	?	?
Worst-Case	$70 Million	
Current Market Capitalization	$50 Million	

Source: Consolidated Financial Statements

I attributed value only to the cash balance of $70 million. In this scenario, some investors would argue that Western Resources is fairly valued with a market capitalization of $50 million due to its burn rate. Firstly, the burn rate is pretty low because the projects are almost entirely de-risked. Secondly, an undeveloped deposit should be valued exactly like a call option on the underlying commodity. To estimate the worst-case scenario, I estimated that the value of the optionality compensate exactly the discount justified by the burn rate. In fact, a call option with a negative value does not exist.

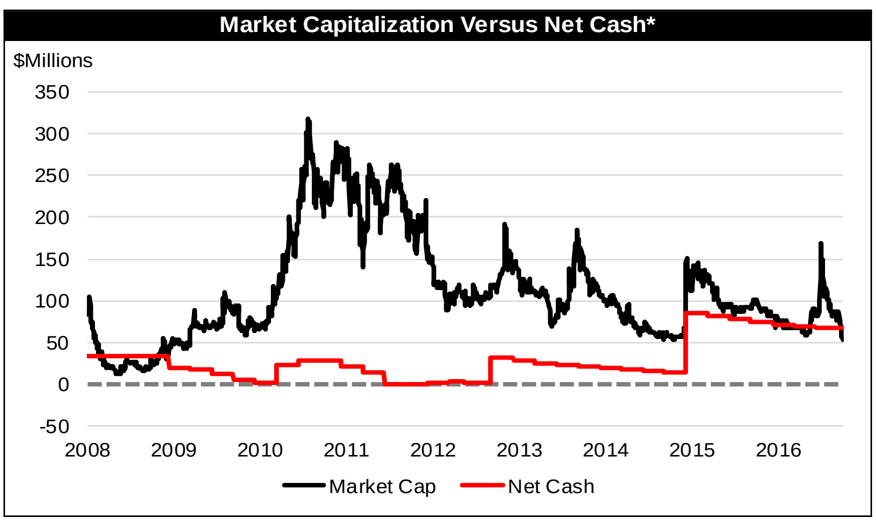
Western Resources - Burn Rate*	
Quarter	**Operating Cash Flow**
December 31, 2015	(2,708,224)
March 31, 2016	(929,394)
June 30, 2016	(535,362)
September 30, 2016	(3,871,991)
Annual Burn Rate	(8,044,971)

Source: Consolidated Financial Statements

** For the year ended September 30, 2016*

Because of the optionality value and the cash balance of $70 million, I believe that Western Resources should be worth at least $70 million. In my opinion, it is impossible to justify the current market capitalization of $50 million. It represents a discount of approximately 30% versus the worst possible outcome.

To estimate the base-case scenario, I plotted the market capitalization versus the net cash value. The net cash value is defined as the cash and cash equivalents plus the term deposits minus the total liabilities.

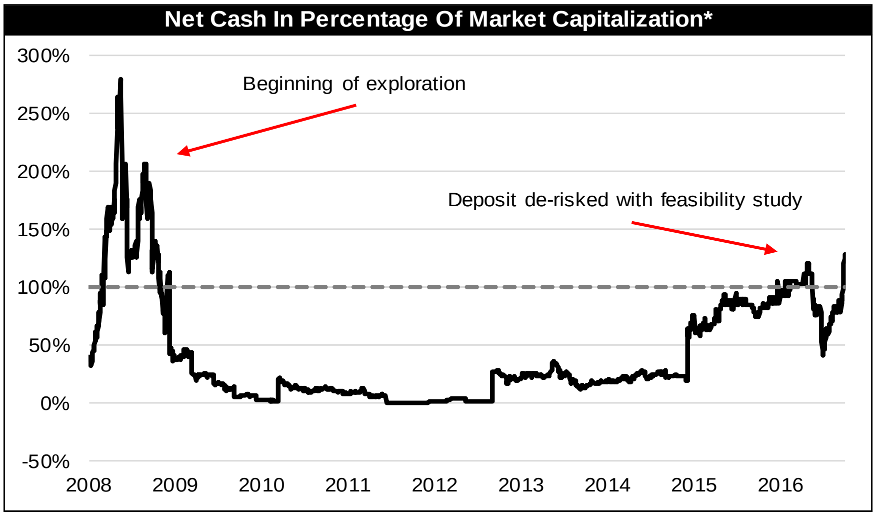


Source: Yahoo Finance, Consolidated Financial Statements

**Net cash is defined as cash and cash equivalents + term deposits - total liabilities*

Western Resources is currently trading at the lowest valuation in its history. The net cash value was bigger than the market capitalization only in 2008. At this moment, the potash price was around $200 per ton which is similar to the actual price. However, the firm was still in the exploration phase. In other words, the resource base was not defined. Because the Milestone project is now almost entirely de-risked, the valuation is definitely lower now than it was in 2008 in my opinion.

With the historical market capitalization and the historical net cash, it is now possible to calculate the historical discount versus the net cash value. The following table illustrates this metric.

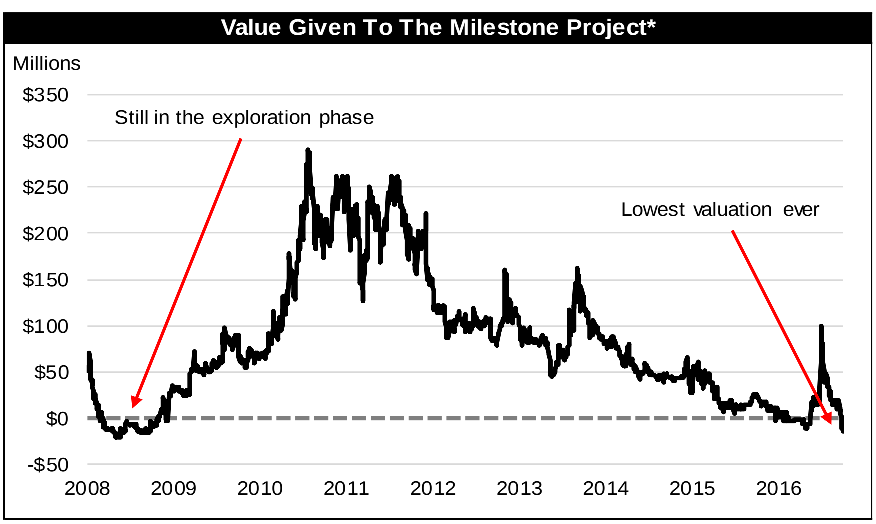


Source: Yahoo Finance, Consolidated Financial Statements, Author's Own Calculations

**Defined as net cash / market capitalization * 100*

Back in 2008, investors would probably have said the same argument about the burn rate. In my own opinion, the fact of extrapolating the burn rate in the distant future is a mistake. Indeed, a lot of events have the potential to unlock value. A liquidation of the company, a spin-off, a takeover or improving conditions in the industry are tangible examples. Moreover, if one of these events happen, the upside potential is quite important.

According to the market participants, the Milestone project was worth $300 million in 2011. According to the market, it is now worth around -$15 million. It illustrates somewhat my hypothesis on the optionality value.

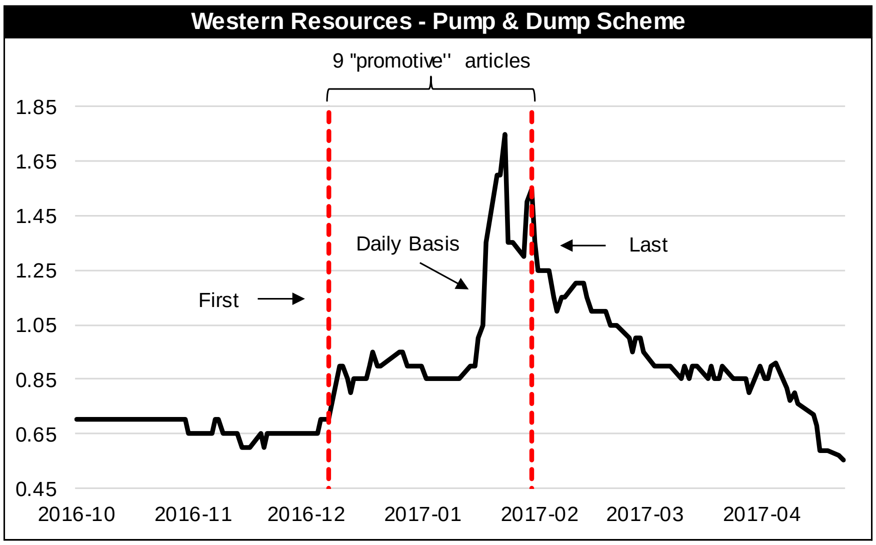


Source: Yahoo Finance, Consolidated Financial Statements, Author's Ows Calculations

**Defined as market capitalization - net cash*

As I said earlier, an undeveloped property should be valued similarly to a call option. The strike price should be around the cash cost of the project and the time to maturity should be approximately equal to the cash balance divided by the burn rate. Consequently, I would estimate the strike price at around $400 per ton and the time to maturity to approximately 8 years.

At such a deep discount, there are a lot of possible catalysts. One of the strangest catalyst that I ever seen occurred on Western Resources at the end of 2016. A promotional website started to pump the stock with successive newsletters. This strange catalyst allowed me to liquidate my entire stake with a solid gain of around 66%. In my opinion, it is the ''dump'' phase that caused the stock to collapse recently instead of real fundamental changes. It created a wonderful situation for investors following the strict principles of Benjamin Graham.



Source: Yahoo Finance

In conclusion, Western Resources is trading well below its net cash value. This incredible discount cannot be justified by the burn rate in my mind. The stock is trading at its lowest valuation ever and the share price seems to be driven by liquidity needs rather than tangible fundamental events. In other words, the share price is not driven by the actions of numerous well-informed buyers and sellers. The current price is a consequence of the pump and dump scheme that occurred few months ago in my opinion. You must be a contrarian or you will be a victim. The waiting is the hardest part. The temptation to do something while you wait is too hard for most people to resist.

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