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Emerson Radio Corp (MSN): A Takeout Candidate?

The stock is trading at $2.08/share and has 27.13MM non-diluted shares outstanding, resulting in a market capitalization of $56.4MM. The Co. has $61.32MM in cash and $60K in debt, so the Enterprise value is a negative $5MM. This essentially means, I could acquire the Co.'s assets and the operating cash flow from the business, for free. If I acquired the Co. at the current market price, I could recoup my initial investment of $56.4MM by dipping into the Co.'s cash balance, and still have $5MM in the cash balance. In addition, there would be $23MM in assets to offset $15MM in liabilities. In theory, the current market price offers $8MM in net assets for free.

However, a negative EV co, unreasonably cheap, discounted stock is more often than not a result of weak operational performance, dim future prospects and cash burn. This is the case for MSN as a result of a fallout by Walmart, who used to carry a microwave line that generated +$30MM in revenue for the Co. The dropped microwave line caused operating cash flow to drop from $20MM to the current $5MM.

Also, the market may believe the assets are inflated, and don't reflect the true market value. This is especially true for A/R, if a customer is facing difficulty, or investments, which may include a portfolio of equities and fixed income that may have depreciated in value. We doubt the Co.'s A/R balance is written down since the customers are primarily Target and Walmart.

The Co. buys products ranging from microwaves, televisions, mini-fridges, clock radios from Chinese manufacturers. The Co. then brands the products with the Emerson brands, known through the long 100 year history, and sells them at a mark-up to discount retailers, such as Target and Walmart, in the US. One author in Seeking Alpha suggested the Co. sell the rights to their brands, and discontinue their wholesale business. This would eliminate the need for working capital, while increasing the gross margin from 10% to 100%, although revenue would be markedly reduced.

We only propose a buyout if the Co. has strong asset value and more importantly, operational stability and growth. We don't rely on multiple expansion and we only want to acquire companies where we could receive sustainable, high yielding dividends, should the market be unfriendly for an exit. In other words, no negative carry. The Co.'s Net tangible book value/Price is 130%. However, the weak operational performance without a firm catalyst spells trouble, especially when negotiating with buyers when it comes time to dispose the Co. at the close of the holding period. What smart investor would want to acquire a declining business, unless there was a possible synergy they could create themselves? Also, we are concerned of the Co's ability to service the leverage, with the low gross margin at 10% and precipitously dropping top line figures for the near future.

In a best case scenario, the Co. turns around performance, which would be through locking a contract with another large retailer, or switching to a branding business. The Co. owns zero manufacturing facilities, so there is no way to improve operational efficiency related to the production of goods. However, we can't say with certainty the Co. will land another large contract. We feel the best option is selling the rights to their brands. We feel the Chinese manufacturers would be the largest beneficiaries if they carried out an acquisition of the Co. Chinese companies have been eyeing takeovers of US companies, since it would provide a reputable brand name for their services and products. Therefore, since the products are already Chinese made goods, it will serve them well to acquire this Co. on the cheap and save themselves the perpetual cost of paying the licensing rights.

In a 40/60 leveraged buyout, it would place 60% of the takeout price of $56MM, or $36MM as debt on the books of the Co., $20MM as equity, and create a negative goodwill of $17MM. Assuming a 10% interest rate for the $36MM in debt, an additional $3.6MM in interest would be serviced at the current EBT of $4.26MM. However, minimal principal reduction would be possible, if any, from operational cash flow. So, the new owners would use the cash balance and pay off the debt, and could reinvest the cash into other projects, or recoup their investment amount via a special dividend, leaving a cash balance of $5MM.

Transaction wise, this deal would go through and would be profitable for the investor. However, we fail to see a catalyst. Sure, we could theorize expansion into China and US using the Emerson brand, but it doesn't count for anything until the documents are signed and approved. In conclusion, it's a great deal at the current market price, which has enjoyed a 20% price jump from last week. The assets support a buy and is still FCF positive, which is rare to find for a negative EV Co. Yet, the Co. has no viable catalyst to warrant a higher offer price, as cash burn may ensue. One may take on the higher risk by offering a higher bid if they feel there is a turnaround strategy implementable through a branding or expansionary plan, but we remain skeptics.