Gaiam (GAIA) – A Value Investor's Dream and a LULU Shareholder's Nightmare

Date: March 26, 2014

Jirka Rysavy, the founder of Gaiam, is a rather remarkable guy. He came to the US in 1984 from Czechoslovakia with no money, spoke very little English and proceeded to roll up the office supply market into Corporate Express which Staples bought in 2008 for $2.65BN. He also started Gaiam in 1988. Sometime in-between then and now, he bought an 80-acre forested tract in mountains above Boulder, complete with a cabin, no running water and an outhouse so he could live sustainably and meditate. Which brings me back to Gaiam – a company that makes products and media for sustainable living. Gaiam is Jirka's baby. Up until very recently, Gaiam was a mish-mash of unrelated business units, making it difficult for investors to understand what exactly they were investing in. To give you a sense, since Gaiam began they:

- acquired and spun-off Real Goods Solar (RGSE, a 2008 IPO, see page 5) – a competitor to Elon Musk's Solar City (SCTY),
- purchased Vivendi Entertainment – a division of Universal Music Group and were the third largest non-theatrical content distributor in the United States behind Warner and Disney (they sold it in 4Q13),
- developed lines of proprietary fitness, wellness and apparel products ,
- built a retail distribution network in over 60,000 stores, and
- created a Netflix-style subscription service in Gaiam TV which has 6,000 exclusive titles that consumers can either download through digital retailers or stream online.

Today, Gaiam only has two business units: branded products (yoga mats, clothing, home goods, etc) and a digital media distribution platform called Gaiam TV. And with the news they announced last week, they will become even more focused, splitting into two separately traded public entities via a tax free dividend distribution later this fall.

It was last week's announcement that has me extremely bullish about the future of both companies as now each can be 100% focused on their specific niche within the yoga / wellness industry.

But let's face it: me being bullish doesn't mean squat. What matters is the value you are getting for the price you are paying, so let's dive into the value of Gaiam today (I would note that because of the recent sale of their entertainment operations, their 10K will be released a bit late – I expect it in a week or so; given the delay, some of the numbers I present below will need to be updated when the K is filed):

- As of today, GAIA holds approximately $5MM in Real Goods Solar (RGSE) and Cinedigm (CIDM) stock.
- As of 3Q13, GAIA had $20MM in deferred tax assets (approx. $60MM in NOL carryforwards) – this will get updated when the new K is out. I know that some of those NOLs were used to shield taxes from their gain on the entertainment unit sale; my guess

is that they are down to $20MM in NOLs, implying a tax-affected value of $7MM.

- At 3Q13, if you took GAIA's current assets (ex-deferred tax current assets) and subtracted all their liabilities, you were left with a surplus of $57MM. Add in the $51.5MM they received in their entertainment unit sale in 4Q13 and you get $109MM (note: this is subject to revision when the K comes out).
- GAIA also fully owns its 149,000 sq ft headquarters with studios located in Louisville, CO. The property and equipment are worth approx. $24MM and the Company is now looking to monetize this value. On last week's earnings call, the CFO said, "we are exploring how we can more effectively utilize our headquarters, a campus of approximately 13 acres and a 150,000 square feet of office space through optimization and/or transaction."

Adding it all up, GAIA's non-operating assets are worth $145MM. As of 4-Nov-13, there were 17.4MM Class A shares outstanding and 5.4MM Class B shares outstanding, for a total share count of 22.8MM. At today's price, that's a fully diluted market cap of $158MM.

That means the market is valuing GAIA's two operating business units at $13MM. Seems like a steal, doesn't it?

It is, but only if these units are creating positive value. As I lay out below, I believe each unit has a ton of value today with the optionality of enormous value creation over the long term. Let's first cover Gaiam Branded Products.

Gaiam Branded Products

Gaiam's branded products are sold online and through a retail distribution network of 38,000 doors (approx. 70% of revenues are from proprietary products). I can't over-emphasize this point – Gaiam has built a tremendous network of retailers that *already sell their products*. Creating new products and pushing them through this channel doesn't take a whole lot of extra effort. And it's not just new products – it's new store expansion and new country expansion that will also drive future growth. On the last call, CEO Lynn Powers made three points worth sharing on this topic:

1. We think there are lots of opportunities not only to grow our business within those 38,000 doors but also to add some doors as we expand Gaiam Restore because of what's happening overall with the drug stores like CVS and Walgreens trying to get into health and wellness.
2. With the growth of the yoga, fitness and well-being market in Europe, we believe we have a huge opportunity to be the global brand for this category. We've instituted multilevel packaging, contracted with a third party logistics company in the UK, opened John Lewis with a full Gaiam store within store and lunched Gaiam.co.uk.
3. We showcased our line at Expo and got good responses from some of the largest retailers in Europe. We will be dedicating resources to opening accounts across Europe with Gaiam's broad products and expect this business to grow quickly during the coming years.

There are a few things that are obvious to me as I survey the yoga / wellness landscape.

- **Global growth isn't stopping anytime soon:** yoga participation has grown at a 24% CAGR over the last decade with total spending nearly doubling since 2004 to $5.7BN annually on yoga classes and products (source). Yoga is more community based than any comparable workout program, which keeps retention high and new membership growth up.
- **Competition is heating up, particularly in apparel:** LULU has held a massive lead in terms of both sales and mindshare amongst consumers. And their strategy has been brilliant: nudge employees to become yoga instructors (or partner with local instructors) and infiltrate the community by spreading "light, love and Lululemon". But competitors have become very jealous of their profit margins (LULU ranks 3rd in retail in terms of sales per square foot behind only Apple and Tiffany's) and want a piece of the action. Nike has entered the market. So too has Under Armour. Gap has Athleta, Nordstrom has Zella, Calvin Klein has Astro, then there's Zobha, Lily Lotus, Soybu, Prana, Victoria's Secret, Mika and myriad others. Yet despite this…
- **No one has yet "won" the mid-price segment of the market:** there doesn't seem to be a real winner yet in the mid-price point range. I believe Gaiam may control their own destiny here as they have already secured significant consumer brand awareness and have built a powerful distribution channel. Which brings me to my last point…
- **Distribution will win out:** in the low to mid-price point segment, the winner will be the company with scale. And that means the winner will be the one with the largest number of distribution partners as I don't think a store-build out makes a whole lot of sense in the low / mid-range.

Given the above, I think it's possible that **Gaiam** – who has built a solid brand reputation within the yoga community over many years – **has a reasonable shot at being the #2 player in the yoga branded products category**. They recognize this opportunity and plan to aggressively pursue it over the coming years (announcement here).

With a branded products business that did $145MM – $150MM in revenue in 2013, Gaiam has the scale and the resources to become a major global player in this market. And once a suitable apparel brand wins enough mindshare in the mid-range, I believe people will begin to question the sanity of spending $90 on a pair of Lululemon yoga pants. **And it's this moment – the moment where an authentic yoga brand is readily available to consumers at a lower price point than LULU – that is a LULU shareholder's worst nightmare.**

Gaiam TV

Gaiam TV is a Netflix-like streaming video subscription business focused on holistic living. The stats are compelling and speak to the already-respectable size of this business unit:

- Global offering with subscribers in over 100 countries.
- Over 6,000 exclusive videos available for streaming or download through www.gaiamtv.com, Apple TV, Roku, Sony Playstation 3, on mobile devices, etc.
- The conversion rate from free trials to subscription is approx. 75%, which is remarkably

high and speaks to the quality of this product.
- ~80,000 subscribers.
- Run-rate revenue = $10MM (2013 revenue = $5.7MM; 2014 is expected to be double or more).

Today, Gaiam TV is losing money (EBIT was negative $8.5MM in 2013). But that’s expected… the Company is investing in the platform (making itself compatible with more operating platforms / on more devices, launching in different languages, marketing to grow their subscriber count – particularly internationally). Personally, I am all for this strategy. As long as their acquisition funnel can scale and lifetime customer value is greater than the cost to acquire a customer (this is the magical venture capital formula), they should go full-bore into growth mode and spend as much money as they can signing up as many people as they can.

On the last earnings call, Jirka said that if they want to get this unit profitable they could do it by the end of 2Q14. This tells me two things: (1) they are just a few months away from a key inflection point – the achievement of “scale”, and (2) this business will soon be profitable at management’s discretion. Both of these things lead me to one conclusion: Gaiam TV is a valuable gem of a business.

There are a few other noteworthy items about Gaiam TV:

1. The cost of producing their own content averages $4,000 per hour (versus $4MM per hour that Netflix pays; it’s an apples-to-oranges comparison, but an interesting data point nonetheless).
2. Acquisitions can be incredibly accretive. Last year, Gaiam bought MyYogaOnline (a 15k member subscriber base) for 3.3x EBITDA. That multiple is even lower when you consider the corporate overhead that can be wrung out.
3. Gaiam is talking to all the major cable companies to offer Gaiam TV to their customers (they already have a few thousand subscribers through their Verizon partnership); for customers, Gaiam TV would simply show up as another line item on their cable or phone bill each month.

My partner practices yoga. A lot. But after years of paying $20 per class and getting bored with the exact same yoga routine, she recently switched to practicing at home with online video instructors. To her, the benefits far outweigh the community bonding she gave up: it cost less, eliminates the hassle of driving and finding parking, allows her to practice on her own schedule and offers more diversity / more personal growth. I have noticed this trend with other experienced yogis too.

Every time I see her practice, I can’t help but think of the fantastic business Gaiam has created.

Conclusion

Gaiam has a rock-solid balance sheet with no debt, is focused on unlocking value, streamlining the company structure and reducing expenses. And it’s chaired by the remarkable Jirka Rysavy who happens to own nearly 27% of the Company (note: he owns all the B shares which gives him 77% of the total voting rights making him the arbiter of Gaiam’s future – he’s a man I’m willing to bet on).

It doesn’t take a genius to understand that Gaiam is dramatically undervalued in the public markets. **Gaiam’s two operating businesses aren’t worth $13MM. They are worth hundreds of millions of dollars with further upside optionality from there.**

The way I see it, **Gaiam is a value investor's dream**.