The Last Man Standing Collection of Short Stories – Volume I

Introduction

The Last Man Standing Collection of Short Stories[1] is a sad yet straightforward analysis of creative destruction in real time. The theme of these volumes is the secular-shift from paper-based to electronic delivery of communications, a defining theme we last examined in 3-Sigma Value's second quarter 2008 letter in which we asked, "Is it Too Late to Short Newspaper Stocks?"

Since then, the newspaper industry has gone through a much publicized series of restructurings and consolidations with no end in sight. Diversified media companies with newspapers (e.g. GCI, NYT, TRBAA) will continue to subsidize money-losing newspaper operations until they are motivated by shareholders to spin them off as separate entities[2]. Meanwhile, highly-leveraged pure-play newspaper companies (e.g. LEE and MNI) are unlikely to survive with equity intact.

The newspaper industry offers a local call-to-action (along with twitter), a voice for local advertising and politics, and a reason to continue printing. It attracts passion and deep pockets and is a symbol of free press and democracy. For these reasons, it is highly unlikely there will ever be one newspaper company in the U.S. with greater than 50% market share of newspapers sold and therefore the newspaper industry does not qualify for inclusion in these volumes.

In contrast, the subjects of *Last Man Standing* each represent more than 50% of the market share in their respective industries/geographies – starting with envelopes (Volume 1), followed by yellow pages (Volume 2), and textbooks (Volume 3). All three of these industries are doomed, and the companies we focus our research on all share the same basic strategy underlying their demise – a debt fueled acquisition binge to offset revenue streams in secular decline.

On August 21, 2013, we read something risible in the newspaper that rekindled our interest in the secular decline of print media. A company we know well, **Cenveo (CVO)**, the leading printer of

[1] Pun intended.

[2] For example, in July 2013, Tribune (TRBAA) announced the spin-off of its newspapers (Tribune Publishing) from everything else (Tribune Company). Everything else includes the Broadcasting Group (tv stations), 31% of Food Network (SNI owns the other 69%), 32% of CareerBuilder (53% consolidated in GCI), 28% of Classified Ventures (owns cars.com, apartments.com, etc.), 8 million square feet of real estate (Tribune Tower in Chicago, Times Mirror Square in LA), and other investments including a piece of the Chicago Cubs. The publishing company will own none of the real estate and pay rent. The publishing company will be larded with a billion dollars of debt.

envelopes in North America, announced it would acquire out of bankruptcy substantially all of the operating assets of National Envelope, which had filed for Chapter 11 protection from its creditors in June 2013 for the second time in three years. This transaction solidifies Cenveo's standing as the dominant printer of mass-market envelopes in the U.S., and the only (last) publicly-traded one.

The Last Man Standing in Envelopes

In 2010, National Envelope, formerly the largest envelope maker in North America, emerged from its prior Chapter 11 under the control of Gores Group in a deal worth a total of about $208 million[3]. Founded in 1952, National Envelope employs over 2,400 people and produces about 36 billion envelopes annually at 9 manufacturing facilities in the U.S. Volume in the envelope industry is declining 3% to 4% annually since about 2001, says Maynard Benjamin, president and chief executive of the Envelope Manufacturers Association.

National Envelope tried to avoid another descent into Chapter 11 by cutting costs at its plants, installing a centralized customer database and creating environmentally friendly envelopes, Gores Group says on its website. But the combination of high fixed costs and declining revenue proved too much to overcome and Gores had no choice but to put the Company back into bankruptcy.

In National Envelope's second Chapter 11 reorganization, the Company listed $148.4 million of secured debt including $37.5 million outstanding on a revolving credit line and $15.6 million on a secured term loan. There was also $55.7 million of second-lien debt that was 82% held by an affiliate of Gores. Revenue of $427 million in 2012 resulted in a $60.1 million net loss, continuing an unbroken series of losses for the Company since 2007.

While National Envelope was spiraling back into bankruptcy, Cenveo, the number two maker of envelopes, was similarly lamenting the drag of declining envelope volumes on its overall financial performance. Cenveo sells commercial print services, labels and packaging in addition to envelopes, and up until they doubled-down on envelopes by acquiring National Envelope, the

[3] $150 million of equity plus the assumption of a roughly $20 million debt to International Paper Co. and a $37.7 million note.

management team regularly referred to the Company as a "label and packaging company". On the Company's fourth quarter and year end 2012 results call[4], CEO Robert G. Burton Sr. made the strategic priority of the Company abundantly clear. He said, "*And even though Rob touched upon it, and you're fully up to date on what we're doing, I just wanted to, again, to be sure that there's no questions in your mind that we are focusing totally and completely on the Labels and Packaging to buy the smaller and midsized companies that allow us to integrate those very quickly*."

Eight months later, on Cenveo's third quarter 2013 results call[5], President Robert G Burton Jr.[6] explained the sudden change in direction. He said, "*As we've mentioned on our previous conference calls, we began a strategic review of our operations early this year. When we started this process, our intentions were to transform Cenveo into a larger label and packaging company and to potentially dispose of assets that were noncore to our future. This mandate hasn't changed, and we've made significant progress to date in our review. Along the way, the National Envelope bankruptcy process started to unfold, and quite honestly, fell into our laps.*"

National Envelope was broken into three parts for a total value of $70 million. Cenveo acquired the operating assets for $25 million cash and $5 million of its stock, while an affiliate of Hilco Merchant Resources bought the receivables for about $25 million, and Southern Paper bought the inventory for about $15 million, or 75% of book value. The aggregate purchase price of $70 million paid off less than half of National Envelope's $148.4 million in secured debt.

In an August 21, 2013 press release announcing a definitive agreement to purchase National Envelope, CEO Robert G. Burton, Sr. said the opposite of what he had been saying on every previous conference call. "This transaction allows us to achieve our dual objectives of **expanding our leading position in the envelope market** and continuing to position us for continued growth."

Cenveo is the last man standing in the once great business of printing envelopes. We believe the equity of Cenveo is worthless. As of September 30, 2013, the Company reported $1.2 billion of debt and an underfunded pension versus $8 million of cash and limited access to liquidity. With EBITDA ~$130 million in 2013 likely to decline to $120 million by 2015, Cenveo is terminally over-leveraged at 10x debt-to-EBITDA.

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[4] February 27, 2013.

[5] November 6, 2013.

[6] Cenveo is a family affair.

Cenveo (CVO) Capitalization as of 9/30/13	
Price as of 9/30/13	**$2.95**
Shares Outstanding	86.0
Market Capitalization	**253.8**
Cash	8.4
Debt	1,188.1
Underfunded Pension & Post-Retire	142.2
Enterprise Value	**1,575.7**
EV / 2013E EBITDA	**12.2x**
EV / 2014E EBITDA	**12.2x**

Cenveo is a leveraged roll-up of old printing companies that own and operate old onset printing presses used to make envelopes, and labels and other commercial printing packages. Many of these companies are distressed, as expected, and therefore management has a notable track record of restructuring and integrating the operations of old commercial printers. When acquiring the assets of a distressed printer, management pays low prices, as low as 1x pro forma EBITDA (post-synergies), and then these assets are buried into a sprawling organization that trades at 12x EBITDA. Magic.

It can be argued that a roll-up of private companies with scale and a professional management team deserves a step-up in valuation. However, Cenveo is generating only ~$30 million of EBITDA per quarter, a low level that is constantly under pressure from restructurings and other one-time items that are anything but one-time. Cenveo is a serial restructurer. Its business strategy is to buy and integrate underperforming assets, and therefore to exclude the charges associated with this strategy is to exclude a basic operating expense.

With $1.2 billion of debt costing ~$100 million per year in cash interest expense (8.2% blended rate), Cenveo is over-leveraged at 9.2x debt-to-EBITDA of ~$129 million per annum. In terms of valuation, Cenveo will never generate enough *leveraged*[7] free cash flow to meaningfully pay down its debt and therefore in order for the stockholders to receive any value these assets have to be worth more than 10x EBITDA. Given that Cenveo is paying as low as 1x EBITDA for a different mix of similar assets, it's hard to see why anyone would pay anywhere near 10x. Cenveo is a deleveraging fantasy. The pie is shrinking not growing. Revenue across the industry is declining mid-single digits and Cenveo is not defying the secular trend. It buys and sells old onset printing presses all of which are in a secular state of decline. There is no real

[7] After the payment of cash interest.

digital initiative at Cenveo. The CEO is a luddite. On the third quarter 2013 results call, he discussed deploying salesforce.com as a CRM tool, "*We're going to rank our people, rank them by performance and their ability to deliver, and which we think it's a great thing to do. You rank all employees and managers from #1 to whatever the size of the group is. And our sales tool that we've been using before,* ***the sales-com-dot-whatever****. With all our sales personnel, it gives us another major tool to work with as we rank these individuals*."

Following is a summary of 3-Sigma Value's Base Case financial analysis for Cenveo. It shows the Company will be unable to materially deleverage its balance sheet by the time its debt matures in 2017/2018[8]. Moreover, Cenveo is a prime beneficiary of zero-bound interest rate policy (ZIRP) and the extraordinary measures the Federal Reserve has undertaken to enable over-leveraged companies to continue doing business. Cenveo pays the minimum or floor interest rate on its term loan – LIBOR+5% with a 1.25% LIBOR floor – equal to 6.25%, a rate that is more likely to rise than fall. The only reason Cenveo is solvent today is because of government suppression of interest rates. In a normal interest rate environment, Cenveo would have already fixed its balance sheet in Chapter 11.

In addition to debt, 19% of the Company's 8,400 employees are members of various local labor unions, and the Company's various pension plans are underfunded. As of December 31, 2012, the total amount of underfunded pension and post-retirement benefits equaled $142.2 million. Given that these liabilities are required to be funded over a 7-year period in the U.S. and over 10-year period in Canada, management expects annual pension payments to continue running at around a $20 million rate.

[8] Term loan facility due 2017 ($358.2 million as of September 30, 2013); ABL facility due 2017 ($81.8 million); 7% senior exchangeable notes due 2017 ($86.3 million); 8 7/8% senior second lien notes due 2/1/2018 ($400 million); 11.5% senior notes due 2017 ($225 million); 15% unsecured term loan due 2017 ($20 million); other debt and capital leases ($29.5 million).

Cenveo (CVO) Summary Financial Analysis - Base Case: Scenario 1			
Sales by Segment:	2013	2014	2015
Print	589.0	559.5	531.5
Envelope	790.6	1,051.0	998.5
Label	332.1	332.1	332.1
Packaging	109.0	109.0	109.0
Total Sales	1,820.6	2,051.7	1,971.1
% Growth	*1.3%*	*12.7%*	*-3.9%*
Gross Profit	306.7	337.4	324.1
% Margin - negative mix shift to envelopes	*16.8%*	*16.4%*	*15.8%*
SG&A - largely variable	212.0	239.0	229.6
Amortization of intangible assets	10.2	10.2	10.2
Restructuring and impairment charges	13.7	13.7	13.7
Total Operating Expenses	235.9	262.9	253.5
Total Operating Income (EBIT)	70.8	74.5	70.6
% Margin	3.9%	3.6%	3.4%
+ D&A	57.9	54.4	52.2
EBITDA	128.7	128.9	122.8
+ Stock comp	3.8	3.6	3.6
+ Non-cash impairment charges	1.5	0.0	0.0
+ Decrease (Inc.) in working capital	8.1	0.0	0.0
- Capex	-25.0	-25.0	-25.0
= Unlevered free cash flow, pre-tax	117.0	107.5	101.4
- Interest expense, net	-110.0	-98.4	-98.4
+ Non-cash interest expense	10.3	10.4	10.4
= Free cash flow available to pay down debt	17.3	19.4	13.4

Compared to $1.2 billion of debt, around $20 million of free cash flow available to pay down debt is miniscule. Therefore, 3-Sigma Value does not expect material deleveraging prior to the Company's debt maturing.

In regards to debt compliance, the Company is in a constant state of re-negotiation with its creditors to delay step-downs in the maximum consolidated leverage ratio[9], and step-ups in the

[9] Total consolidated debt to consolidated EBITDA. There is also a maximum consolidated first lien leverage ratio covenant.

minimum consolidated interest coverage ratio[10]. Credit is loose and as a result, covenant compliance is malleable. Ultimately, however, when interest rates rise and/or covenants are held, Cenveo will default.

In conclusion, these assets are not worth anywhere near 10x EBITDA. They're not even worth 5x. In discussing the sale of Cenveo's forms business to Ennis for 4x EBITDA of $10 million, CEO Robert G. Burton Sr., said "*That is a good price no matter what you are selling in today's environment.*"[11] More recently, Cenveo sold its short-run custom envelope business to Ennis for $50 million. This business had sales of approximately $40 million and was one of the higher margin divisions in the Company. Basically, **Cenveo is selling profitable niche businesses and buying bankrupt mass market businesses.** On the Company's third quarter 2013 results call[12], CEO Robert G Burton Sr. said the following, "*You're aware that we sold the custom envelope group to Ennis. And you know last year when we sold the forms business. And just so you know, these are very good businesses. And these are businesses that we had, and the only reason that we sold them is because we wanted to be in these other business segments. These are good businesses. These are market leaders in these businesses.*"

The obvious reason why Cenveo is pursuing a strategy of selling good businesses to buy bad businesses is to acquire revenue. As long as top line revenue is growing and not tumbling, management can argue to its stakeholders – creditors and shareholders – that the Company remains a going concern. National Envelope generated around $600 million of revenue prior to its 2010 restructuring. Management estimates that number is now around $300 million. Still a large number, for now. However, this zero margin commodity business was basically traded for niche businesses that generate less revenue but were among Cenveo's highest margin (~20% gross margin). Even if the Burtons can successfully squeeze profits out of mass market envelopes (Upside Case), these profits merely replace the profits they sold to Ennis and are losing to the internet. The most likely scenario for Cenveo is one in which they are forced to restructure in Chapter 11 just like National Envelope did.

Base Case Target Price = Zero.

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[10] Consolidated EBITDA to consolidated cash interest expense.

[11] May 10, 2012.

[12] November 6, 2013.