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Where Food Comes From

Research

Date	Target	Price	Upside
05/03/2020	5 USD	1,9 USD	163%

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Market leader with huge moat in small fast-growing niche

- **Where Food Comes From is the clear market leader in farm verification in the US. It's a really small but significantly fast-growing market.**
- **We think WFCF taps into most of the long-term megatrends we see in the society today.**
- **WFCF have consolidated the space and now are by far the market leader with huge moats around their business.**
- **WFCF trades at a modest valuation with a net cash balance sheet and high recurring revenue that grows at a nice pace.**
- **Founders is still CEO and President with 30 % ownership**
- **Board composed of both industry experts and financials backers with high ownership stakes.**
- **We see a clear multi-year growth plan ahead and a significant margin expansion opportunity.**

Ticker	WFCF
ISIN	US96327X1019

Currency	USD
Target	5,0
Latest	1,9
Stocks in issue (mil.)	25,2
Market cap (mil.)	50

Nøgletal (2020)	
P/E*	22,1
FCF Yield	4,9 %

*adjusted for non-cash D&A on intangibles.

NØGLETAL *(thousands USD)*	**2017**	**2018**	**2019**	**2020**
Revenue	15.488	17.804	20.774	23.341
EBITDA	1.054	2.046	2.812	3.384
EBIT	200	1.104	1.715	2.262
Net Income	-171	675	1.023	1.616
EBITDA margin	6,8%	11,5%	13,5%	14,5%
EBIT Margin	1,3%	6,2%	8,3%	9,7%

Why is it cheap?

The first thing to consider when buying into a stock is if its cheap. If your answer is yes you want to have a sense of why its cheap. If you can't think of a reason for that maybe it's not really cheap at all.

Regarding WFCF there are several reasons why the stock is so cheap:

1) It is trading on the US OTC. This limits the accesability for a lot of investors to buy it. We needed to call our broker Nordnet on the phone and place our buy orders.
2) Both the OTC listing and the small size makes the company uninvestable for most bigger funds.
3) Like many of our other successful investments (like Piteco etc.) the reported earnings numbers don't tell the full picture. WFCF amortize intangibles on prior acquisitions. At the same time, they invest heavily in different software applications that both will deliver

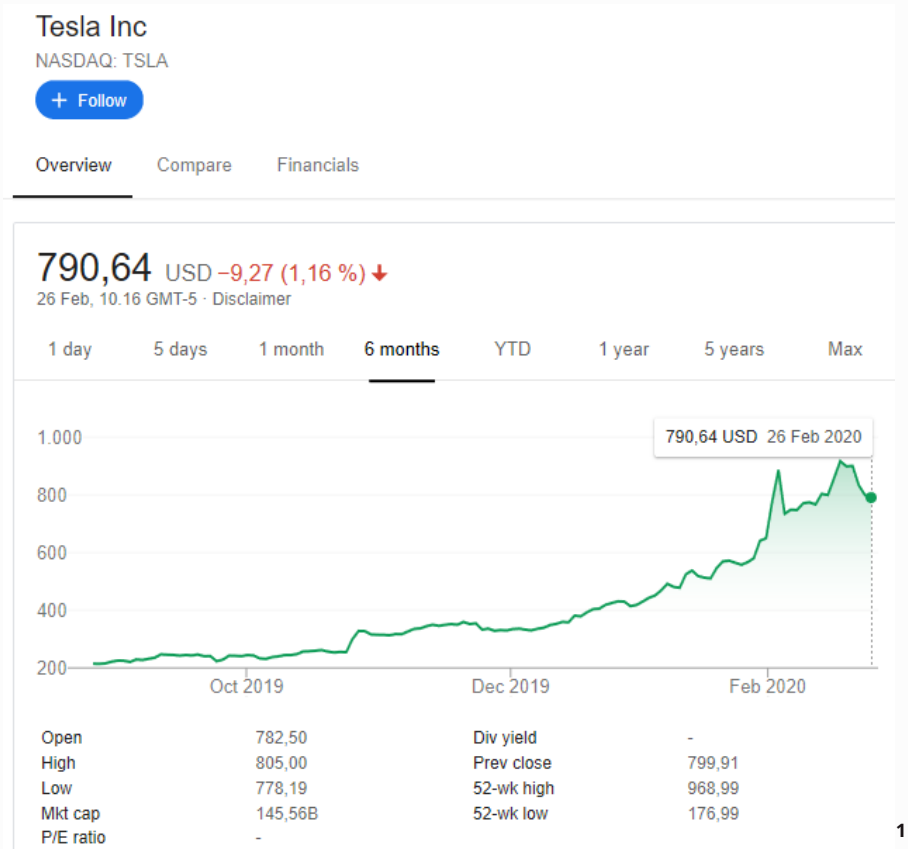
recurring revenue streams in the future and lower internal cost. Looking at the FCF instead, the stock is clearly cheap. When normalizing margins its really cheap.

4) Because some of the audits are related to china export, some investors fear the business would be hurt big by tariffs and trade negotiations (this has clearly not panned out).

We think that over time investors will start to realize how good a company WFCF is. As the company keeps growing and scale fixed expenses the reported earnings will explode in the coming years.

A real ESG investment:

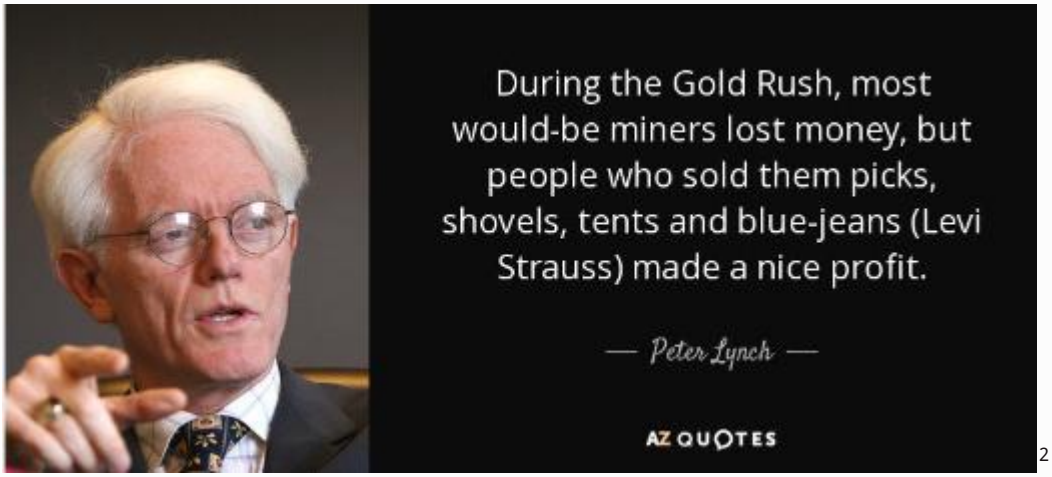
Really all big investments related to ESG trades at insane valuations these days. Here is the poster child of this frenzy:



[1]

[1] Google finance

What we have come to realize is. The true value is in the suppliers:



[2]

Where Food Comes From really taps into all those global mega-trends right now:

- People want to know more and more about what they eat.
- People want to make sure their food is non-GMO treated
- People want to know their meat are produced with good animal welfare
- People want to know the food are produced in and environmentally friendly way

We are becoming a world where we probably want to eat less and less meat over time. But the meat we eat, we want to know everything about.

[2] https://twitter.com/ashishkila/status/926710195912261635/photo/2



What does they do?

So, what do WFCF actually do?

When you go to the local grocery store and want some beef you sometimes see a label on the product that says its Non-GMO treated, it has animal welfare standards etc. It could be gluten-free, antibiotics free etc.

But how do you know that's true? That's where WFCF comes into the picture. They do the actual farm visits to control those statements. The best way to think of it is like an auditor that come to audit a company's annual report so that external stakeholders can put trust into the numbers.

That's the same value creation WFCF delivers to consumers. They make sure that what producers say about their product are actually tested and controlled.



WFCF sits on the whole value-chain in farm verification.

In addition to those farm verifications WFCF also sells the actual ear-tags that farmers place on the cattle. They also develop and sell SAAS software solutions that handle documents and other data about the process.

http://wherefoodcomesfrom.com/what-we-do/





WFCF are licensed to more than 40 different standards in different segments. The by far biggest segment is beef where they are the undisputed leader. But through M&A and organic growth they have also expanded into a lot of different verticals like almonds, flowers, truffles, mushroom, wine, dairy etc.





A recent example of the constant expansion into new verticals is the Hemp Industry. As Hemp are getting legalized into consumer and medical products throughout the US and Canada the US Hemp Authority made WFCF their program administrator for the hemp verification standard:

http://wherefoodcomesfrom.com/wp-content/uploads/2018/12/3-Hemp-PR-draft-6.pdf

As Hemp are used in medicine and to some extend consumer products, it's really important that the product is safe and developed the right way. With this standard WFCF can verify growers that comply with the requirements. This will give purchasers of hemp the ability to distinct between the products they buy based on a standardized verification process.

Most of the direct costumers to WFCF are the farms who pays for the audits and eartags etc. But WFCF also sells to some big blue-chip costumers:



Besides being a costumer to WFCF those big brands are the ones who pushes the industry forward and create demand for WFCF products. Farmers listen when a company like McDonalds or Wendy's go out and say they want sustainable produced beef in all their burgers.

WFCF also work close with producers like Tyson food. When Tyson buy cattle, they can sell the thongs to Japan, the beef to Europe, Testicles to China, the head to Mexico and the liver to Africa to take an example. But most of those countries demand strict age and source verification on all the import. When Tyson can get a much better price for a verified product, they can afford to pay more for the cattle in first place. This give incentives to the farmer to get source and age verification to sell to Tyson.

Huge secular tailwinds:

One of the things we like the most about WFCF is the long term secular tailwinds there is here. People want to know more and more about their food and what they put into their mouths. Both

from a health perspective, but also from an environmental perspective, animal welfare perspective, human rights persepctive etc.



One of the drivers are from political mandatory rules. In most of Europe (like Denmark where we live) animal traceability is mandatory. Every cows and pigs etc. have ear-tags. It's the best way to control diseases etc.

So far this has not been mandatory in the US (mostly because of lobbying against it). But because its mandatory in Europe, China etc. every US farmer that want to export their beef have to have age and source verification. This is a big revenue driver for WFCF as US farmers can achieve much better prices exporting their meet to especially China.

Kathryn Britton from WFCF talks about how farmers can get better profit margins using verification:

https://www.alltech.com/podcast-blog/beefing-profits-through-verification-programs

In the US the Animal Disease Traceability (ADT) program sets some guidelines for how to implement traceability:

https://www.aphis.usda.gov/aphis/ourfocus/animalhealth/SA_Traceability

We see a clear change that this will become mandatory at some point. But with political changes its hard to predict when.

But the big driver is not ADT – its consumers.

When companies like Wendys:

https://www.qsrmagazine.com/sustainability/wendys-makes-major-advancement-beef-sourcing

https://www.restaurantbusinessonline.com/food/wendys-plans-use-more-sustainably-sourced-beef

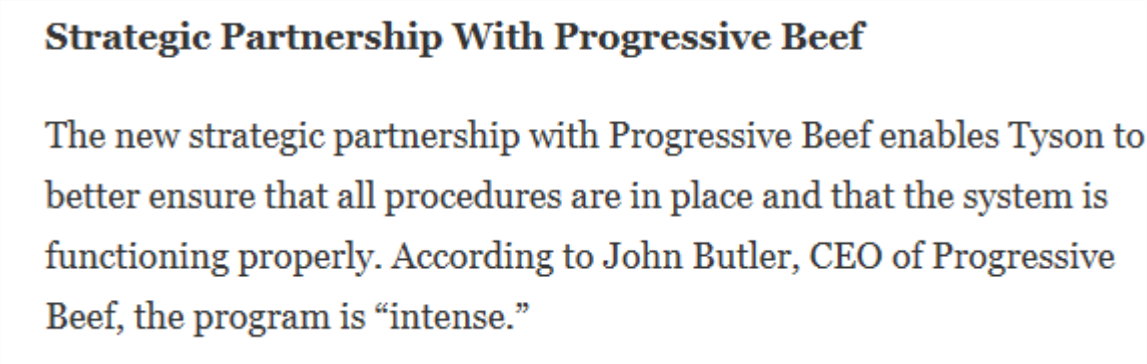
or McDonals:

https://corporate.mcdonalds.com/corpmcd/scale-for-good/beef-sustainability.html

put pressure on the whole supply chain to deliver sustainable beef it helps WFCF. When Wendys go to Tyson and say they want sustainable beef, Tyson go to farmers and say they want more verified beef and farmers go to WFCF to get it done.

Here is Tysons response to antibiotics in beef:

https://www.forbes.com/sites/aliciakelso/2019/02/08/tyson-turns-to-strategic-partnerships-to-raise-industry-beef-standards/#dcc200338c7b



Strategic Partnership With Progressive Beef

The new strategic partnership with Progressive Beef enables Tyson to better ensure that all procedures are in place and that the system is functioning properly. According to John Butler, CEO of Progressive Beef, the program is “intense.”

It is worth mentioning here that WFCF owns 10 % of Progressive beef and is their authorized verification partner. So, any push from Tyson will definitely benefit WFCF.

There are some real structural growth drivers that benefit WFCF.

Here is from Cargill about non-gmo treated food:

> "Growth has been extreme and consistent," said Hans Eisenbeis, director of marketing and communications for the Non-GMO Project. "In terms of the verification program, we continue to grow 15% to 20% every year. In terms of consumer demand, we're seeing 9% growth, considerably more growth than most other attributes, including organic, which has started to level off."[3]

Forecasted growth into Gluten-Free products:

> According to the current analysis of Reports and Data, the **global Gluten-free products market** was valued at USD 4.35 Billion in 2018 and is expected to reach USD 7.91 Billion by year 2026, at a CAGR of 7.7%. Gluten is a protein, naturally occurring in food-grains like wheat, barley, rye and spelt. Gluten is composed of two main proteins called glutenin and gliadin, out of which gliadin is responsible majorly for most of the health related issues. When it is mixed with water, the mixture results in glue like dough formation, it gives a soft and fluffy and yet elastic texture to the dough, in fact the name gluten is derived from glue like property possessed by this protein.[4]

We are seeing the same trend in Antibiotics, Animal welfare, sustainable grown, organic growth, socially responsible grown etc. Consumers care about this and push the trend that ultimately benefit WFCF.

M&A

Most of the growth that WFCF has achieved over the last 10 years has been organic. We normally don't like acquisitive companies when we invest. But WFCF have been really good at making small

[3] https://www.foodbusinessnews.net/articles/14368-non-gmo-project-growth-extreme-and-consistent
[4] https://www.prnewswire.com/news-releases/gluten-free-products-market-to-reach-usd-7-91-billion-by-2026--reports-and-data-300939613.html

bolt-on M&A deals that gives them scale, geographic expansion and product expansion. We like those types of M&A deals. Not growth just for growths sake.

Acquired Company	Year Acquired	Business Focus	Certifications / Technology
ICS	2012	Grain, dairy, beef, pork, tobacco	Organic, Gluten free, Non-GMO
Validus	2013	Pork, poultry, dairy	Animal welfare, sustainability
Micro Technologies	2013	Beef	Source & Age, NHTC
Merck (Tri-Merit)	2014	Beef, dairy	Source & Age
Sterling Solutions	2014	Beef, dairy	Source & Age, NHTC, BQA
SureHarvest	2016	Software for producers and other players in high value specialty crops	SaaS / Sustainability
A Bee Organic	2017	Crops, bees, chickens, honey, eggs, coffee, herbs	National Organic Program
Sow Organic	2018	Software for Organic certifiers	SaaS
Progressive Beef	2018	10% membership interest in standard	Sustainability, animal care
JVF Consulting	2018	Software developer	SaaS

As can be seen from above some of the recent M&A deals have come in the technology space. WFCF recognize the true impact technology will have on their business in the future and wanted to be at the forefront on this.

The last segment WFCF have not been able to participate in was the fast-growing seafood space. Yesterday they ended up acquiring Postelsia Holdings to solve this:

https://seekingalpha.com/pr/17799183-where-food-comes-from-inc-enters-seafood-space-acquisition-of-postelsia-holdings-ltd-leading

By adding Postelsia to the WFCF family they now operate in every desired vertical.

A huge and widening moat:

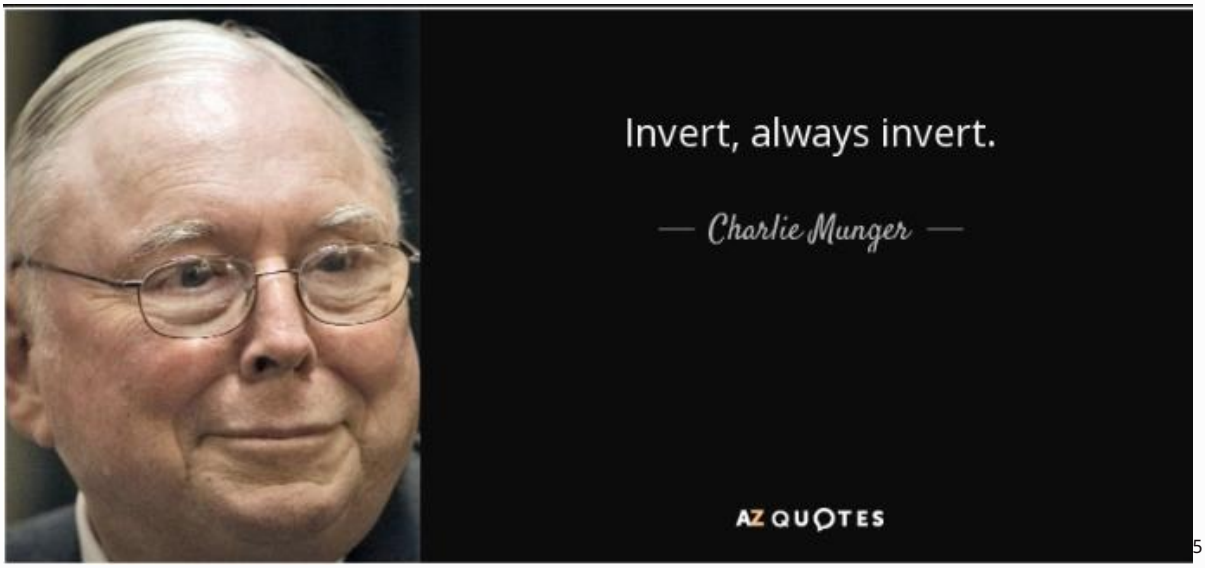
We have never seen such a huge moat for such a small business that didn't have a monopoly.

If you think about how integrated WFCF is in the value-chain its quite amazing:

1) They sell a real product/hardware in form of eartags upfront.
2) They then do manual audits on the farms
3) They then use SaaS software products to document and distribute those data and audits

For someone to compete with WFCF its not enough to be a farm verifier, a product company or a software company. To truly compete with WFCF, you need to be able to handle it all.

WFCF only have a market cap of around 50 mio. USD. The CEO John Sounders have mentioned several times that even if Bill Gates wanted to compete with him it would probably take him several years and several hundred million dollars to get there. There is a lot of advantages with being in a small market and have such high market-share. There is really not a lot of room for other players.



[5]

As Charlie Munger puts it, a good way to think about different scenarios is to invert them. Think about this scenario? If I gave you 100 million USD. Would you be able to compete with WFCF? Or would you be better off buying WFCF at a 100 % premium to the current share-price?

To compete with them you would need to:

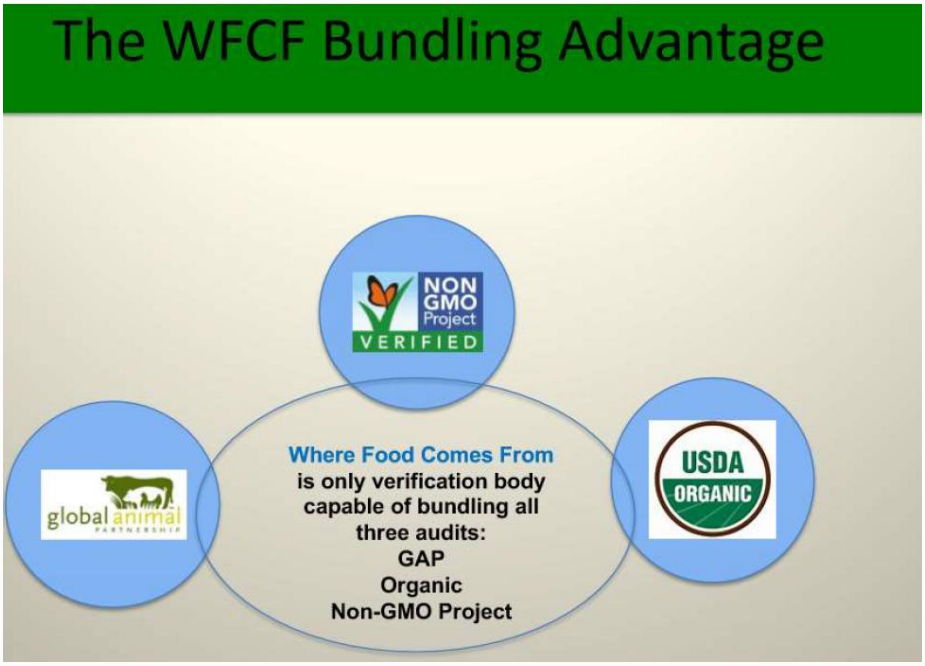
1) Develop a suitable RFID eartag product and land several costumers.
2) Hire and train a big amount of farm auditors
3) Develop integrated software-solutions to handle document filings.

[5] https://www.azquotes.com/quote/1407211

4) Build relationships with farmers and convince them to change supplier

Oh, and you would have to spend several years to get licensed to actually do the audits. A new competitor would either have to spend a lot of money and time to get licensed to all those standards or acquire a lot of different small players that have those licenses. An example is the non-GMO license. It took WFCF more than two years to get licensed. When they got licensed, they were only the 4th licensed company. When they got licensed on the "Global Animal Partnership" they were only the second licensed company.

One of the big advantages WFCF has with their current scale is the possibility to bundle standards in one farm visit.



If a farm or grower are audited to several standards, they would much prefer to only interact with one auditor. It strengthens the relationship and also lower the cost for the farmer.

To compete with that, a new entrant would need to bee licensed to a lot of different standards. It would not be enough to have a few standards and take that away from WFCF as costumers prefer bundling.

Scale and relationships.

This is a relationship business. Farmers build a relationship with their auditors. Think about how seldom listed companies change their auditors? And here they have a least "the big-4" to choose between. And for smaller companies several more options. Companies don't change that often because as long as the price they get are competitive they prefer their current auditor.

It works the same way with farm verification. If a farm pays 1.000 $ to WFCF, do they really want to change auditor if someone offers them 800 $? Not likely.

And WFCF has build huge scale. They have 80 % or something marketshare in some standards. And definitely in bundled services they are really the only supplier. To have an auditor visit several farms in close geographical reach are a lot more cost effective than if the auditor has huge distance between visits. A new competitor would not have that scale advantage to begin with.

And like financial audits first year audits are normally more expensive as the new auditor have to learn about the costumer from scratch. A new competitor would have to swallow that expense to win over WFCF on price competition.

Beside the bundled services farmers also want audits form the same company they buy the eartag and buy software products etc. Its just more convenient to have fewer suppliers. Especially when they buy services across the value-chain.

WFCF is building their own standards and brand:

To really capture the market, build a stronger moat and connect more with costumers WFCF have launched their own standards.

So far, they have launched BeefCARE, DairyCARE and PoultryCARE:

http://wherefoodcomesfrom.com/wp-content/uploads/2020/01/1-BeefCareFinal.pdf

http://wherefoodcomesfrom.com/wp-content/uploads/2020/01/DairyCARE2020-1.pdf

http://wherefoodcomesfrom.com/wp-content/uploads/2020/03/1-PoultryCARE-Draft3.pdf

Those standards come on top of the Gluten-Free and Black-Angus standards introduced last year:

http://wherefoodcomesfrom.com/wp-content/uploads/2019/08/Gluten-Free-PR_August-2019.pdf

http://wherefoodcomesfrom.com/wp-content/uploads/2019/05/Black-AngusDraft2.pdf

Their goal is to make those standards the default-standard everyone would want to comply with. By building a brand around those standards it can help farmers that comply with the standard and get better prices for meat etc.

And remember those standards are trademarked. Its not some public standard a potential competitor can apply to. As WFCF build more and more trust about those standards from both farmers and consumers the chance of anyone coming in and replicating it decreases significantly.

As we have described we think WFCF have an extremely wide moat around its business. And its is not only wide, they constantly worry about how to expand their moat and build a bigger and better business.

The ultimate goal:

When we have talked to John, he has always told me his dream is to create a trusted consumer brand. For a 50 million USD market cap company that's a big goal.

The ultimate goal is for consumers to relate to and identify with the WFCF label in their grocery stores. That consumers will know and trust the brand and hopefully even pay more for products that display a WFCF brand.



They are already doing this in small scale today. The retailers or distributors simply pay a small royalty per pound of product sold that has the WFCF label on it. This is a two-step process to achieve:

1) You need to have a lot of products verified. Not only does the meat need to be verified at farm, but it has to be tracked internally in the slaughterhouse and packaging facility.
2) Consumers needs to be educated about WFCF and the label.

Both takes time and WFCF don't have the resources to push either really hard. The good news is it becomes more relevant as times passes. As more and more farmers and producers are forced to be verified anyways (as the big chains increasingly demands it) the grocery chains won't have to push for the products to be labelled (they already will be).

On educating the consumer about the label so they get familiar with it etc. that is something that will take many years to build.

But imagine the revenue possibility here to get a royalty on products sold with your quality stamp on it in every grocery store in the nation? To be the default brand in costumers' minds when they think about food quality.

It's a long-term goal, but it's important to remember it's not some hypothetical future product. Its already live in small scale and growing.

Management

WFCF fits our "Founder-strategy" well. The company is today run by couple John (CEO) and Leann (President) Sounders. They founded the company and still owns 30 % of the shares.

John founded the company immediately after college while Leann worked 7 years in different corporate roles (to support the family while John was building the business). From 2003 and forwards she joined WFCF as president. There is a story about how WFCF came to life here:

http://voyagedenver.com/interview/meet-john-leann-saunders-food-comes-castle-rock-co/

We have had several phone calls with John and their friendly IR chief Jay. Unfortunately, I have not had the opportunity to meet John in person yet, but hopefully I will be able to visit them in the states at some point.

We reason with a lot of Johns thoughts about the long-term play here. One area is the huge software investments the company are making. Those investments hurt the margins in the short term but will improve the business a lot in the long term. Those software investments are both about creating SAAS products and other system the company can sell to farmers etc. But they are also about creating systems and processes that can help the company to be more efficient internally. It's about how they track data, documents, store and share those etc. That is a cost driver now that will be a cost saver in the future.

The management team are constantly thinking about ways to improve the business. Even stuff like Blockchain they consider how could be applicable in farm verification:

http://wherefoodcomesfrom.com/blockchain-food-industry/

We love management teams that want to test and learn on new stuff and constantly think about ways to improve and grow without loosing focus on operations.

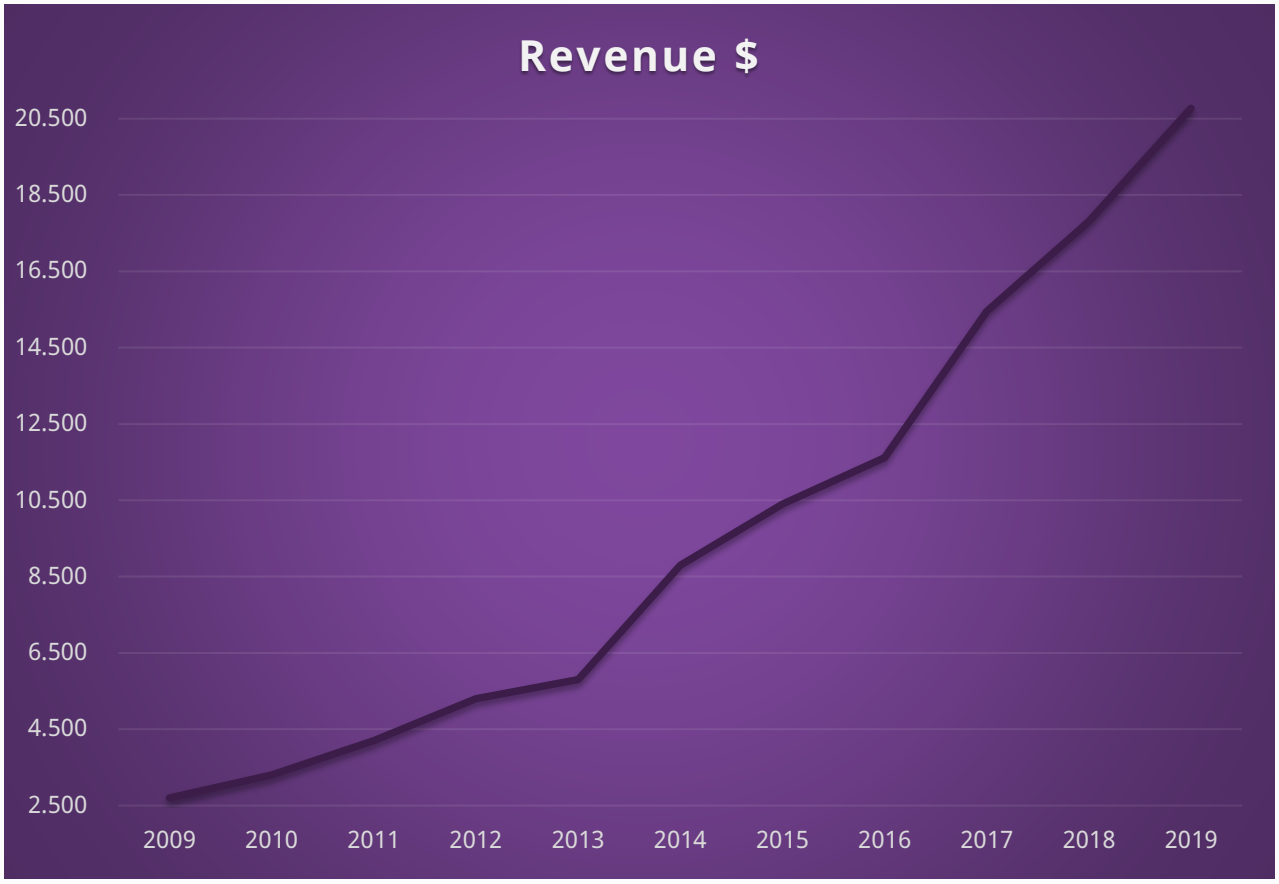
The board of directors are beside John and Leann Greame Rein, Michael Smith, Pete Lapaseotes, Adam Larson, Robert Van Schoick II and Tom Heinen.

Especially Graeme Rein is exciting as he is the CIO of Yorkmont Capital Management. Yorkmont Capital controls more than 10 % of the shares in WFCF. We like that a long-term investor with a big shareholding sits in the board room which gives a good balance to the founders.

The other board members add different industry knowledge.

Financials

WFCF have grown consistently every year since it was founded. Below we have shown the revenue development over the last 10 years:



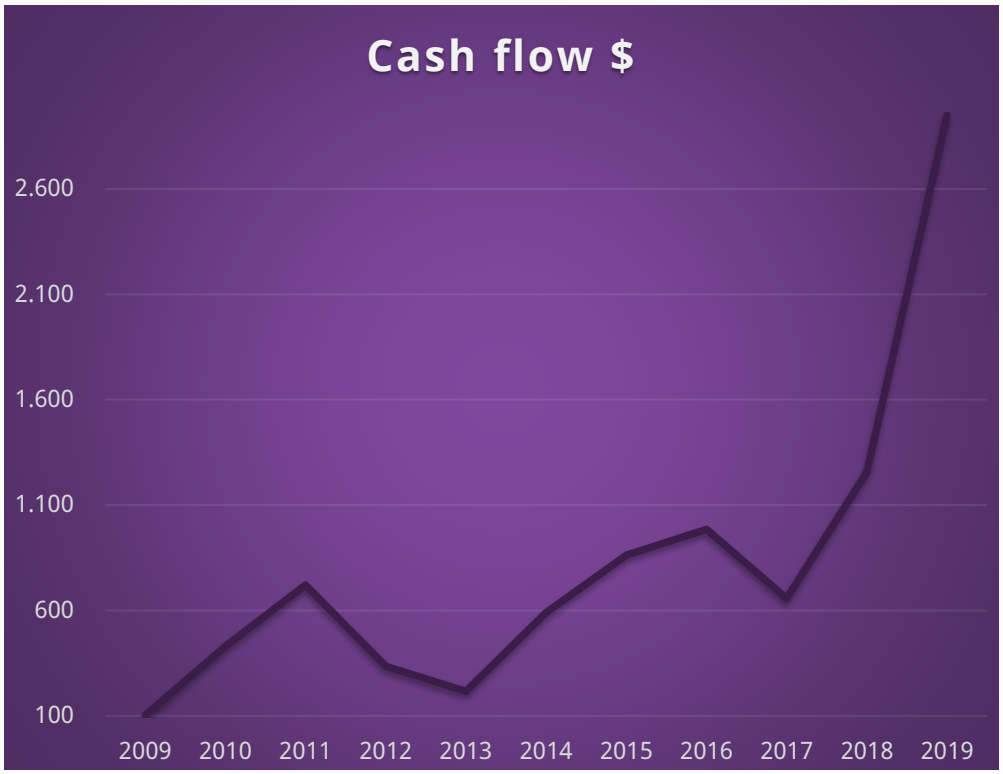
Over the last 10 years revenue have grown at a CAGR of 23,2 % per year.

This growth has been achieved with +15 % organic growth and bolt-on M&A deals on top of it. It has been delivered with virtual no dilution (most dilution has been offset by share buybacks over time).

Today we see a lot of those “recurring revenue businesses” that show revenue growth but report big losses to get there. That is not the case with WFCF. Despite the fact that revenue have grown at more than 23 % per year, EBITDA and Cash flow have followed.



EBITDA have even grown faster than revenue at a 40,5 % CAGR or a 20x increase over 10 years.



Cash flow have grown even faster. It has grown at a 45,9 % rate or a 30x increase in 10 years.

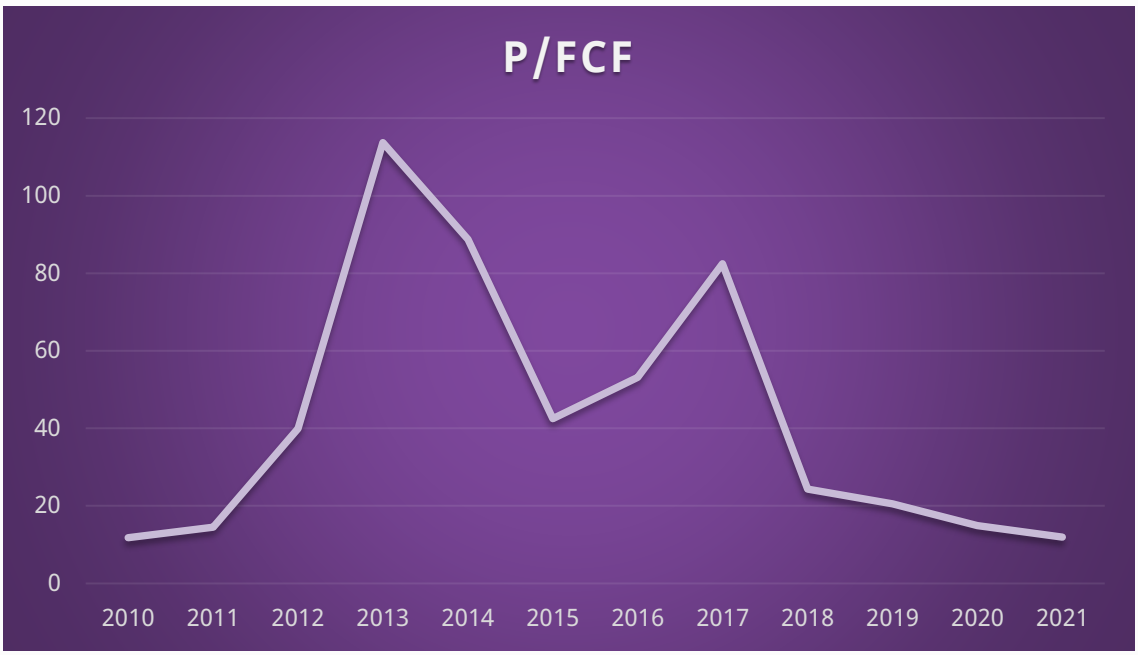
Estimates:

It is hard to put a value on WFCF. What is the value for a small fast-growing company with huge moats and market leadership in a fast-growing niche industry with big industry tailwinds behind it?

Over the last ten years from 2009 to 2019 WFCF have grown revenue close to 10x from 2,7 mio. USD to 20,8 mio. USD. That is a 10-year CAGR of around 23,2 %. WFCF have been cash flow positive in all years and have only have some modest share dilutions (shares outstanding have only expanded 15 % in the period where revenue and profits expanded more than 1.000 %).

We see a lot of ways WFCF should be able to grow revenue at a 15-20 % rate also for the next 10 years with all those industry tailwinds that supports them. The return from buying the stock now would be significant even without multiple expansion.

But WFCF are only trading at 21x our 2020 free cash flow estimate. That reduces to 16 and 12 times 2021 and 2022 FCF as the company scale their software investments and reach the margin potential. We can probably all agree that 15-20 x FCF multiple are way to cheap for a company with this moat, recurring revenue and growth characteristics.



A funny fact here. The last time WFCF traded at such a low multiple was in 2010. The stock went from 0,3 to 3,0 or a 1.000 % return in 3 years following that. I am for sure not saying we will get a 1.000 % return this time around as the valuation clearly overshot in 2013.

But just applying a 30 x 2021 cash flow multiple (around 20x 2022 FCF) would translate into a fair valuation of around 5 USD per share for WFCF in 12-month time. This corresponds to more than 150 % upside from current share price levels.

We would want to emphasize this is a long-term play for us. We own around 3 % of all the shares outstanding and is one of the biggest shareholders in the company.

We can also look at the opportunity in another perspective. Today there is around 25 million cattle in the US. Only around 10 % are currently traced with eartags. WFCF has a marketshare of about 80 % of that market.

As it takes around 2 years for a cow to grow into slaughter, there is a demand for around 12,5 million new eartags each year. At around 2 $ a piece it's a 25 mio. USD market opportunity just in eartags for WFCF.

For every cow that gets an eartag WFCF also need to do a farm verification once a year. That business is several X of the actual product sale. Besides the farm audit there need to be made a report every time a cattle moves place. A cattle normally moves around 2 times from birth to slaughter. That's around a 3-5 $ per cattle per year opportunity or around 100 mio. In TAM that keeps growing.

WFCF also invest in traceability inside slaughterhouses where they help producers with software and traceability. That can be a bigger future opportunity.

Today the revenue is around 25 mio. USD. And this 150-200 mio. USD market opportunity is just in beef. There is pork, lamb, dairy, fish etc. etc. not to mention fruits, vegetables etc.

My point is. Its not a matter of the market opportunity. It's a matter of how good WFCF is in developing this market. Because there is not a competitor, they can take market share from and grow that way. They need to develop the market themselves.