



BY JOHN KINGHAM

DIVIDEND HUNTER

WHAT TO DO WHEN A COMPANY SUSPENDS ITS DIVIDEND

Should I stay or should I go? John Kingham talks us through his thought processes when considering whether or not to sell one of his least successful investments.

In mid-2018, I invested in **Xaar (LON:XAR)**, a pioneer in the world of digital inkjet printheads for a range of commercial and industrial applications.

The company was founded in Cambridge during the early 1990s and had grown to produce revenues of around £100 million, selling primarily to the graphic arts, industrial and packaging markets. It had a 10-year track record of consistent and rapid dividend growth, zero debt and a dividend yield of 3.3%. It was a little smaller than my usual investments, being listed as a small cap and having 10-year average profits of just £10 million. But I thought it was a good company and so I invested, expecting to hold the shares for the next five or 10 years.

However, Xaar's revenues and profits have collapsed and the dividend has been suspended. This is obviously bad news, so this

month I want to review Xaar and, more generally, what to do when an investment goes seriously wrong.

Xaar's cash crisis

In its 2019 interim results, published in September 2019, Xaar announced that revenues were down by more than 36% and that losses of £52 million had been incurred.

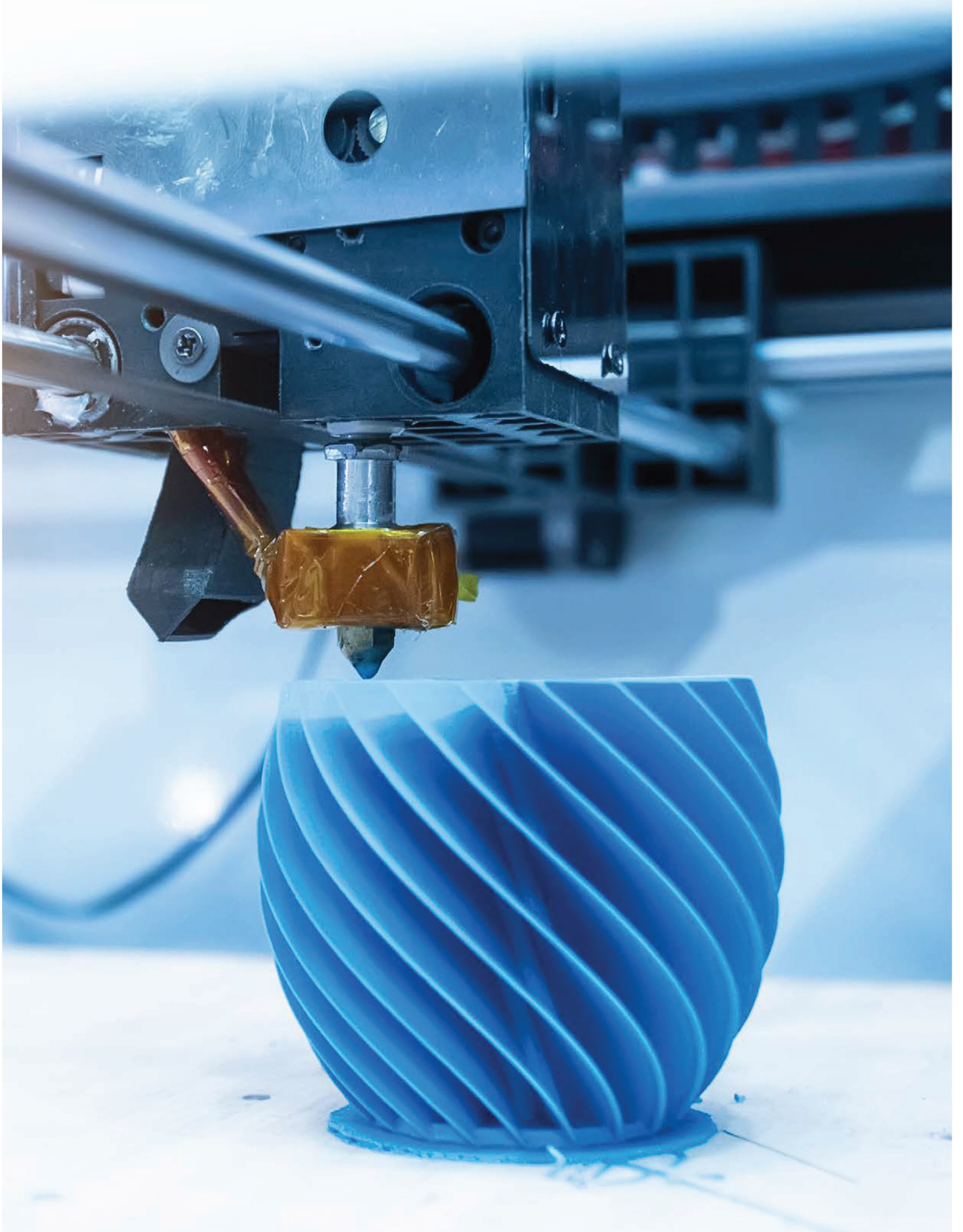
More significantly, Xaar had effectively run out of cash to fund the development and industrialisation of its next-generation thin film printheads, into which the company had sunk many tens of millions of pounds

over the last decade. All further thin film research and development (R&D) activities would end and the value of related machinery, stock and capitalised R&D expenses were being written down by £39 million.

To make matters worse, customers (printer manufacturers) had already signed up to use the Xaar 5601 (the company's flagship thin film printhead) in their new printers. This is likely to make the task of mothballing the thin film project much harder, as these customers have already invested in the development of printers to use Xaar's new printhead. Xaar must now license its technology to another manufacturer who can fulfil its obligation to these customers or come to some other arrangement which avoids Xaar being sued or suffering considerable financial and/or reputational damage.

Unsurprisingly the chief executive is on the way out, as is the chief

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financial officer. The chairman will step down early next year.

It would be fair to call this a disaster. One response would be to sell the shares immediately, and a few years ago that's probably what I would have done. However, these days I prefer to work through the following questions with the goal of maximising the return on seemingly failed investments, as follows:

1) Why did this happen?

If we're to avoid a recurrence of unpleasant events, we need to understand what went wrong in the first place.

In Xaar's case, the root cause of this crisis was a mismatch between the amount of cash needed to fund the development and industrialisation of its next-generation thin film printheads, and the amount of cash generated by the company's existing operations. This mismatch has been driven by a rapid decline in Xaar's revenues and a far less rapid decline in its R&D investment. To understand this in more detail we can review the evolution of Xaar's R&D spend over the last decade.

In 2010, Xaar generated revenues of £47 million and spent £4.7 million (10% of revenues) on R&D. This is a reasonable amount for a research-driven cutting-edge technology company like Xaar. By 2013, revenues had exploded upwards to £127 million thanks to its groundbreaking inkjet printheads for the ceramic-tile market. Xaar then stepped up its R&D investment to £16.4 million, or 13% of revenues.

By 2016, revenues had fallen back to £76.2 million as the initial transition of the ceramic-tile market to digital inkjet printing came to an end. However, R&D continued to climb to £22.4 million. This left Xaar with an R&D to revenue ratio of almost 30%, which was clearly unsustainable.

When I bought Xaar in mid-2018, my assumption was that R&D would



be scaled back as necessary, even if this meant delaying the launch of the 5601. But that isn't what happened.

In my opinion, management became fixated on reaching their stated 'vision' of achieving £220 million revenue by 2020. To reach that goal, management knew the thin film 1201 and 5601 printheads would be absolutely necessary, and so they continued to fund thin film R&D even as it became clear that the company wouldn't be able to fund those products all the way to profitable scale.

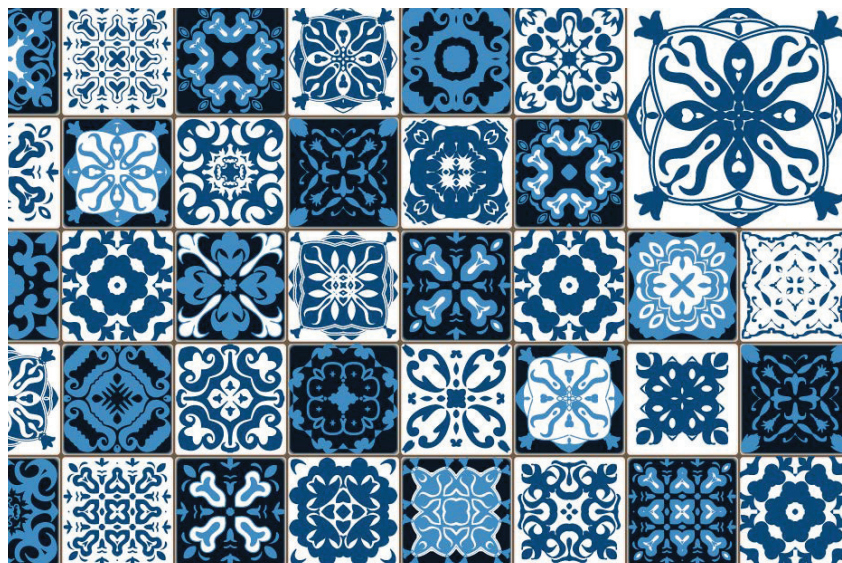
In the 2018 annual results, published in March 2019, Xaar announced that it would need to tie up with a strategic partner to share the costs (and benefits) of bringing the thin film printheads to market. But as the months passed no strategic partner appeared; and yet the company continued to invest heavily in its thin film products. At the same time, and still without the strategic partner which was absolutely necessary to bring these printheads to full production, Xaar

publicly announced three high-profile customers for the 5601 printhead. Soon after that, and still with no strategic partner, Xaar was forced to end the thin film programme to avoid running out of cash.

In my opinion, this could have been avoided if management had not been so focused on achieving their growth 'vision', which seems to have been based on little more than the fact that £220 million and 2020 share the same digits. I'm not a fan of this type of publicly stated top-down goal as it often leads companies to do (almost) anything, regardless of how risky it is, to achieve that goal. I much prefer bottom-up goals, where the goal is to provide the most value to customers in your niche over the long term, with growth being merely a side effect of doing a good job, rather than the primary goal.

I think Xaar's management should have scaled back their thin film expenses more or less in line with the company's post-2013 revenue declines. More importantly, management should never have

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signed customers up for the 5601 printhead knowing that Xaar wouldn't be able to manufacture those printheads without a strategic partner. Management were, in effect, crossing their fingers and praying for a 'knight in shining armour' to appear. Unfortunately for Xaar's shareholders and employees, their prayers went unanswered.

2) Were any red flags missed?

With at least a broad understanding of why the dividend was suspended, the next step is to see if we missed any red flags that, with hindsight, were clearly visible if we knew what to look for. In Xaar's case, there were two main drivers of the dividend suspension: declining revenues and management's decision not to cut R&D funding. I'll start with declining revenues.

In the years leading up to my mid-2018 purchase, Xaar had seen its revenues rocket and then decline, due to the rapid transition of the ceramic-tile printing market to digital inkjet printing.

In my purchase review I wrote about this, saying that the ceramic-tile boom and bust could lead to "... massive investment in supply capacity (factories, machinery, etc.) which is then left underutilised once demand collapses, with the risk that it becomes an expensive white elephant". This is a pretty good description of what

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eventually happened. While Xaar's massive investment in supply capacity wasn't enough to cause a crisis by itself, it did suggest that management were possibly over-optimistic, short-sighted or too focused on their growth vision. This verged on being a red flag and perhaps I should have paid more attention to it.

A more obvious red flag was the declining revenues. My investment checklist (as it was then) included the question: "Does the company operate in markets where demand is expected to grow?" I answered 'yes' and said that in aggregate I thought it was likely that Xaar's various end markets would grow over the next 10 years. I still think that's right. But what I didn't think deeply enough about was the risk associated with the ongoing collapse of demand in the ceramic-tile market, which back then was still Xaar's core market.

With hindsight, I should have deconstructed Xaar's component markets (graphic arts, industrial and packaging) to see how each of them had performed over the previous 10 or 15 years. This would have given me a better insight into how its markets and its market share were evolving.

For example, graphic arts was Xaar's first major market, growing rapidly to peak revenues of £35 million in 2007. That boom was followed by a long bust to almost zero revenues in 2019 as the company struggled to maintain its share of this maturing market.

The industrial market has been dominated by the ceramic-tile printing market, and it followed the same pattern as the graphic-arts market but on a much larger scale. There was a substantial jump in revenues from £6 million in 2009 to £98 million in 2013, and then a substantial drop back to £18 million in 2018 as the market matured.

A prudent assumption would have been that revenues from the ceramic-tile market were heading close to zero, as they had in the graphic-arts market. If I'd made that assumption, then it would have made sense to look at how the rest of the industrial market (ie excluding ceramic tiles) had fared over the past decade or so.

In the 'other' industrial (excluding ceramic tiles) market, revenues had grown fairly steadily, from around £1 million in 2010 to £10 million in 2018. The packaging market had



also produced fairly steady revenue growth, rising from around £8 million in 2006 to £17 million today.

To summarise, revenues from what had once been Xaar's two largest markets (graphic arts and industrial ceramic tiles) were in decline and two smaller markets ('other' industrial and packaging) were producing reasonably steady revenue growth.

This was a major red flag. It was a warning that the bulk of Xaar's past revenues and earnings were based on a one-off boom and bust in the graphic-arts market and then the ceramic-tile market. It would have been reasonable to assume that revenues from those markets were unlikely to recur in future on the same scale. And if that was the case, then those past revenues and earnings should be excluded from any estimate of the company's value.

This would have completely changed my opinion on Xaar's price at the time of purchase in mid-2018. When I bought Xaar it had 10-year average profits of about £10 million. Excluding profits from the ceramic-tile boom would have reduced those profits to an average of about £3.4 million. This is the earnings power I should have used when valuing Xaar, rather than including earnings from a one-off boom. This reduces average earnings per share from 18p to about 6p. With a purchase price of 312p, this would have changed the price to 10-year average earnings ratio (PE10) from a reasonable 17 (the FTSE 100's PE10 at the time was 17.6) to a not very reasonable 67. The most I'll pay for a company is 30-times its 10-year

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average earnings, so Xaar was clearly way above that once the one-off profits from the ceramic-tile boom had been stripped out.

As a result of this missed red flag, I have already updated my company review checklist to include a simple but very powerful question: has the company demonstrated consistent earnings power? This will hopefully prompt me into analysing the company's earnings record in more detail, with the goal of understanding what's going on in more depth, rather than just at the headline level.

The second driver of Xaar's dividend suspension was management's decision to maintain thin film R&D funding in the face of declining revenues and profits. Having looked at this again, I don't think there were any obvious red flags. In other words, I don't think it was obvious that management would effectively drive Xaar off a cliff in pursuit of their "£220 million revenues by 2020" goal. A different management team could easily have put the thin film project to sleep in 2018, which would probably have avoided the current crisis.

3) Should the company be sold immediately?

At this point we would understand (broadly) why the dividend suspension occurred and the red flags that had been missed. We should have also updated our investment checklist or other written process so that those red flags are more likely to be spotted in future. The next question is whether the company should be sold immediately or held for, perhaps, the longer term.

The answer to this question depends on a variety of factors, such as whether the company is good enough, whether the price is low enough and whether you can learn anything useful by staying invested.

Amazingly enough, I still like Xaar because it has two businesses ('other' industrial and packaging) which have fairly steady track records of growth.

Also, the ceramic-tile boom gave Xaar enough cash to acquire Engineered Printing Solutions, a printer manufacturer in the US, which is growing and seems to produce reasonably consistent results. The ceramic-tile boom also allowed Xaar to launch a 3D printing joint venture with Stratasys, the global leader in 3D printing. While this venture doesn't make any money (yet), it doesn't suck funds out of the core business either. And Stratasys has stated that it might buy out Xaar's share within the next three years, for \$33 million or more.

So Xaar does have several reasonably steady growth businesses and a potential cash windfall from the 3D printing business. However, I still wouldn't buy Xaar today for several reasons. First, Xaar's average profits (excluding the ceramic-tile boom) are below £4 million, and that's far too small for my liking. Also, Xaar is a young company and only really reached some sort of scale in the early 2000s. That's fine if you like that sort of thing, but with hindsight (and what



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should have been foresight) it just isn't for me. I prefer larger, older, more established companies with proven track records of market leadership.

So, while I like Xaar, it isn't the sort of company I would buy today. But I already own Xaar, so let's move on to the next question.

Is the price attractive? If I were looking to buy Xaar, then I think its current share price of 50p is interesting. With historic average earnings of 6p (excluding ceramic tiles) that's a PE10 ratio of just over 8, which is very low. The market's assumption must be that Xaar is either not going to grow, ever, or something worse. I will admit that Xaar's future is very uncertain, but I still think it's an interesting opportunity at the current price.

Could you learn anything by staying invested? Xaar is a mistake that has already led to a significant re-write of my investment checklist, with an emphasis on the basics of consistent earnings power, good profitability and a strong balance sheet. Just as importantly, I have changed my mindset from one which was (unintentionally) looking for reasons to buy a company to one that is now focused on looking for reasons not to buy a company (I have, in effect, become the 'abominable NO-man').

However, I think there could be more to learn if I continue to hold Xaar while it works through its current

crisis. Xaar currently makes up less than 1% of my portfolio, having dropped from around 4%, so even if it goes bust the loss would be quite small. More positively, I think Xaar could potentially provide useful lessons over the next few years about how fundamentally sound companies manage their way through self-inflicted problems.

In short, I think the potential benefits of learning about difficult environments, management mistakes and turnarounds outweigh the potential benefits of selling Xaar and reinvesting that 1% of my portfolio into something else.

Making lemonade from lemons

Here's a final recap: while it's important to try to avoid making investment mistakes, it's inevitable that some will be made. And when a mistake is made, don't just close your eyes, sell and run in the other direction.

Try to understand the root causes of the problem, whether there were any red flags you should have spotted, and whether you should sell the company or keep holding, based on a review of the company, its current share price and the potential for any further lessons.



About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

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