February 25, 2019

Pioneering Technologies: Where there's smoke………

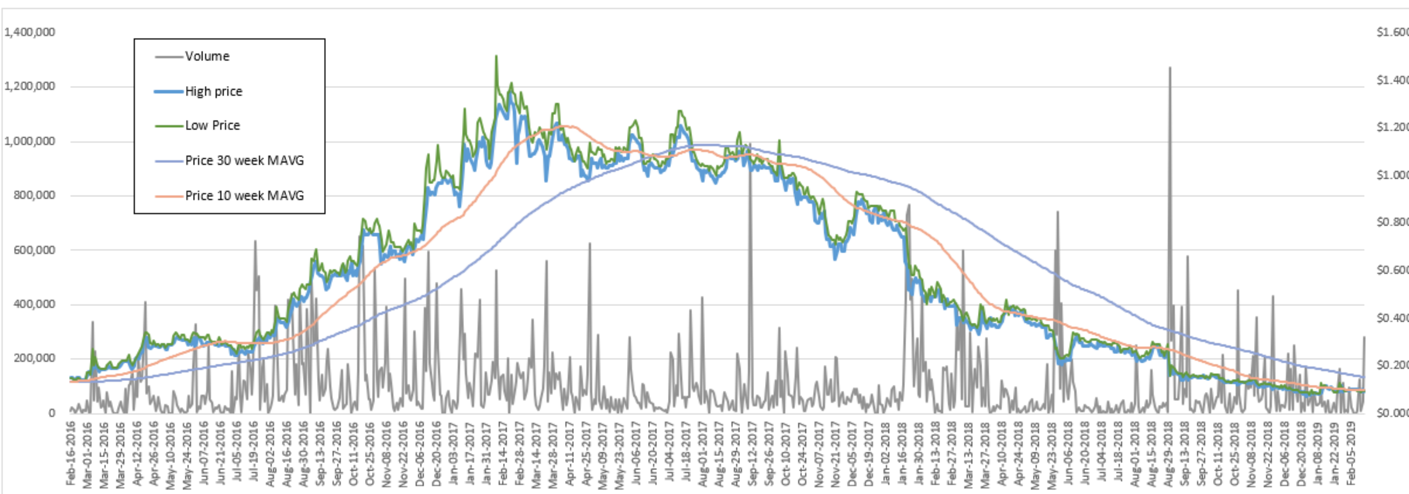
It was with a fair bit of dismay that I read the recent headlines that Pioneering was terminating executives with cause. Not only was the company underperforming, it now had the added burden of some very negative press, the likes of which is not seen often. In the 20 years that I have been investing, this was the first time I've been stung by an event quite like this. There's been times in the past where company shenanigans have reared their ugly heads, but usually they are in the form of inflated revenues (and inflated receivables), wildly exuberant press releases, or something that leaves a few more "tracks". Pioneering, by comparison, did not (and currently does not) have inflated revenues or receivables, and had few press releases over the last year. This, to quote a former Secretary of Defence, was what you might call one of the "unknown unknowns", or at least it was to me. In any case, there's another quote that's probably applicable here, and that is the fact that it serves little purpose to cry over spilled milk. At this point, one must determine what to do next.

What now?

Regardless of the fact that this particular company has caused some severe indigestion, the starting point is still the same: what can one glean from the technicals, the fundamentals, and the market outlook. Once these have been assessed, then one can make a reasoned decision how to proceed. Please note that despite the change to a more "formal" report format, we continue to use green, red, and amber text to highlight particular issues as being positive, negative, or neutral to the investment thesis.

The technical perspective:

Moving averages are slowly converging. While I generally do not consider myself to be a technician, I do pay attention to moving averages to get a feel for what the current sentiment is like. As one can see from the 3 year chart below, PTE has retraced all of the gains that were made since 2016, and is basically right back where it started from. At this time (February of 2019), the takeaway is that both the 10 and 30 week MAVGs are slowly converging once again. Financials for Q1 are less than a week away, and ***if*** (yes, that is an enormous "if") PTE can show some significant positive progress, one could see some price strength, and the 10 week MAVG could conceivably cross over the 30 week MAVG. However, you will note the heavy use of the words ***if*** and ***could*** in those prior sentences. Things will, for once, have to get better rather than worse – which is probably a good segue into fundamentals.



The fundamental perspective:

There's no debt – but there's not much cash either. On page 6 of the latest MD&A, PTE indicates that they have $2.30 MM in cash and investments as of January 28th 2019. As per the year end financials, they had (as of Sept. 30th 2018) $3.66 MM in cash and investments. This suggests that they burned $1.36 MM from Oct. 01 2018 to Jan. 28th 2019, a total of 120 days. The very simple math here is that if they cannot get traction with sales, they will burn through their entire cash position in approximately 6 ½ months, or about the middle of August of 2019. While it is obviously impossible to project the exact cash burn rate, this is reasonably close to the high estimate of cash burn that was originally made back in September of 2018. At that time, with $5.70 MM of cash and investments (as per financials dated June 30 2018), it was estimated that the entire cash position could be gone by October of 2019.

Receivables are not out of control. The classic kiss of death, an enormous receivables balance that is going to be collected "any time now" is not present. Additionally, the vast majority of receivables are current (as shown below), which at least provides some comfort that no AR write offs have yet to occur.

14. TRADE AND OTHER RECEIVABLES

The Company's trade and other receivables are from: trade receivables and customer sales and Harmonized Services Tax ("HST") receivable due from government taxing authorities. The Company held no collateral for any receivable amounts outstanding as at September 30, 2018. The following comprises trade and other receivables:

	2018	2017
	$	$
HST recoverable	102,815	110,314
Trade and other accounts receivable, net of allowance	661,072	2,326,511
	763,887	2,436,825

Trade receivables greater than 30 days are considered past due. An aging analysis of the trade receivables is as follows:

	2018	2017
	$	$
Less than 1 month	694,916	2,219,418
31-60 days	24,225	122,307
61-90 days	17,870	3,648
Over 90 days	31,876	96,452
Total trade and other accounts receivable	768,887	2,441,825
Less: Allowance for doubtful accounts	5,000	5,000
Net trade accounts receivable	763,887	2,436,825

Inventory isn't out of control – but it is big. As of January 28th 2019, page 6 of the MD&A states that PTE has roughly $8.0 MM of current assets. Given that total liabilities are a paltry $1.38 MM, and there is no long term debt, this should be music to our ears. It is – sort of. The fact of the matter is that $4.1 MM of these current assets is finished goods inventory (see below), and sales have been slow. While it is true that this inventory isn't perishable, if there is even the *slightest* chance that this inventory is in question, it puts the entire company at risk. If sales had not dropped so precipitously, we probably wouldn't even mention inventory. However, given that sales have been slowing down rather than speeding up (or staying flat), we would be foolish not to be aware of this situation.

6. INVENTORIES

Inventories are comprised of the following:

	2018	2017
	$	$
Finished goods	4,191,681	1,256,648
Total Inventory	4,191,681	1,256,648

Inventory expensed (excluding impairment) during the year is $1,787,170 (2017 - $4,356,181).

G&A expenses have stayed in line with estimates. When we previously reviewed PTE Q3 statements, we estimated that full year G&A costs (including non-cash expenses) should come in around $6.0 MM. Thankfully, this was indeed the case, with full year G&A costs coming in at $6.07 MM. When one adjusts for non-cash expenses, full year G&A cash costs came in at $4.78 MM. While these are up from last year, our concern was that they would continue to increase as the fiscal year progressed, further damaging an already tenuous situation.

Tangible book value is solid – for now. At the time of writing this (February 2019), PTE book value comes in at about $0.15 per share after adjusting for cash burn up to the end of January 2019. So, the optimist would say that at a $0.10 price, one is purchasing the company at a 33% discount to tangible value. Additionally, if one looks at PTE in a net-net context, it is still a bargain, as the net-net value per share, also adjusting for cash burn up to the end of January, is $0.11 per share.

However, it's no great secret that cash burn, if it doesn't stop, will eventually scare away even the most hardened of value investors. With this in mind, the table below encapsulates what the tangible value of PTE would look like if the bleeding doesn't stop. We assume that PTE continues to burn cash at the same rate as it did in the 4 month period from the end of September 2018 through to the end of January 2019, approximately $340,000 per month.

Tangible book value is solid-for now...

Date	Sep-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19
Shareholders equity	$ 9,825,597	$ 8,457,237	$ 8,117,237	$ 7,777,237	$ 7,437,237	$ 7,097,237	$ 6,757,237	$ 6,417,237	$ 6,077,237
Shareholders equity on a "net-net" basis	$ 7,626,765	$ 6,258,405	$ 5,918,405	$ 5,578,405	$ 5,238,405	$ 4,898,405	$ 4,558,405	$ 4,218,405	$ 3,878,405
Shares outstanding	56,001,801	56,001,801	56,001,801	56,001,801	56,001,801	56,001,801	56,001,801	56,001,801	56,001,801
Basic Book value per share	$0.175	$0.151	$0.145	$0.139	$0.133	$0.127	$0.121	$0.115	$0.109
Net-net book value per share	$0.136	$0.112	$0.106	$0.100	$0.094	$0.087	$0.081	$0.075	$0.069

As one can see, depending on what one believes, todays price is either a bargain or a value trap. Given the unfortunate fact that results to date have been poor and the company is currently dealing with its own internal strife, I would not fault investors for cutting bait, as it is difficult to determine whether that light in the distance is the break of dawn or an approaching train. On the other hand, those investors that are extremely patient and extremely risk tolerant will make the astute observation that outsized returns often come in murky, opaque packages. To be clear, the current situation is exactly that.

Outlook – what does the future hold:

PTE needs to repeat or improve on 2017 sales. In fiscal 2017, PTE revenues came in at $10.28 MM with a 50% gross margin. While this is a far cry from 2018 revenues, the fact that it did indeed occur suggests that it's not impossible, hence the amber color of this section – it's not impossible, but recent results aren't exactly screaming that it will.

With their current cost structure, $10 MM seems to be the low water mark to achieve a cash flow neutral state, assuming 50% gross margin and cash G&A costs of approximately $5.0 MM.

Gross margins are a concern. On page 6 of the most recent MD&A, one can read the following:

> As at January 28, 2019 the Company has a strong balance sheet with no debt, approximately $2.3 million in cash and short-term investments and total current assets of approximately $8 million. The Company currently has significant inventory on hand, a large portion of which was purchased prior to the implementation of U.S. government tariffs. This is expected to allow the Company to meet current demand and maintain current gross profit margins.

Those last two sentences are a very clear signal that the 50% gross margins that we see today could very well change – and possibly not for the better.

Increased sales are (theoretically) around the corner. The company makes the following statement on page 5 of the MD&A (below):

> The Company remains committed to this distributor model as it has recently begun to see traction with distributor sales organizations and their end customers in the form of increased product sell through, repeat purchase and a growing pipeline. This indicates an increase in sales velocity and the Company's focus will be on continuing to educate and train distributors on the cooking fire problem and SmartBurner solution while at the same time driving end customer awareness for the SmartBurner product.

The use of words like "traction", "increased", "repeat", and "growing" are strong words, and their use here is interesting. Whereas comments in the MD&A for prior quarters made clear reference to longer sales cycles, there has never been the use of words as pointed as these. This creates a bit of a perplexing situation for us, as on one hand there are clear signals that margins may suffer, whereas here there is a very strong signal that sales should improve. With all of that in mind, until actual results manifest themselves in a tangible way, we remain neutral on statements such as this.

The market opportunity is still there. Some of you may recall a statement made previously, which is repeated here: The market opportunity of over 40 million rental units (https://www.nmhc.org/research-insight/quick-facts-figures/quick-facts-resident-demographics/) is still sitting there. PTE doesn't need to sell to every single one of them, but it does have to sell to more of them. The problem of kitchen fires is still one that landlords would like to reduce or eliminate, and until that changes, the Smartburner should still be something of interest to them.

Finally - what action are we taking ?

We continue to hold PTE – and may even add at these levels. This statement may sound surprising, but it must be viewed within the context of an entire portfolio of companies such as these. Bear in mind that our original position in PTE was initiated at prices similar to what we are seeing today, not at the much higher prices that we saw in 2016 and 2017. While it is very difficult to buy (or even hold) when negativity is so prevalent, it is also the time when everyone else has thrown in the towel. Additionally, while it may be irrelevant to the overall investment thesis, it is nonetheless interesting to note that investment firms with much larger pockets (and audiences) than us issued "Buy" recommendations in 2017, at a time when optimism was at its highest, and leading some investors to buy in close to the peak. Our approach is somewhat different.

To provide some more context, we maintain positions in 10 to 20 small and micro cap companies which we believe may provide very significant upside. Because of our focus on these small (and volatile) companies, we know that we may be subject to larger than normal swings, which goes with the territory. When things get good, they can be very, very good – and when things get bad, the same applies.

In closing, we would say that any investor contemplating a long position in PTE should be extremely risk tolerant, and extremely patient, as it is unlikely that any turnaround will manifest itself over night. As always, if you have comments or opinions, please feel to send an email or leave a comment via the website.

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