Rarely do I find a company that has a near monopoly in a fast growing market. Where Food Comes From is the largest third party verifier of food production practices. The major tailwind here is that now more than ever, our population wants to know where our food comes from, how it's produced, and what's actually in it. And we want a third party to tell us those things—who's going to trust Tyson to tell us how their own cattle are treated? Where Food Comes From conducts on-site audits to verify over 30 claims, including gluten free, non-GMO, organic, non-hormone treated, humane handling of animals, and many others. The products they work with are beef, lamb, pork, poultry, dairy, eggs, produce, and grains, and they are expanding into seafood and beverages. This verification segment is 87% of revenue and is the bread and butter of their business. The books Zero to One and Marketing High Technology both talk about how the best companies are ones that first dominate a niche and then are able to expand that niche. Where Food Comes From (WFCF) checks both those boxes. This segment also includes source and age verification (what farm a cow was born on and how old it is) which is becoming more important, as I'll discuss below.

In addition, WFCF sells cattle identification ear tags that help trace cattle throughout their lives. The USDA says it better than I can: "Traceability does not prevent disease, but knowing where diseased and at-risk animals are, where they have been, and when, is indispensable in emergency response and in maintaining disease control and eradication programs." The USDA is in the process of implementing their Animal Disease Traceability mandate that will eventually require up to 800,000 farmers to improve their tracing capabilities. Currently, WFCF works with 10,000 farmers so there's a long runway for growth. Ear tag sales are 12% of revenue.

The last 1% of revenue is a labeling program for grocery and restaurants. The idea here is that when you pick up a package of beef at your local grocery store and it has a Where Food Comes From label on it, you find comfort knowing that beef has been source verified by a third party. Ideally, consumers are willing to pay extra for this. WFCF gets a $0.01-$0.03 per pound fee for these labels. Labeling traction will come last for WFCF. To get a grocery store to be a labeling client, that grocery store has to convince (or force) every one of their cattle farmers to get audited by WFCF. This is a major undertaking that, frankly, most grocery stores don't want to bother with. Getting just one grocery chain as a labeling client is currently a two-year sales cycle. How labeling becomes more viable in the future is that WFCF will audit more and more cattle farmers as part of their core verification business discussed above. Eventually, it becomes much easier for grocery stores to become labeling clients because some (or all) of their beef suppliers will already be verified by WFCF. It becomes much easier for WFCF to go to grocery chains and say we already work with the majority (or all) of your beef suppliers, we can offer this labeling service to you and have it ramped up in six months instead of the current two years. By the way, WFCF is the most dominant in beef so that's what I'll mostly talk about, but keep in mind the majority of what I discuss applies to poultry, pork, lamb, etc. A true blue sky long-term scenario is the Where Food Comes From label becomes the Good Housekeeping seal of approval of the food industry, but that's getting ahead of ourselves.

Industry overview

There are a lot of outside factors that affect WFCF's business. The most obvious is the size of the animal populations that they verify (cattle being the most important). If the US cattle population is high, WFCF has a larger potential market. When feed prices rise (mainly soybeans and corn), farmers send their animals to the processing plants early to avoid losses from high feed costs. This decreases the respective animal populations. Viruses that kill animal herds (such as the recurring Avian flu with chickens) have a negative effect on populations. Finally, the majority (~60%) of cattle are raised in the central plains of the US where weather and droughts can affect populations.

On the other hand, as developing countries get wealthier their diets generally include more complex proteins, creating increased demand for US protein exports. The problem with the current export market is the strength of the US dollar has pushed down export demand, which increases domestic supply. Increased supply hurts domestic pricing and can cause producers to slaughter early. Lower domestic cattle prices also forces producers to cut expenses, which sometimes includes services from WFCF.

One source of increased export demand that's about to ramp up is China. Interestingly, the US is one of only two meat exporting countries without a mandatory identification program for livestock. This is the reason China used to have a ban on importing US meat, but they recently lifted that ban. Their only requirement is that all US meat they import must be source and age verified.

Supply chain

Beef production is not vertically integrated because the amount of land required for each step in the process is far more than what's needed for pigs or chickens (most chickens are born, raised and processed within a two-mile radius). Because of this, most cattle operations are small: 77% have fewer than 50 heads of cattle and the average is 40. There are around 800,000 cattle farmers in the US that make up the entire production supply chain.

The first step in the chain is the traditional farmers that breed cows to produce calves, which are kept onsite until they are weaned off their mother's milk at 6-10 months of age. Most of these cow-calf operators then sell their weaned calves to the highest bidder at livestock auction markets where they are purchased by stockers/backgrounders. Stockers and backgrounders put additional weight on the animals. Both of these operations bring cattle to 600-800 pounds at 8-14 months of age. Next, feedlots feed grain to the cattle and bring them to a slaughter weight of 900-1,400 pounds (or 12-22 months of age). Finally, packers and processors slaughter the cattle and package and/or process the beef onsite. An important point about these steps is that cattle are continuously being intermingled with cattle from other farms (as opposed to other livestock that mostly travel in groups).

Cattle moving through these various farms at different locations is why more tracking is needed. The previous system traced animals at slaughter and could only track backwards from there. The Animal Disease Traceability (ADT) program is what's called a book-end plus system. It identifies animals at birth and at slaughter so they can be traced forward from birth and backwards from slaughter. Adding in tracking requirements for cattle that move across state lines during their life results in a system that is much more comprehensive.
There are a lot of companies in this beef supply chain, but the largest ones have significant leverage over the others.

These large companies include producers (Tyson, Cargill, JBS-Swift), supermarket giants (Wal-Mart, Costco), and fast food hamburger joints (McDonald's, Burger King, Wendy's). When one of these companies demands something from the thousands of farmers that supply them, those farmers listen. McDonald's has proven this recently when they did a beef sustainability pilot program requiring all of their Canadian beef suppliers to get verified by Where Food Comes From. A lot of the future demand for WFCF's products and services will come from these industry giants requiring it.

Tailwinds

Consumers are eating healthier and demanding more information about where their food comes from. People are more concerned about food safety and animal welfare than ever before. Because of this demand from their customers, those huge companies from the previous paragraph are pushing for increased transparency. Also, food scandals can have major negative effects on retailers or restaurants, so they view verification as kind of an insurance policy against that.

These are the reasons McDonald's recently did the pilot program in Canada. Interestingly, the farmers who participated were already completing 95% of the sustainability criteria—they just didn't have a way to communicate that to consumers. The fact that it wasn't much of a burden on farmers is important. McDonald's hopes to be purchasing all sustainable beef by 2020. This is similar to their previous venture into sustainable seafood. It took them a decade to slowly ramp up, but now 100% of their whitefish comes from fisheries certified by the Marine Stewardship Council. KFC, Chick-fil-A, and Wendy's have committed to phasing out chickens raised with antibiotics by the end of this decade (may not directly affect WFCF, but it's a sign that these issues are becoming more important). Other industry giants like Cargill and Tyson have also been discussing similar verification and sustainability projects.

In addition to consumers demanding it, there are many government entities forcing third party verification on the industry. In July, Obama signed the GMO Labeling Bill, which requires mandatory labeling of GMOs on certain product labels. Earlier this year, Vermont became the first state to develop non-GMO labeling standards. There are many other states that have similar bills in various stages of legislature as well.

The USDA's Animal Disease Traceability (ADT) program started in 2013 and is designed to be phased in through various stages. Right now, only 10-20% of the beef industry is currently affected by the ADT. When that number gets to 50% the next phase kicks in, which requires every single calf born to be identified. No one knows exactly when that next phase will kick in (or how long the phase-in period will be), but management is expecting a very large boon to their business at that point.

Separate, but intertwined with the ADT, is the USDA's Agricultural Marketing Services (AMS), which developed a source and age verification program in 2003. The AMS was nothing more than a marketing program—a way for farmers to add value to their products—but source and age verification is also required for beef exports. So there's nothing mandatory about the AMS unless you want to export your beef. In the past few months, Saudi Arabia and China (#2 beef importer in the world) have lifted their ban on importing US beef. Source and age verification will be required for all exports going to these two countries.

So there are two regulatory forces at play here—the ADT will force mandatory identification and tracking and then increased export demand will force source and age verification. In addition, consumer demand for more transparency from food producers is forcing the major players in the beef industry (Tyson, Wal-Mart, McDonald's, etc) to force audits onto their farmers.

Competitive advantages

One of WFCF's biggest competitive advantage is their scale. They are the largest third party food verification company with the widest selection of audits available. This allows WFCF to bundle audits together. If a farmer needs two or three audits, it's easier to have WFCF come out and do them all at once as opposed to hiring different companies to do each one. Bundling is lower cost to the customer and higher margin for WFCF so it's a win-win. They are the only ones with this capability because their competitors are too small—most are local or regional groups that verify one specific thing (organic, kosher, etc). Many of these groups are non-profits.

WFCF is able to go to a farmer that wants source and age verification (for export) and give them other audits for very little additional money. The more verifications a farmer has, the more places their cattle are allowed to be sent after processing. For example, Tyson can buy those cattle and send the ribeyes and strips to Whole Foods, the tongues to Japan, the small intestines to Mexico, the chucks and roasts to the EU, the liver to Egypt, and the ground beef to McDonald's. Tyson can only sell different pieces of the cattle to those different places if the farmer got the required verifications and audits. Tyson wants to be able to generate as much premium from that one animal as they can, so they want their farmers to have the verifications and the audits.

Next, WFCF customers should be quite sticky with a low churn rate. In my mind, it's similar to public companies bringing in an auditor every year. As long as that auditor doesn't piss you off, it's easier to stick with the same one. It's also very much a relationship-based business. If the CFO of a company works with a specific auditor every year, he probably comes to like them and knows what to expect. Think about how often public companies change auditors. It's not never, but it's not too common either. And in WFCF's case, they have far fewer competitors for their customers to think about switching to. Follow-up annual audits are also cheaper than the initial audit. So if a farmer wants to move away from WFCF, he'd probably have to pay more to redo the more involved initial audit from a competitor. WFCF only has two competitors in the beef verification space (Verified Beef and Samson). Both are private so I don't know a ton about them, but they are clearly very, very small companies.

Finally, there are some barriers to entry in this business as FDA accreditation is required for third party verifiers. In addition, verifiers must be approved by separate groups that handle specific claims, such as the National Organic Program, Non-GMO Project, and the Global Animal Partnership. It took WFCF over two years just to get approved to do audits for the Non-GMO Project (which is now the fastest growing part of their business). The Non-GMO Project has only approved four companies to do their audits and the Global Animal Partnership has only approved two. Walk through a Whole Foods and you'll see those two labels everywhere.

Management

John Saunders founded the company in 1998 and is currently Chairman and CEO. His wife, Leann, joined in 2003 and is the President. Together, they own 30% of shares that are currently worth $15 million. Compare this to their combined 2015 compensation of $500,000 and I'm betting they care a lot about the stock price. The main thing I took away from talking to John is his passion for what he does. The first question I asked him was about the ADT and I barely spoke for the next 25 minutes because he wanted to explain it so thoroughly. John is also one of the most straightforward CEOs I've spoken to, which I appreciate very much. He has no problem discussing areas they're struggling with or future challenges they may face.

Each of the directors (besides one) owns at least several hundred thousand dollars' worth of shares which is always good to see. Graeme Rein of Yorkmont Capital Management sits on the board and owns 7.2% of shares. I always like investors on the board because they're focus is share appreciation. I've only met Graeme once, but I came away impressed. He is very smart.

Bear case

The first thing I don't like about these types of verification businesses is their incentives. I feel like they are incentivized to verify as much as possible because they want to please their customers. If something is borderline and WFCF doesn't give it the go-ahead, that potential client will go to a competitor. This is one thing I've never loved about the credit rating agencies (there's a scene in The Big Short that perfectly depicts this).

Second, there are a lot of efforts to completely change the food industry with things like vertical farming and meatless meat. The reason for this effort is that farming does a lot of damage to the land and environment. Livestock (especially cattle production) is a significant contributor to greenhouse gas emissions and thus global warming (unless you're like Trump and think global warming is a lie propagated by the Chinese). Vertical farming shouldn't affect WFCF, but meatless meat that is indiscernible from its real counterpart is a risk.

I'm not too concerned about there being a mass movement of meatatarians going vegetarian and eating plant-based proteins, but I do think lab grown ("cultured") meat is a potential threat longer term. In my mind, it seems plausible that growing meat in a lab via stem cells can replicate the real thing. The good news is that no one is close to having a cultured meat product ready for commercial sales. Memphis Meats is one of the leaders in this space and their goal is a commercial product by 2021, so this is just something to keep an eye on for now. It also makes me feel better that the demand for increased auditing of food producers is in the early innings. WFCF has a low single digit percent of their overall target market, so even if livestock demand decreases, the investment can work out just fine. In my opinion, there's no going back on a lot of these trends (revolving around increased transparency in the food chain) so as long as traditional food production remains, consumers will want third party verifiers.

The biggest headwind facing the company right now (why their growth has slowed recently) is the strength of the US dollar. Unfortunately, this reverberates throughout a lot of their business. Not only is there less source and age verification and non-hormone treated audits (which is required for EU export), because of that there's more cattle supply in the US so beef prices are down and farmers' budgets are cramped. I have zero ability to predict currency fluctuations, but I work under the assumption that currency (especially among first world, stable countries) will balance out in the long term. So I don't get too caught up in these types of headwinds. If the USD doesn't come down in the next year, I expect China ramping up imports will help alleviate some of the export problems.

Valuation

There's no sugarcoating it—WFCF is expensive any way you look at it. They're selling for somewhere around 75-100x trailing twelve month earnings depending on what adjustments you make. With that being said, WFCF has one of the most dominating competitive positions I've seen in a small public company. They also have zero debt and cash levels nearly 3x their total liabilities.

First, they have 90%+ market share in beef verification (they also have majority share in poultry, pork, and lamb) which makes them the de facto choice for those farmers for anything else they need. If you're a farmer, why bring in another company to do non-GMO verification when WFCF already comes to your farm once a year? Why bring in three or four companies to do separate audits and verifications when one company, in one trip, can do all of them at once and give you a discount for bundling them together? The large fixed cost in an audit or verification is sending an employee out to the farm for a few hours or days. Once the WFCF employee is there, it's very little incremental cost or time for WFCF to add on services.

Second, even with a massive share of the current market, the overall market has a long runway for growth. In their older presentations, they estimated the auditing market at $100 million, but the demand for organic and non-GMO has surprised them and they're now thinking the tangible addressable market is closer to $200 million. With $10 million in auditing revenue this year, that's only 5% of the overall market. In client numbers, WFCF works with 10,000 of the 800,000 cattle farmers in the country. This amounts to just over 1%. However, WFCF works with the largest cattle farmers in the country, including the top 25 ranches. Their average farmer has 250 cattle vs the nationwide average at 40. So they work with 1% of cattle farmers, but they work with the biggest ones, so their share of the tangible addressable market is larger at 5%. In addition, they recently hired their first two auditors in Canada, which has another 68,000 cattle farmers.

There are many forces that will pull those other 800,000 US cattle farmers to need source and age verification and various audits. First, any farmer who wants to export beef must get source and age verification and audited for non-hormone treated. Export demand is currently depressed due to the strong US dollar, but once China ramps up export demand will increase. That might not even matter because the ADT will eventually require all cattle to be source verified anyway. Finally, more farmers will be required to get certain audits as large industry players force it upon them (like McDonald's did in Canada). The timeline on all of these events is unknown, but that 100x valuation is because of the impending demand explosion for WFCF's services.

To get an idea of the potential market, management has said in the future their average revenue per farmer will probably come down to around $500 (currently closer to $1,000 because they work with larger farms). $500 * 800,000 cattle farmers = $400 million. This doesn't include poultry, pork, lamb, grains, Canada, or dairy that I haven't even mentioned yet. Earlier this year they won a deal with Dannon's US division to certify 90% of their milk sources. If McDonald's goes through with verifying their US beef production, who do you think their first choice is going to be after they already worked with WFCF in Canada? WFCF got that Canadian pilot program thanks to Leann Saunder's relationships at McDonald's, which plays into another benefit of how important relationships are in this business.

Thanks to the McDonald's Canadian program, WFCF worked closely with the Canadian Roundtable for Sustainable Beef. Leann Saunders recently served as Chair of the US Meat Export Federation. They've also got a decent amount of business thanks to their decade-long relationship with National Beef, who has made many introductions for them. WFCF also already works with all the largest farms in the country and thus the largest packers and processors. If Tyson goes forward with requiring more auditing or verifications, chances are pretty good they'll call the company that already audits their largest cattle farmers.

Finally, I have a hard time killing this company. No technology is going to get rid of the need for their services. Even if there is a new way to verify, audit, and tag cattle, a third party physical person still has to go to the farm and perform the audit. I don't think consumers demanding more clarity in where our food comes from is a fad; it's here to stay and it's only increasing. As said before, the only thing I can imagine permanently harming their business is plant-based or lab grown proteins advancing and tasting identical to the real thing. I could see that happening someday, but they aren't even close right now. If a perfect imitation does get invented, it'll still have to be cheaper to gain mass acceptance. Even then, I think it'll take a long time to convert carnivores over to eating fake meat, even if it does taste similar.

An interesting thought experiment is if I was given $200 million to kill this company, could I? I really don't think I could. Even if I get the licenses and pass all the regulatory hurdles and become only the fifth company to be approved to audit for the Non-GMO Project and the third company certified by the Global Animal Partnership, how do I convert farmers to work with me? WFCF's services are pretty cheap, ranging from a couple hundred to a couple thousand dollars, call it a $1,000 average currently. Their service gross margins are 50%. If my new business model can somehow sustain half as much margin to undercut them, are farmers going to switch to me to save $250 a year on something that's important to their business? Everyone knows WFCF and they're the safe bet. It's a relationship business and they have those relationships in place. I'd probably be better off buying WFCF for $100 million (doubling shareholders' money) and pocketing the other $100 million.

If you ask me for a price target for one or two years from now, I have no idea. What I do know is this company has a near monopoly in a market that is set to rapidly expand at some point in the future. I think the most likely scenario is a few more years of 10-30% growth and then at some point a watershed of business comes via ADT's next phase kicking in, more states (or the federal government) requiring non-GMO labeling, McDonald's or one of the other giants forcing their farmers into audits, China ramping up meat imports, etc. WFCF went from $1.3M in revenue in 2007 to ~$11M in 2016 and I expect growth to accelerate at some point before the next nine years are up. The next question is what kind of free cash flow (FCF) margin can this business do? John told me margins will keep expanding for a while thanks to the highly scalable business model—evident by their low capex and they only hired two employees from 2013 to 2015 as they nearly doubled revenue. They've already achieved FCF margins in the mid-single digits so I don't think 10% is unreasonable for a company with a monopoly or near monopoly in the majority of their business. Slap a 10% FCF margin on a $100M business and that's $10M FCF vs a current enterprise value of $41M. So basically 4x. And if I'm right about the quality of the business, WFCF will never sell for 10x, even at maturity it will deserve a 15-20x FCF multiple.