

# Green beans

## SunGard Astec Analytics' Andrew Shinn examines the curious case of Coffee Holding Co.

### MARKET PERSPECTIVE

While investors short stocks that they believe will decline in value, it's often assumed that short sellers choose companies that they think are poorly managed. As the case of Coffee Holding demonstrates, however, there can be many reasons why a stock is overvalued, and it may have nothing to do with the competence of the company's management.

Coffee Holding Co., Inc. (NASDAQ:JVA) is a coffee wholesaler with its executive offices in Staten Island, New York, and its production facilities in Ohio and Colorado. Almost half of the company's revenue is generated by selling unroasted coffee beans to Green Mountain Coffee (NASDAQ:GMCR). Coffee Holding has benefited from the recent success of Green Mountain Coffee, including the announcement on March 11, 2011, that Starbucks would make its coffee available in Green Mountain Coffee's Keurig system.

Coffee Holding's stock price has averaged \$5 for the past several years. Beginning in 2008 through to early 2009, the stock price declined from \$5 to less than \$1. From a low of \$.60 on March 3, 2009, Coffee Holding's share price quickly rebounded to \$4.24 on May 24, 2009. Even this increase of 600 per cent in three months, however, was less than the 630 per cent rise from \$4.02 on March 9, 2011 to more than \$30 on July 11, 2011.

Without conducting a survey of buyers and sellers of a stock, it's difficult to attribute a rise in share price to any specific cause. But it's safe to assume that the rise in share price on March 17 and 18, 2011 was related to Coffee Holding's announcement of record earnings on March 17. The company stated that it "double[d] net income as compared to the same period last year" due to its "horizontal integrated business structure combined with [its] hedging policies." While the price of coffee recently hit a thirty-year

high, Coffee Holding's "cost of sales only slightly increas[ed] by 0.02 per cent." Coffee Holding's net income for the three months ending January 31, 2011, was \$1,041,000, while for the three months ending January 31, 2010, it was \$557,000. However, while the market reacted favourably to Coffee Holding's earnings release, if you take into account net gains from hedging, net income from recurring business actually declined from quarter to quarter.

The company has not always been so lucky when it comes to predicting the future of the commodities market. In the company's 10K for the period ending October 31, 2008, Coffee Holding announced a net loss of more than \$2.5 million for the year. The company stated that "the decrease in net income primarily reflects hedging losses when the price of coffee surged to a 10 year high and subsequently collapsed during February and October 2008." Because the company does not have a great track record in the derivatives market, investors should not hope that Coffee Holding's luck with derivatives in 2010 and 2011 will continue.

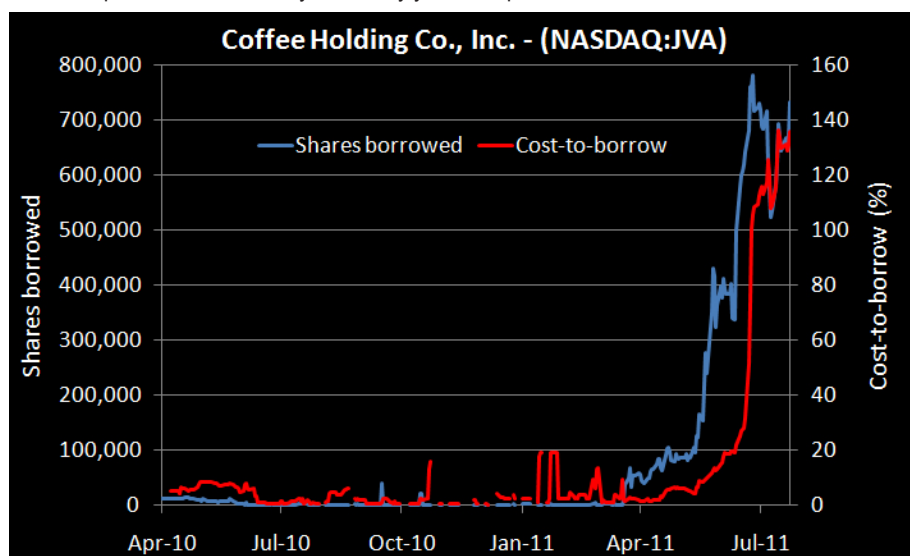
While Coffee Holding's stock increased on March 17, 2011, from \$4.45 to \$5.95 after the company announced its earnings, the more significant stock price increase did not start until June 8, when the stock jumped from \$8.50 to \$12.14 in one day. Savvy short sellers who were aware of the non-recurring nature of Coffee Holding's earnings started shorting the stock en masse after June 8. Shares borrowed in SunGard Astec's Lending Pit system increased from 127,000 shares on June 8 to 429,000 shares on June 21. Short sellers who correctly picked up on the issue but shorted the stock prior to June 8 timed the trade incorrectly. If these early short sellers were lucky, they quickly exited the trade, because over the next month, the stock increased 147 per cent to over \$30 per share.

While the stock never closed above \$30, a director at Coffee Holding named Daniel Dwyer made a nice trade on July 11, 2011, and sold 700 shares at \$30.54. Coffee Holding's CEO, Andrew Gordon, and his brother David, the company's executive vice president, did not time the market as well as Mr. Dwyer did, but the brothers sold 150,000 and 140,000 shares, respectively, at around \$24. One wonders what the Gordon brothers were thinking as the market bid up what once was a \$28 million market capitalisation wholesale coffee company to \$165 million. The company's current market value is \$85 million.

According to a roaster in Bloomfield-Hills, Michigan, who was quoted in a Crain's Detroit article on August 7, 2011 it's much harder for wholesalers and roasters to raise prices when selling to coffee shops than it is for coffee shop owners to increase the price of a cup of coffee to consumers. So there is an argument that wholesalers such as Coffee Holding need to hedge against coffee price increases. However, the case can also be made that wholesalers should not worry about hedging against price increases. In fact, this case is made by Coffee Holding itself. While the company has certainly benefited recently by hedging, the company routinely states in its SEC filings that "historically, we generally have been able to pass green coffee price increases through to customers, thereby maintaining our gross profits."

As it stands on August 23, Coffee Holding's share price is \$15.33, almost 50 per cent off its July peak.

According to Astec's Lending Pit, shares borrowed on July 21, 2011 was 781,000. Over the next two weeks, short sellers returned 258,000 shares. However, since August 4, the number of shares borrowed has increased to 713,000, so short sellers believe that the shares still have further to fall. What this case demonstrates is that short sellers test anomalies. Sometimes they win, other times they lose, but short sellers should be considered a sanity check on over-excited investor sentiment. **SLT**



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