Dyadic: two lottery tickets for the price of none $DYAI

- Dyadic (DYAI; disclosure: long) trades for below its cash value and is buying back shares like crazy
- The company has two massive options: their C1 tech for healthcare, and a big lawsuit
- Position sizing has been a real struggle for me here; I'd love to hear your thoughts

Upfront note: Dyadic (DYAI) is an illiquid OTC stock. I'm long some. Please do your own research. Remember that nothing on this blog constitutes investment advice; in fact, one reader accused this blog of being a source of "alternative facts," so it's possible no one should be reading it.

This week, the blog is focusing on companies trading below their cash value. The first post was on Ophthotech (OPHT; disclosure: long a little), a pharma company whose stock collapsed after its main drug had an awful phase 3 trial.

Today's company is Dyadic (DYAI; disclosure: long). The company has a fantastically interesting history that I'm not going to dive into, so you should absolutely read that before continuing.

At today's share price of ~$1.50, DYAI is trading below their net cash per share of ~$1.62. If DYAI was just trading below net cash, they'd be interesting. But they are also buying back shares and they have not one but two potential "lottery ticket" assets in addition to their cash, giving them three sets of assets in total:

1. Cash and Cash equivalents: At September 30th, Dyadic had ~$56m in cash, short term investments, and long term investments, or ~$1.62/share. In addition, they have ~$7.4m in cash in escrow that should be fully released in July of this year, which would add another ~$0.23/share in cash to the balance sheet for a total of ~$1.85/share in cash and "soon to be" cash. Compared to today's share price of ~$1.50, that alone should make investor's heads pick up.
2. A lawsuit again Greenberg Traurig, which is related to some of the company's crazy history. This suit was originally against 4 defendants, but the other three defendants have already settled. Two of the other three defendants settled for just over $2m each (see Q3'16 10-Q; p. 17), while one settled for $525k. Dyadic has said Greenberg is the primary culprit, so it's possible that a win or settlement against them could be for multiples of what the other settlements were. Per the Q3 call, jury selection was January 6th and

the trial should run ~6 weeks, so we'll probably hear something on this suit in the next few months.

    a. The attorneys for the suit are working on contingency, so while we might see a bit of elevated expenses due to the trial, the trial shouldn't burn too much cash.

3. The company's C1 technology in the pharma sector. This is the most mysterious part to me- you can check out some video interviews with the company or just read their transcripts (I would suggest searching for "partial characterization" in this transcript and reading around there) and see that they're wildly bullish on its potential. And it's understandable why- they sold the industrial piece of the technology to DuPont for $75m.

Note that I have called the lawsuit and C1 tech lottery tickets, but I don't mean to imply that they are one in a million shots. I'm just using the term since the two options represent binary events with massive upside if successful and no value if they fail.

In addition to those three assets, the company has been an active share repurchaser: they repurchased ~6.5m of their shares through the first 3Qs of 2016, or ~15% of their shares outstanding (see 3q'16 10-Q; p. 19); in addition, p. 21 of their Q3'16 10-Q discloses that they repurchased an additional ~1m shares for $1.64/share from September 30th through early November. On top of all that, they repurchased just under 2.4m shares for $1.54/share in a block trade on 1/11/17. Adjusting for those repurchases, I have DYAI trading with ~31m shares outstanding after having repurchased 20-25% of their shares outstanding in the last 13 months. Given all of the share repurchases were done at or around net cash, the share repurchases will be massively accretive for stock holders if DYAI has either of their two options pay off.

So the bull case looks something like this- the company is trading below net cash and buying back shares hand over fist. Sometime in the next few months (February per the Q3 call; maybe March if it's delayed slightly), they might win a lawsuit with a payout that could easily top eight figures… not insignificant given they have ~31m shares out. Add that payout to their ~$1.86/share in net cash + escrow currently (my estimate after adjusting for all the repurchases), and shareholders are buying at a massive discount to the potential cash balance by year end. If the C1 technology for pharma ends up being worth anything, shareholders today could be buying a multi-bagger for below net cash.

There is, of course, one big question. And that's what C1 for pharma is worth. I think the C1 technology overall was validated somewhat when DuPont bought it for industrial uses for $75m. However, Sanofi Pasteur had partnered with Dyadic on the technology for pharma since 2011 and, in mid-2016, Sanofi decided not to continue the partnership. I don't claim to be an expert on the technology (I barely understand it to be honest with you), and DYAI's conference calls and filings are filled with descriptions of lots of upside optionality for C1, but the fact Sanofi didn't want to extend that partnership calls into question the technology's validity.

The C1 tech is probably the main piece of the bear case: C1 never catches on, and the company sinks all of their money into it trying to jump start it or get it to work. Combine that C1 scenario with a loss in court, and you have the recipe for downside from today's share price. In addition to the "C1 failing" bear case, there's also just some strange red flags around the company: obviously there's the history w/ the China fraud and everything that led to the lawsuits, and the fact that their largest shareholder would sell half their shares back to the company for less than cash value a few months before a trial that could potentially net millions raises another big question. Combine the questions from the history, the big shareholders selling, Sanofi walking, and a decent deal of illiquidity, and you can probably explain today's low share price- shareholders are just worried there's something strange here, and most investors have probably been burned one too many times by companies seeking to validate their tech by sinking all of their money into the tech well after it has been proven ineffective / making wild acquisitions.

Still, I don't think that's likely here. Management guided to a cash burn of $5-6m in 2017 to develop C1, and the CEO has pretty consistently said that if he can't find someone to partner with them to help commercialize C1 after another couple years of development, he'll liquidate the company (see the Q2'16 call). The CEO is also a major shareholder (~15% of shares after all the repurchases if my math is right), so he should be reasonably incentivized to not go wild burning cash. But I think the best argument that the company won't go wild burning cash is their capital allocation to date- companies that have no regard for shareholder value or plan on chasing windmills simply don't buy back shares at as fast a clip as DYAI has over the past year.

Overall, I think DYAI is a fantastically interesting risk/reward at today's prices. I own some, but I've found myself really struggling with position sizing on it- I've got a small position in it, but doesn't a company trading below net cash that's buying back shares like crazy deserve a large position? How can I justify a larger position given the strange history and the fact I don't understand / trust in the C1 technology? Does some of the story have a "too good to be true" feel to it?

If anyone has any thoughts on the C1 tech, the lawsuit potential, or anything else DYAI related, I'd love to hear them either in the comments below or over email.