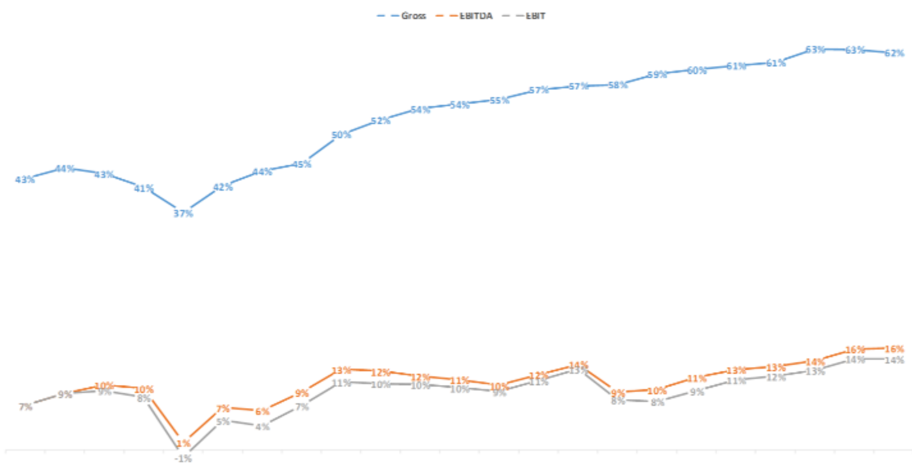
SINGULAR DILIGENCE

Tandy Leather Factory
(NASDAQ: TLF)

Tandy Leather Factory (NASDQ: TLF)
Stock Price: $8.64



	EV/Sales	EV/Gross	EV/EBITDA	EV/EBIT	EV/Owner
Majestic Wine	0.73	3.17	6.91	8.51	8.42
Games Workshop	1.23	1.76	6.76	9.07	9.92
Michael Companies	1.76	4.40	11.32	13.33	13.22
International	2.48	5.34	8.32	15.59	15.59
Harley-Davidson	2.84	7.24	12.10	13.79	13.79
Minimum	0.73	1.76	6.76	8.51	8.42
Maximum	2.84	7.24	12.10	15.59	15.59
Median	1.76	4.40	8.32	13.33	13.22
Mean	1.81	4.38	9.08	12.06	12.19
Standard Deviation	0.87	2.09	2.49	3.11	2.94
Variation	48%	48%	27%	26%	24%
Tandy	1.02	1.64	6.37	7.14	7.14

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	18	24	28	31	28	25	22	27	30	37	40	42	46	51	55	54	52	54	60	66	73	78	83	18	83	42	45	19	42%
Gross Profit	8	11	12	13	11	11	10	12	15	19	21	23	25	29	32	31	31	33	36	40	46	49	52	8	52	23	25	14	55%
EBITDA	1	2	3	3	0	2	1	2	4	5	5	5	5	6	7	5	5	6	8	9	10	12	13	0	13	5	5	3	67%
EBIT	1	2	3	3	0	1	1	2	3	4	4	4	4	6	7	4	4	5	7	8	9	11	12	0	12	4	5	3	70%
Receivables					2	2	2	2	2	2	2	2	2	2	2	3	2	1	1	1	1	1	1	1	3	2	2	1	32%
Inventory					8	8	7	8	9	9	11	12	12	14	16	17	17	16	19	20	23	26	30	7	30	14	15	7	44%
PP&E					1	1	1	1	1	1	2	2	2	2	2	4	9	10	10	10	11	13	15	1	15	2	5	5	94%
Working Liabilities					2	2	2	2	3	3	3	3	3	4	4	4	4	5	6	6	7	8	7	2	8	4	4	2	46%
Net Tangible Assets					10	9	8	9	9	10	11	12	13	14	16	20	23	23	24	25	28	32	38	8	38	14	18	9	51%
MARGINS																													
Gross Profit/Sales	43%	44%	43%	41%	37%	42%	44%	45%	50%	52%	54%	54%	55%	57%	57%	58%	59%	60%	61%	61%	63%	63%	62%	37%	63%	54%	52%	8%	0.16
EBITDA/Sales	7%	9%	10%	10%	1%	7%	6%	9%	13%	12%	12%	11%	10%	12%	14%	9%	10%	11%	13%	13%	14%	16%	16%	1%	16%	11%	11%	3%	0.31
EBIT/Sales	7%	9%	9%	8%	-1%	5%	4%	7%	11%	10%	10%	10%	9%	11%	13%	8%	8%	9%	11%	12%	13%	14%	14%	-1%	14%	9%	9%	3%	0.38
TURNS																													
Sales/Receivables					11.94	13.32	12.86	14.02	13.42	16.61	18.75	22.14	23.90	24.09	23.10	21.10	28.23	45.72	48.76	51.20	67.60	98.77	120.26	11.94	120.26	23.10	35.57	30.50	86%
Sales/Inventories					3.61	3.38	3.11	3.45	3.34	4.08	3.65	3.51	3.87	3.57	3.36	3.13	3.14	3.31	3.23	3.29	3.18	3.00	2.82	2.82	4.08	3.34	3.37	0.30	9%
Sales/PPE					19.77	20.92	23.48	29.50	28.05	29.76	23.63	21.25	24.22	27.69	30.36	12.22	6.06	5.45	6.00	6.42	6.54	5.94	5.64	5.45	30.36	20.92	17.52	9.94	57%
Sales/NTA					2.88	2.79	2.68	3.17	3.27	3.86	3.49	3.36	3.65	3.51	3.42	2.72	2.25	2.38	2.48	2.60	2.58	2.41	2.20	2.20	3.86	2.79	2.93	0.51	18%
RETURNS																													
Gross Profit/NTA					108%	116%	118%	143%	162%	200%	187%	183%	201%	199%	196%	156%	133%	143%	150%	158%	163%	152%	138%	108%	201%	156%	158%	30%	0.19
EBITDA/NTA					3%	19%	17%	29%	42%	48%	41%	37%	37%	42%	46%	25%	21%	27%	32%	34%	36%	38%	35%	3%	48%	35%	32%	11%	0.35
EBIT/NTA					-3%	13%	10%	22%	35%	40%	36%	33%	34%	39%	44%	22%	17%	22%	28%	30%	32%	35%	32%	-3%	44%	32%	27%	12%	0.43
GROWTH																													
Sales		32%	15%	12%	-10%	-10%	-13%	23%	11%	24%	7%	5%	11%	10%	9%	-2%	-3%	4%	10%	10%	10%	8%	7%	-13%	32%	9%	8%	11%	1.42
Gross Profit		37%	13%	6%	-19%	0%	-8%	26%	22%	29%	10%	6%	12%	13%	10%	-1%	0%	5%	11%	11%	14%	7%	6%	-19%	37%	10%	10%	12%	1.27
EBITDA		69%	32%	6%	-89%	415%	-20%	80%	54%	21%	0%	0%	2%	28%	24%	-34%	1%	24%	22%	15%	17%	22%	7%	-89%	415%	19%	32%	92%	2.91
EBIT		69%	21%	0%	-112%	-489%	-29%	126%	70%	20%	6%	-1%	4%	31%	27%	-39%	-7%	27%	30%	16%	19%	23%	6%	-489%	126%	17%	-8%	116%	-14.04
Receivables					-30%	-4%	-15%	45%	-4%	5%	-16%	-6%	11%	7%	19%	-2%	-54%	2%	4%	6%	-38%	-7%	-18%	-54%	45%	-4%	-5%	21%	-4.30
Inventories					-2%	-6%	-4%	27%	5%	-2%	40%	-13%	15%	23%	10%	2%	-8%	5%	20%	-1%	30%	2%	25%	-13%	40%	5%	9%	15%	1.70
PP&E					-4%	-26%	-17%	15%	18%	15%	50%	-6%	0%	-8%	7%	273%	47%	-6%	6%	0%	16%	21%	5%	-26%	273%	6%	21%	64%	2.98
Working Liabilities					-25%	-2%	3%	80%	24%	-28%	66%	-38%	43%	4%	38%	-31%	21%	19%	19%	2%	20%	2%	-14%	-38%	80%	4%	11%	32%	2.97
Net Tangible Assets					-5%	-9%	-10%	18%	-2%	12%	23%	-2%	6%	21%	4%	43%	-1%	-3%	14%	-1%	23%	9%	24%	-10%	43%	6%	9%	14%	1.62

MARCH 2015

SINGULAR DILIGENCE

Geoff Gannon, Writer | Quan Hoang, Analyst | Tobias Carlisle, Publisher

Tandy is a Hidden Champion that Totally Dominates the Leathercraft Retail Market

OVERVIEW

Tandy Leather Factory has a complicated history. In a cultural sense, the Tandy of today is very similar to the Tandy that existed from just after World War Two until 1978. The easiest way to explain Tandy's history is to go back to the man who pioneered leathercraft retail: Charles Tandy.

Charles Tandy was the son of Dave Tandy. Dave Tandy co-founded the Hinckley-Tandy Leather company in 1919 in Fort Worth, Texas. This company sold leather for shoe repair. The modern Tandy was really born in the mind of Dave Tandy's son Charles during World War Two.

Here is the CFO of Tandy Leather Factory (back in 2007) explaining Charles Tandy's career: "He started Tandy Leather after he got home from World War Two. He had seen leather craft being used in many of the military hospitals for rehabilitation and also as a recreational activity on many of the military bases while he was serving in the navy. He believed that he could develop a market for leather craft if it could be taught to the general public. So as a result, Tandy Leather was effectively born. Fast forwarding a few decades, Charles Tandy used the cash that was being generated through these little leather craft stores around the country to purchase the names that you know now: RadioShack, Pier 1, Bombay, and ColorTile. Those were all original Tandy – they were Tandy companies originally, and they were all acquired with the cash that was generated from Charles Tandy's original company, which was Tandy Leather company."

The connection between RadioShack and Tandy Leather may seem stretched today. But, the model was originally identical. Charles Tandy had been running Tandy Leather stores – small 1,500 square foot hobby shops with a manager paid 25% of the store's profit as a bonus – from the 1940s up to 1963. In 1963, Charles Tandy bought RadioShack out of bankruptcy. He implemented the exact same store model: undesirable (low rent) location, 1,500 to 1,800 square feet, one manager, bonus equals 25% of store EBIT. RadioShack eventually became wildly successful as electronics went from a fringe hobby to the mainstream. Leather crafting never became mainstream. Today, Tandy has 79 retail stores and 29 wholesale stores in the U.S. Management estimates the U.S. can support another 20 to 40 retail stores.

There are no good estimates of Tandy's market share. However, most competitors and customers of Tandy agree that the company's dominance of the leather crafting retail business in the U.S. is nearly total. Tandy estimates there are perhaps a few hundred individual retail stores run by competitors. Almost all are single store competitors. The majority of these retail competitors are also customers of Tandy's retail business. Tandy is more than 10 times the size of its next nearest competitor.

Tandy may have the largest relative size advantage over its competitors of any retailer anywhere in the world. The reason for this is historical. Today's Tandy is the result of a merger between two companies: Tandy Leather and The Leather Factory. Both companies trace their roots back to Charles Tandy.

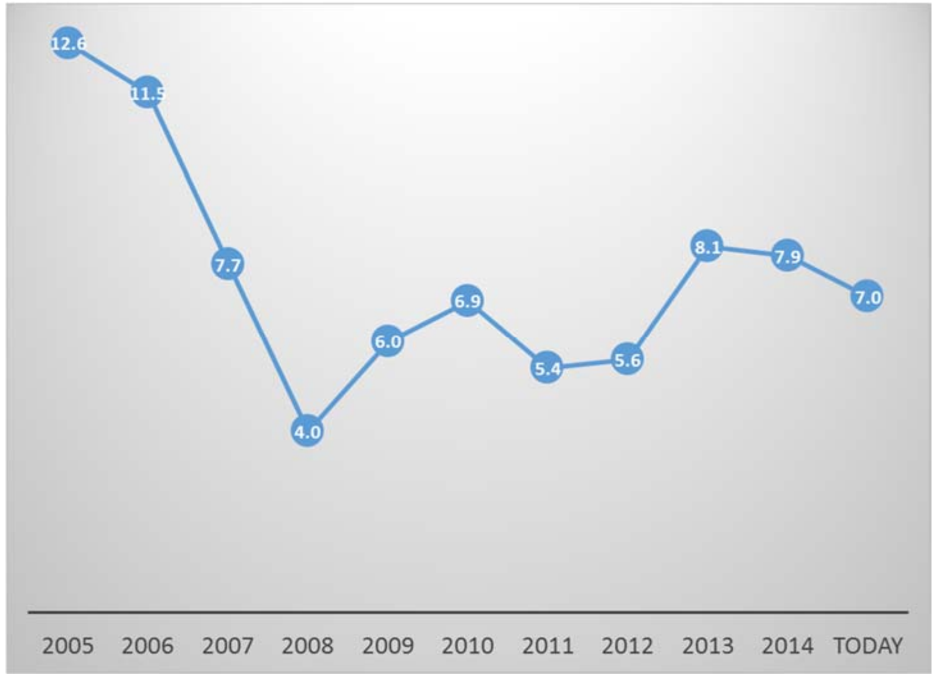
The original Tandy's success peaked around the time of the death of Charles Tandy in 1978. After Charles Tandy died, his successors (the top executives at Tandy were now dominated by RadioShack men) fired the President of Tandy Leather. The fired man was Wray Thompson. He had been with Tandy since 1958. After being fired, Wray Thompson and another disaffected Tandy employee, Ron Morgan (who had been with Tandy since 1969), decided on the idea of re-creating the company's success. They liked the model that Charles Tandy had created and then grown at Tandy. But they knew RadioShack executives were going to take Tandy in a different direction. They wanted to re-create the old Tandy model. But they had a problem. Tandy existed. And it didn't just exist. Tandy dominated the business. How could they compete with a near monopoly? Wray Thompson summed up the problem succinctly: "Tandy had 100 percent of the craft market share…We focused on tools and hardware and never did pure retail."

From 1980 to 2000, The Leather Factory (run by two ex-Tandy employees) grew into the dominant wholesale leather craft company in America. Meanwhile, Tandy – run by RadioShack employees – declined. Wray Thompson put it best: "(When I left Tandy) it was bringing in $45 million a year in sales. When I bought them, they were doing $7 million."

As Tandy Leather Factory's CFO explained: "So, at one point, they had 350 stores…domestically…by the mid-90s they had closed most of those. And by the end of the 90s…by the time we bought them, they had closed them all. They had decided that mail order and the internet business was going to be the way to go in the future…we all decided that wasn't the case…we had the opportunity to purchase them at the end of 2004…The name in itself (was) worth well more than we paid for it…We bought Tandy Leather with the intention of opening retail stores again. Remember Wray Thompson and Ron Morgan, our founders, had grown up in the business under Charles Tandy opening retail stores in the 60s and 70s. We believe very much in the bricks and mortar concept."

Today, Tandy has 29 wholesale stores. They expect to keep that number stable. They also have 79 retail stores. Eventually, they plan to have 100 to 120 retail stores in the U.S. This is really no different than what they have said just about every year for the last 10 years. They have added the possibility of an international expansion. Tandy has targeted 20 countries they could enter that could each support $5 million in sales. Tandy has $79 million in companywide sales today. U.S. retail sales could one day be about 40% higher. International sales could one day rival U.S. sales.

The company uses the same compensation approach as the original Tandy where there is only one manager



As an obscure "hidden champion": Tandy's stock price has often traded below 8 times EBIT

per store who is paid $36,000 a year plus 25% of store EBIT. Associates who do not manage the store make $10 an hour.

Tandy's growth depends on the ability to attract store managers. Tandy's CEO, Jon Thompson, explained the problem: "Really, the only reason we haven't grown nationally has been we really had a tough time trying to hire managers. Normally, when we hire somebody, we require them to move and…whenever we mention that to our potential employee, that seems to be a deal killer for 99% of them….We've had some problems over the years trying to hire. And some of that, I think goes with the fact that our stores have normally not been in very good locations: high crime areas, rundown looking. We're just trying to upgrade those units, trying to make sure we have a little more appeal, to be able to hire people a little faster."

Tandy's traditional store model was for a 2,000 square foot location with $50,000 of inventory, $15,000 of computers, and $10,000 to $15,000 of store set-up costs. So the total cost was about $80,000. Rent expense is usually $10 to $15 per square foot.

The new model is 5,000 to 6,000 square feet. It has 3 times the inventory ($150,000) and more than 3 times ($100,000) the equipment and set-up costs. Staffing is based on volume rather than store size. Even a 6,000 square foot store only uses one manager (paid $36,000 a year plus 25% of store EBIT) and 3 full-time associates (paid $10 an hour for 40 hours of work or $400 a week).

Tandy's high gross margins (60% or better at the retail stores) and low capital investment allow the company to earn roughly 30% pre-tax returns on capital. The company follows the old Charles Tandy approach of completely funding store growth from the free cash flow of the mature stores. Tandy does not borrow. The company is capable of earning up to a 20% after-tax return on its equity. This makes Tandy an above average business. It sells for 7 times EBIT. That is a below average price.

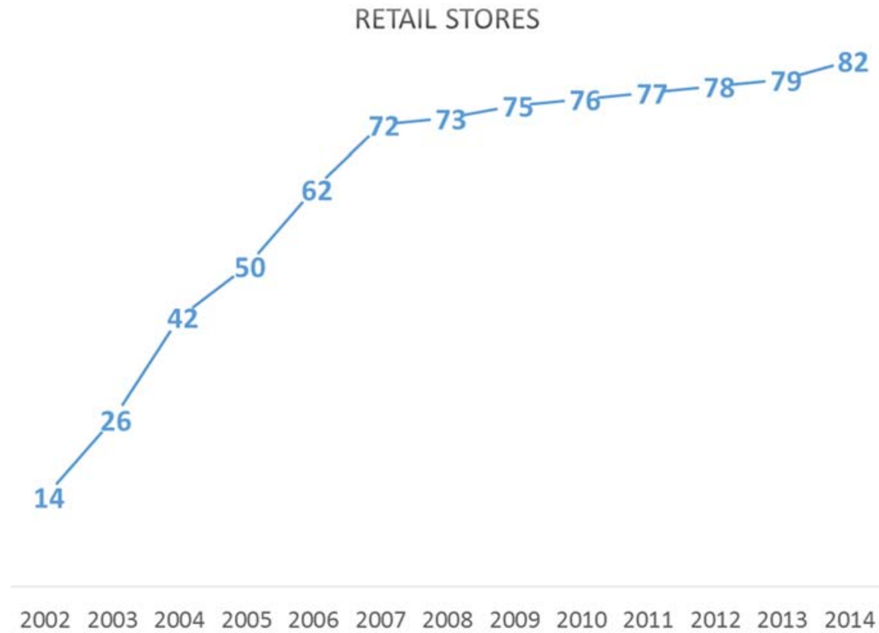
DURABILITY

Leathercrafting is a Durable Hobby

Leathercrafting is a niche hobby. Interest in that hobby has been very stable – and very low – for about 40 years. There was a boom in leathercrafting during the hippy years from about 1965 through 1975. During this time, suede was incredibly popular. Tandy's factories were working round the clock. They still could not produce enough to meet demand. Except for this faddish boom and bust tied to the hippie movement – leathercrafting has been a quiet niche hobby for around 100 years.

Most of the people who visit Tandy's stores are hobbyists. They are buying supplies for practical items they plan to make for themselves or to give away as gifts. These are items like belts, wallets, horse saddles, purses, shoes, gun holsters, etc. Some of these items are related to camping and hunting. And some of the adults interested in leathercrafting learned the hobby as boy scouts or girl scouts. Tandy has high gross margins. It is not the cheapest place to buy leather hides. Professional leathercrafters make and sell leather products. They care a lot about price. These professionals may choose competitors who sell wholesale at prices lower than Tandy. Tandy's competitors include Springfield Leathers, Brettuns Village, and Weaver Leather. These competitors are much smaller than Tandy. Springfield Leather has only a single store in Springfield, Missouri. Weaver Leather sells online and through brick and mortar retailers focused on niches like equipment for horses. These competitors are not as big as Tandy. Nor are they as integrated as Tandy. They may have more appeal to professionals. Tandy is focused on leathercrafting hobbyists. Demand from that group is durable.

Leathercrafting hobbyists have diverse demands. The average customer at a Tandy store buys about $50 worth of product. They buy several items at once. The average price of items other than leather is about $10. So, a typical trip to Tandy might 5 different items costing about $10 a piece. Some customers will also buy a leather hide from Tandy. Hides can be much more expensive than other items. The high price of hides is not caused by Tandy marking up the hide heavily. Rather, leather hides – as a commodity – are not cheap.



Tandy's inability to find "qualified personnel" has limited store growth – and store manager growth – to just 2% a year from 2007 through 2014

The best way to understand the diversity of what little items Tandy sells is to hear from actual customers. One customer "(got) components for a new leash for (his) daughter's dog". Customers use basic components for different purposes. One Tandy customer talks about the "bins of scrap leather which is perfect for bracelet making" as well as the "blank belts, bracelets, purses, wallets, etc. that can be used as a starting point and you would just decorate them from there." This same customer also mentions the "kits that offer the basics for any leather projects such as belts, moccasins, cell phone cases, etc." Notice how there is often no overlap between what one customer is making and what another is making – using some of the very same components. A different Tandy customer says "I make dreamcatchers, medicine pouches, and other leather goods." One customer makes modern leather crafts like "guitar straps" while the next makes "all kind(s) of medieval leather goods like belts, pouches, and armor." Obviously, there are no macro events that affect the demand for cell phone cases, guitar straps, medieval replica armor, and dreamcatchers all at once. All that matters for Tandy is the company's competitive position within leathercrafting and the popularity of leathercrafting as a hobby. The actual products people make as part of their leathercrafting are incidental to Tandy. It is the enjoyment customers get from planning the finished product, picking out the things they need from Tandy, and then actually crafting the item that matters. Tandy is not a wholesale parts store. It is a hobby shop. This is summed up well by one customer's eclectic list of possible needs: "a keychain ring, snaps…sinew, feathers, lace, (and) beads." You can get any of these items from an online retailer like Amazon. If you buy them in bulk, you might be able to pay a much lower price than you would at Tandy. But, the hobbyist is interested in finding one place where they can get inspiration by seeing exotic leathers, kits, accessories, and other leathercrafting supplies laid out altogether. Tandy also offers customer service from people who know about leathercrafting. This is important to some customers: "Even better than the goods are the knowledgeable, hipster staff." Another customer mentions that one store's "manager is an amazing resource and he is always quick to offer helpful suggestions when you get overwhelmed by the multitude of products. I believe they even have classes if you'd like a little more help." In fact, Tandy does offer classes in leathercrafting. Several customers say "the best part about (Tandy) are the people. They are extremely knowledgeable about how to do things. They can answer all your questions and set you off in the right direction." These last two points are important. At most stores, customer service does not include "how to do things" or what "the right direction" is. The kind of service these customers are talking about is more similar to what someone looks for in a Home Depot or an AutoZone. The customer often comes with a specific problem or – in Tandy's case – project in mind. They do not know how to solve the problem. The selection they are faced with is overwhelming. They may need to be shown several items around the store for inspiration. Or they may actually have to be told how to do something. In fact – as will be explained in the value section of this report – the closest "peer" company to Tandy is really Games Workshop. That is the U.K. based company that owns the Warhammer concept and runs hobby shops focused on introducing people to that war game and then supplying these hardcore hobbyists with the needed supplies to play the game. Both hobbies are extraordinarily small niches. Literally 99 out of 100 people have never given a moment's thought to Warhammer or to leathercrafting. The stores of both companies are small. Their locations are unimportant. And the individual store manager's ability to serve his local diehard hobbyist base and to expand that base is key. Store managers are more important at Tandy than at almost any other kind of company.

In 2010, Tandy's CFO explained the importance of managers by saying: "the key to the success of the stores is not the location. It is the manager. Bad location doesn't make any difference if you have good managers….it is just a matter of finding (the) right person to fit into that market and do a good job." Tandy has had a hard time finding good managers. When they hire someone from outside the company to become a manager they require that person moves for training, spends time working at a top performing store, and then moves to the store they will run. Managers are paid just $36,000 a year plus 25% of their store's EBIT as a bonus. At times, Tandy has found it impossibly hard to get new recruits to move to a different part of the country – especially for a $36,000 base salary. This is probably why Tandy has recently stopped opening new stores and instead relocated existing stores to better locations and bigger formats. Adding a store requires a new manager. Relocating a store puts the same veteran manager to even better use. Since the manager is paid the same 25% of store profit as a bonus – the manager of a bigger store makes more money. In 2013, Tandy's CEO said: "Really the only reason we haven't grown nationally has been we really had a tough time trying to hire managers…if we could hire more people, we would probably open more stores. We would love to open six a year if we could but right not it's been pretty slow…So it will just remain to be seen whether or not we can get enough managers." When Tandy has a good manager in a new market, they can increase sales a lot. For example, Tandy was doing $650,000 of sales in all of Europe in 2008. In 2009, Tandy opened a store in the U.K. In 2010, the company had $1.3 million of sales in Europe. The old Tandy once had 350 stores in the U.S. That company – under the management of Radio Shack executives – lost many of its best store managers. The company collapsed to the point where it actually closed every U.S. store. So managers matter. Outside factors will not determine Tandy's durability. The quality of Tandy's stable of store managers is all that matters. As long as Tandy has good store managers – it will endure.

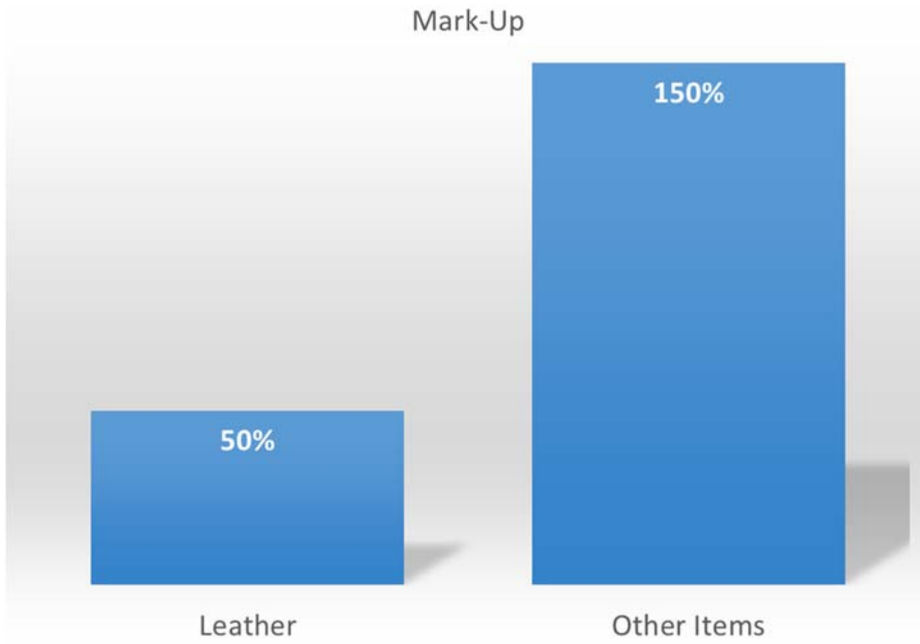
MOAT

Tandy Faces No Meaningful Competition in Over Half its Business

Tandy gets about 40% of its sales from leather. The other 60% comes from leathercrafting supplies that are not actually made of leather. These include kits, tools, patterns, buckles, conchos (a type of silver ornament), lace, etc. Tandy is many times larger than any of its competitors. It is common for Tandy to order 100 times more product than a close competitor might. This much higher purchasing volume is important in gaining experience in certain non-commodity aspects of the leathercrafting business and especially in design.

The aesthetic appeal of items is important. Tandy can have bigger production runs and better design than competitors. In fact, as Tandy explains in its 10-K: "Most of our competitors come in the form of small, independently owned retailers who in most cases are also our customers. We estimate that there are a few hundred of these small independent stores in the U.S. and Canada…to our knowledge there is no direct competitor across our entire product line. Our large size relative to most competitors gives us the advantage of being able to purchase large volumes and stock a full range of products." We spoke to several competitors in preparing this report. None of those competitors was willing to go on the record saying anything about Tandy. There is a good reason for this. We were unable to find any competitor who was not also a customer of Tandy. In other words, competitors competed against Tandy on the sale of items to end customers while at the same time relying on Tandy. Competitors outsource their production needs to China. Their purchase volumes are small. And they are often unable to reproduce key aesthetic elements of Tandy items such as the precise design or finish. Many competitors get patterns and tools from Tandy. Some also buy metal products. These are the areas where it is most difficult to compete with Tandy. Competition is easiest to attempt in the most commoditized part of the business: leather. As Tandy's CFO explained in 2007: "We have some competition in selling leather and we always have to stay aggressive. We don't have competition selling our overall range of products. We do have competition in selling leather skins and hides." The retail of actual leather is a bad business. Tandy sells leather at about a 50% mark-up (30% gross margin) while it sells its other items at a 150% mark-up (60% gross margin). The average customer spends about $50 in one trip to Tandy. Tandy's sales mix is about 40% leather and 60% other items. So, an "average" trip to Tandy might be for something like $20 worth of leather and $30 worth of other items. From such a trip, Tandy would make just $6 in gross profit on the leather and $18 in gross profit on the other items. In other words, Tandy gets about 75% of its gross profit from items other than leather. Tandy's moat is around these non-leather items. Leather is a commodity. However, leather accounts for only about 25% of Tandy's profits. Tandy's moat surrounds 75% of its profits.

Tandy's moat in non-leather items comes from 3 sources: 1) Experience 2) Buying Power 3) Selection. Tandy has some of the most experienced store managers. It also has the longest experience in working with a supplier. Through frequent large orders on specific products it can have more experience in areas competitors are not knowledgeable about like metalworking. The items sold along with leather are low cost. A lot of units have to be ordered at once to get a factory to produce them. A competitor may need to order 3,000 units simply to get an item manufactured for them. Each Tandy store carries over 2,500 separate items. There are many items Tandy sells where it would not be economical for even Tandy's largest competitors to place manufacturing orders with Asian factories for specific competing designs. It is easier for them to buy some of these items from Tandy. And that is what many of them do. As a result of buying from Tandy, these competitors never gain their own internal experience. They essentially outsource this learning process to Tandy. Expensive and high volume units are different. It is very practical for competitors to go head-to-head with Tandy in leather. It is impractical for them to compete in pattern books, conchos, etc. As explained earlier, Tandy does have competition. But almost all of this competition actually relies on Tandy for some of its supplies. As Tandy's CFO explained in 2005: "We don't believe we have any head-to-head competition doing exactly what we're doing. The wholesale arm of our business, The Leather Factory, sells to other retailers, including the national craft chains. On a limited scale, those chains are our competitors due to their huge retail presence. But the number of leathercraft items that they carry is extremely small relative to their overall product line. Thus, even though they carry some of the same items that we do, they don't have nearly the selection that we do. There is also some competition in local markets from small, individually owned 'mom and pop' independent retailers. Most of these are customers of ours. Our advantage is that there is no other company with the geographic coverage we have dedicated to leathercraft like we are."



Tandy has monopoly like pricing power in "other items" – but has to price leather like the commodity it is

It seems that anyone who competes with Tandy also uses Tandy as a supplier. The Tandy brand name is the best known in leathercrafting. Competitors spend very little on advertising. Other brand names are basically unknown even to people interested in leathercrafting. Some hobbyists are aware of a local independent store and use it repeatedly. And others may search online where a few competitors of Tandy do spend their advertising dollars on Google. But even these hobbyists are aware of Tandy. Everyone in leathercrafting knows Tandy. Very few people know about more than a couple other competitors. And many of those competitors are known for a specific geographic area or a specific niche of the leathercrafting business.

It is important to remember that while Tandy's moat is wide – it does not surround 100% of the company's sales or profits. Tandy sells leather. Leather is a commodity. It has very different product economics from the other items Tandy sells. The average non-leather item Tandy sells has a retail price of $10 and generates $6 of gross profit for Tandy. A side of leather retails for more than $100 and generates only $30 of gross profit for Tandy. So, if someone comes in to Tandy and buys 5 different $10 non-leather items, that can generate $30 of gross profit for Tandy. If they spend twice as much - $100 – on leather, that will only generate the same amount of gross profit. Leather is the single most expensive item a hobbyist will buy. It is the item they are most price conscious about. They will look for a bargain. So, Tandy's moat surrounds only its non-leather items. Leather truly is a commodity.

In recent years, Tandy has widened the moat around its business. The company has relocated existing stores to better locations with bigger layouts. This allows an even wider selection. Some of Tandy's stores have gone from the 2,000 square foot layout to the 6,000 square foot layout. Inventory turnover is low compared to other retailers. This means the store functions as both a warehouse and a showroom. It is a place for customers to browse and get inspiration. This holds down Tandy's return on capital because so much cash has to be tied up in inventory on the store floor. But it widens Tandy's moat because customers can be sure that they can find anything they need in the store. Tandy can beat all competitors on its wide selection of a huge range of items all presented in a single store. That is the moat that matters most to customers. And Tandy has widened that moat with its new larger format stores.

QUALITY

Tandy's Pricing Power in "Other Items" Makes it a Good Business

The product economics of Tandy's leather and non-leather items is different. Leather is a commodity. Tandy makes a gross margin of around 30% on leather. The gross margin on Tandy's other items is over 60%. Overall, Tandy has an unusually high gross margins compared to most retailers coupled with unusually low inventory turnover compared to most retailers. This is caused by keeping a wide selection of hard to find items on the store floor. This topic was covered in the company's Q4 2013 earnings call: "Relative to other retailers, the turnover rate is lower. I think it turns, on a consolidated basis it turns in the low threes annually. And historically that's been because we keep – the way our system, the way we're set up is a buyer source(s) product worldwide, everything comes here to our warehouse in Fort Worth (Texas). And our stores replenish or order replenishment starts once a week. So we're shipping an order, replenishment order to all of our stores weekly out of the stock here in inventory as opposed to having the vendors that we buy from ship directly to the stores. It's more cost effective to have it all housed here and shipped to the stores weekly." In 2012, Tandy's CFO explained the importance of keeping a lot of inventory on hand by saying: "We can eliminate sales gains if we have limited inventory. All of the stores are full of product and we believe that strategy is working, as evidenced by the sales gains...there is little to no risk of inventory obsolescence. We are only buying our stock leathers that sell consistently day in and day out." In 2007, the same CFO explained why obsolescence risk is so low by saying: "A lot of the products that we carry in our stores today are the same products we were offering 10 or 15 years ago."

The CFO went on to give a good example of the kind of little, random trend that sometimes crops up as a fad in this business: "The hot item at the moment is crystal rivets. We're seeing colored crystal rivets on purses and belts and apparel, even on horse tack. It's something that you can definitely incorporate into leathercraft items, and the market seems to be really taken with it. We'll see how long it lasts." So, Tandy sometimes has to purchase large volumes of items like crystal rivets and then store them at the company's warehouse and send them out to the stores weekly for replenishment as needed. Next year, the demand for crystal rivets will change. But while demand for that item was hot, Tandy needed to have a good supply of those rivets on hand at all of the company's stores. If Tandy did not have crystal rivets on hand – it would lose sales and disappoint customers. That is why Tandy has such low inventory turnover. But it is also part of the reason for Tandy's high gross margins. You can charge a lot for exactly the right item when it is on hand at the time and place where the customer is browsing. Tandy makes a good profit on something like a crystal rivet because each customer is buying a small number of rivets combined with other items for the same project – all gathered in one store in one trip. If customers went home looking specifically for the absolute best price on a crystal rivet alone – without worrying about getting other items, what shipping would cost, when the item would be delivered, etc. – then they might find the same item at similar or lower prices elsewhere. But most of Tandy's best profits come from non-leather items – like those crystal rivets – sold in small quantities to individual hobbyists. The sale mix of leather (which is a commodity) and non-leather items (which Tandy prices almost like a monopoly) combined with the mix between retail and wholesale is what drives the slight annual differences in Tandy's margins. Tandy has no problem passing along price increases to customers. It is clear that Tandy – outside of leather – employs a simple cost plus pricing model. Tandy generally contracts ahead with the same suppliers it uses year after year for a fixed price it will pay for its suppliers for the calendar year. Tandy then applies a standard percentage markup to its cost. It then prints an annual catalog with the item supplied and the marked up retail price. The markup on non-leather items sold at retail is greater than 150%. In other words, Tandy makes more than a 60% gross margin on the little non-leather items it sells in its retail stores to individual hobbyists. The product economics of this part of the business are where Tandy gets its business quality. Tandy is a good business – an above average business – because it has pricing power when selling non-leather items to hobbyists. Tandy has power as both a buyer and seller. The company is able to bargaining for as low a price as anyone will get on these non-leather items from its suppliers and then it is able to charge as high a price as others might charge at retail for the items. In fact, Tandy does not set prices in reference to its competition. The competition does set prices off Tandy though. Certain competitors will match Tandy's prices on items the competitor gets from Tandy – just so they will not lose a customer. The reason for doing this is simple. If a customer wants to buy a hide of leather – which may cost hundreds of dollars – and a concho (which will cost at most tens of dollars), the competitor does not want to lose a customer simply because it is unable to produce a concho of equal quality to Tandy. So, the competitor will acquire and pass along the desired item at no profit to keep the customer. This seems to happen with certain metal goods and pattern books and other proprietary items that Tandy is especially strong in.

Tandy replaces about 10% of its catalog items each year. Most of these replacements are minor variations. One slightly different buckle replaces another. The price is set every October. The catalog price is based on cost. There are over 2,500 different items to price. It is very obvious that – with the exception of leather – Tandy simply prices off its cost without any reference to competitor pricing. Here is an example from a 2006 earnings call: "Our leather skins and hides and our

Tandy's retail stores consistently make a 60% gross margin

larger volume items didn't increase that much – probably less than 1%. Metal products – rivets and snaps and belts and buckles and that type of item - they increased probably on average 7% to 8% nearly across the board. Our kit business didn't go up, because the leather cost didn't go up. Our laces didn't go up, because they're made out of leather lace. But it was primarily our hardware and all of our metal products that took the big increase, and that's – everybody's read about the cost of metals, primarily copper and zinc and steel. And we've negotiated. We've changed a bunch of vendors to keep those costs down. And we're reading the market every day to try to find a batter price of a quality product." That quote is typical of Tandy's pricing policy. The retail price of an item is simply a marked up version of the input cost. Leather rises and falls with the commodity price of leather, metal with the commodity price of those metals, and so on.

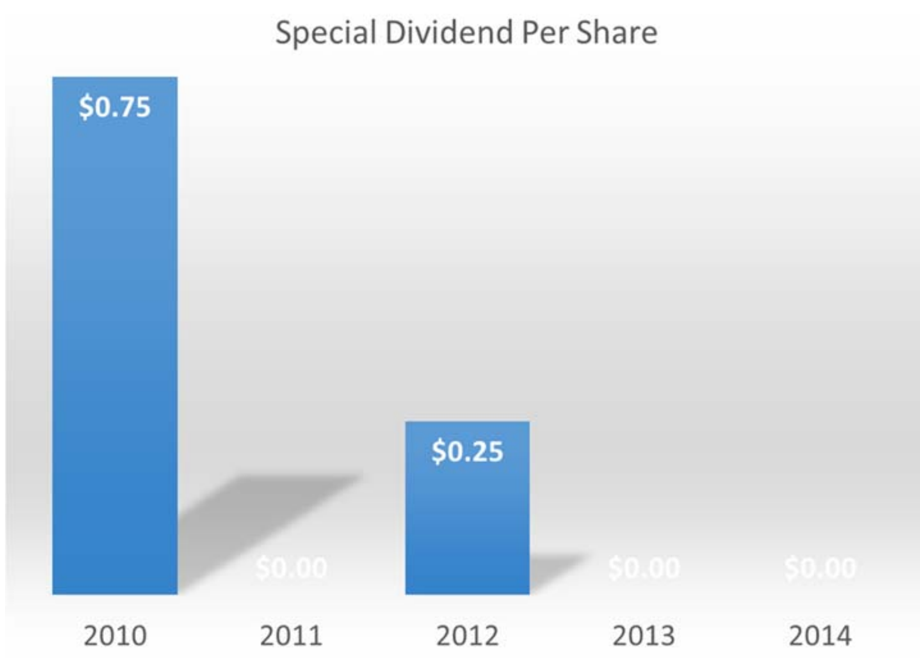
The best illustration of Tandy's cost plus pricing is The Great Recession. Tandy's EBIT margin fell from 13% in 2006 to 8% in 2007 and 2008 and did not recover to 13% again till 2012. This decline was caused only by an increase in operating costs as a percent of sales. Selling and General costs went from 45% to 51%. Tandy did not lower prices to boost sales volume. Nor did gross profit budge. There was no pricing pressure from suppliers or customers that Tandy responded to. Customers just bought less. This is exactly what a monopoly looks like when demand for its output declines. Volume drops. Price stays the same. From 2004 through today, Tandy's EBIT margin averaged about 10% while inventory turns averaged about 3 times. Those are good estimates for Tandy's profitability. So, EBIT is 10% of sales and sales are 3 times net tangible assets and 10% times 3 equals 30% return on net tangible assets per year. Tandy would then – if unleveraged – pay a roughly 35% corporate tax. This leaves a 20% after-tax return on equity for shareholders. Tandy should be able to earn a 20% return on equity without ever using debt. That makes it an above average business with far above average safety.

CAPITAL ALLOCATION

Tandy Invests in New Stores – And Pays Out Special Dividends When Too Much Cash Builds Up

Tandy generates more earnings than it has been able to use on new store openings. The company has been able to relocate some of its smaller stores from about 2,000 square foot locations to more like 6,000 square foot locations. The bigger stores do not necessarily need more staff. They do need more inventory and equipment. A lot of Tandy's earnings have gone into growing inventory.

Historically, Tandy has attempted to disgorge cash through special dividends and share buybacks. The share buybacks have not worked. Investors should not expect Tandy to buy back shares. Instead, they should expect the share count to stay almost perfectly still. Tandy uses almost no share based compensation. Over the last 10 years, Tandy's share count has not increased at all. Management likes to keep $5 million in cash on hand. The company paid a 75 cent per share – over $7.5 million – special dividend in 2010. In 2012, Tandy paid another 25 cent per share – over $2.5 million – special dividend. This disgorged over $10 million in cash that otherwise would have built up on the balance sheet. Over the last decade, cash on hand has ranged from about $3 million to $13 million. That matches pretty well with statements from the CFO that $5 million of cash was the desired minimum to have on hand. Tandy ended last quarter with $10.64 million on hand. The company likes to keep $5 million at all times. So, that suggests $5.64 million of excess cash. The company has 10.28 million shares outstanding. So, a special dividend of 50 cents a share would not be a problem. The number right now is around 55 cents a share of cash beyond the $5 million minimum management insists on. Tandy does not pay a regular dividend. Taking the excess cash on the company's balance sheet today and combining it with the two special dividends the company paid in the past would suggest a rate of cash buildup beyond $5 million of about $1.50 per share over 5 years. In other words, the company would seem to have the ability to pay a regular dividend of around 30 cents per share annually. The 10-year average EPS for the company is 45 cents a share. So, with a two-thirds payout ratio – that would bring the capacity for a regular dividend to something like 30 cents per share. The stock price is $8.75. If Tandy really did pay out 30 cents a share annually – it would have a dividend yield of 3.4%. Is that realistic?



Tandy has paid out $1 of special dividends in total over the last 5 years (for a rate of $0.20 a year)

If Tandy does not grow the square footage of its stores, it should have the capacity to pay out a dividend in that range. However, that does not mean Tandy has any plans to pay a regular dividend. In the past, Tandy tried to disgorge the cash it could not use opening new stores or relocating existing stores to bigger locations through share buybacks and dividends. In theory, the board would prefer share buybacks because Tandy's top executives believe the stock can get a better return for shareholders than shareholders could get by putting their dividends elsewhere. But, in practice, management felt that share buybacks did not work well because the stock is too illiquid. During an average trading day, somewhat less than $100,000 worth of Tandy stock is bought and sold. The difficulty of buying back enough stock was discussed in a 2012 earnings call: "It doesn't make a lot of sense in the board's discussion of…a share buyback. We have done it, we have tried it a couple times. They are not very successful. We have got the constant liquidity issue. There (are not a lot of) shares out there. So buying them back, I don't see that that really is going to help that issue or situation any." There are two problems here. One is the actual buying back of stock. So, as discussed earlier Tandy has maybe $5 million to $6 million of excess cash. The stock only trades about $100,000 or less on an average trading day. There is no rule for how much stock it is safe to buy back without greatly influencing a stock's price. Warren Buffett has said that historically Berkshire has bought 25% of the daily trading volume of a stock it was acquiring without noticing any problems caused by this buying activity. That does not mean the stock would be the same price without Berkshire's buying. But it gives an idea that if Warren Buffett thinks that buying 25% of the daily trading volume of Coca-Cola or IBM or any such stock is nothing to worry about in terms of raising the price too much too fast – then it is fine for a company to buy back up to 25% of its daily trading volume. This could be used as a theoretical limit. At that rate, it would take Tandy about a year to spend $5 million to $6 million on a stock buyback. During that time, more cash would pile up. As explained before, Tandy might build cash at a rate of $3 million or more per year. This means that if Tandy started a year with $6 million of excess cash and tried to buy back 25% of the daily trading volume of the stock for the full year – it would still end up with something like $3 million or more of cash left over at the end of that year. In fact, constantly buying shares just to keep cash from building up on the balance sheet could easily cause Tandy to buy 15% of the shares traded in the market. The way to buy back a lot of stock is to do a one time tender offer. Some companies have done this. They borrow money and name a price at which they would like to buy stock. Shareholders determine what price they would like to sell at. The company also names an amount of cash it would like to spend. The shareholders who offer to sell for the lowest amounts are bought out in order till all of the cash set aside for the purchase is exhausted. Tandy could certainly take actions like these – either continuously buy back 10% to 25% of the stock's volume over long periods of time or (more likely and) make tender offers from time to time. The tender offers might work better. They would be a good use of company money. At today's prices, the shareholders who refused to sell into such a tender and instead held their Tandy stock for the long haul would probably do well. They would do better than if the company made no stock buybacks at all. But there is a complication.

One reason the price of Tandy stock is low relative to what Quan and I appraise it for – and compared to retail stocks with similar growth histories - is probably because the stock is illiquid. However, Tandy's degree of illiquidity is irrelevant to an individual investor. Remember, Tandy often trades close to $2 million worth of stock in a single month. Based on the Warren Buffett rate of buying about 25% of each day's volume – this means an individual investor could put $500,000 a month into Tandy during periods of average trading activity. An individual investor can easily afford to take months to buy a stock he plans to keep for the long haul. So, Tandy does not really present any problems for an individual who wants to put even millions of dollars into this one stock – provided he is patient. Some individual investors are not patient. Individual "traders" are – by definition – never patient. And most institutions – regardless of whether they say they are traders or investors – are reluctant to enter a stock they can only put a small part of their portfolio in. More importantly, the deal breaker for most institutions and quite a few individuals is simply that they do not want to buy into a stock that they would need to patiently sell for months to exit in an orderly fashion. For that reason, Tandy shares might be more valuable in the market if they were more liquid. They might be less valued by the market today because they are less liquid than some other stocks. So, buying back stock might not be as effective in raising the stock price. Personally, Quan and I would prefer Tandy used all of its excess free cash flow – the free cash flow not used to relocate existing stores or open new stores – on the biggest share buybacks possible. Tandy stock is cheap. The business is above average. The valuation is below average. Buying back stock is the best investment – other than opening new stores or relocating old ones to bigger formats. However, investors should not expect Tandy's management to buy back stock. Instead, they should expect special dividends from time to time when cash is more than $5 million. Someday, Tandy might also start paying a regular dividend. This is more likely than the company buying back a meaningful amount of stock. So, while the best course of action is for Tandy to use its free cash flow to buy back stock – the company is most likely to disgorge its excess cash through special dividends instead. At the moment, Tandy has 55 cents per share of excess cash that – in all likelihood – will eventually be paid out in a dividend.

VALUE

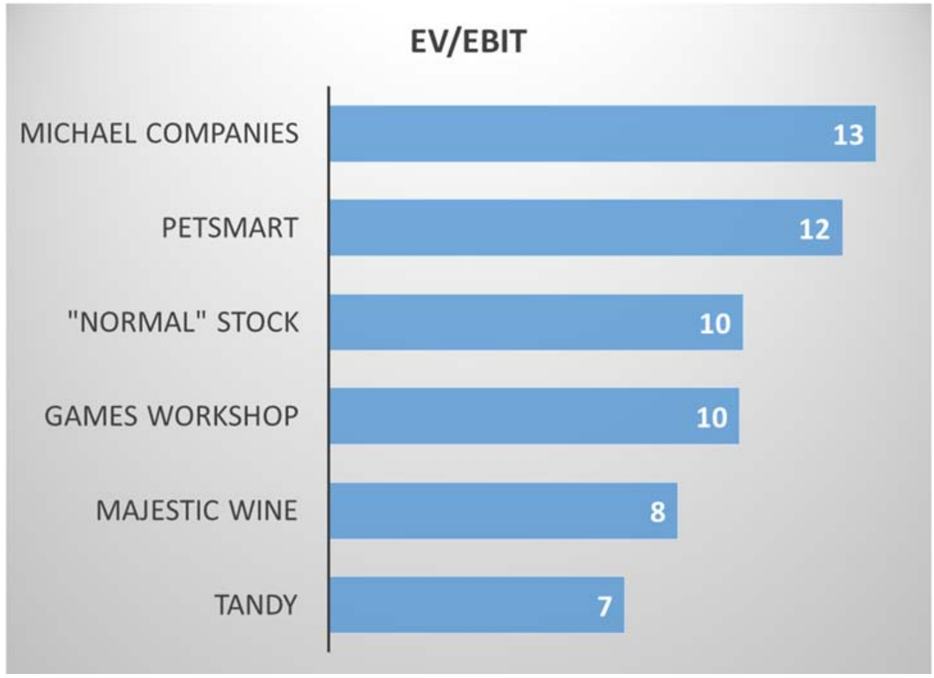
Tandy Trades at 7 times EBIT While Average Quality Companies Often Trade at 10 Times EBIT

Tandy is an above average business. It has a wider moat and better growth prospects than most businesses. Tandy's growth prospects are a little unclear because the company needs to find managers to run new stores. Tandy can relocate existing stores to larger locations without hiring a new manager. But if Tandy wants to increase its store count – not just the square footage of its chain wide selling space – over time it needs to hire new managers. Tandy has been unable to do this. In recent years, the number of stores Tandy runs has grown by less than 2% a year. Sales and profits have still grown much faster though. And the limit on the store count is due to a limit on good managers. The old Tandy – the one run by Radio Shack till it closed all the retail stores – once ran 350 stores in the U.S. Tandy can also open other stores in other countries. The details of Tandy's growth prospects will be discussed in the growth section that follows this one. However, it is important to note here in the value section of the report that Tandy does not have a below average long-term growth opportunity. In fact, it may have above average long term growth potential. But this depends on finding new managers.

Tandy's most recent Earnings Before Interest and Taxes (EBIT) was $12 million. The company has a stock price under $9 a share and a little over 10 million shares outstanding. It also has $5 million of net cash. This gives an enterprise value of $85 million. That $85 million enterprise value divided by the $12 million EBIT gives an

EV/EBIT ratio of 7.14. We can flip the ratio and get the pre-tax earnings yield on Tandy. If we divide EBIT into EV we get a 14% pre-tax earnings yield. Corporate taxes run about 35% in the U.S. – so that leaves a 9% unleveraged yield on the stock. This includes both the portion of earnings that Tandy reinvests in the business and any dividends it pays out. If Tandy reinvests earnings, that yield can grow over time. A 10% annual return in a stock is a good, high target for long-term investors to think about. The stock market is expensive right now. Given today's prices, we can almost guarantee that an investor who buys into an index like the S&P 500 will get a return of less than 10% a year over the next 10-15 years or so. So, if an investor can get a return near 10% from Tandy – then that investor should consider buying Tandy stock.

What would it take to achieve about a 10% annual return in Tandy stock? A normal EV/EBIT ratio for a company is about 10 times. This works out – when the company uses no debt – to an after-tax P/E of 15. That is a normal price for a normal stock. It is a good valuation reference point to keep in mind for this discussion. Imagine Tandy were trading at about 12 times EBIT today – instead of the 7 times EBIT it really trades at. If an investor bought shares of Tandy at 12 times EBIT and held the stock for 10 years while Tandy grew EBIT at a rate of 7% annually while paying out 40% of its earnings in dividends each year – this investor could make a 9% annual return in the stock if he was able to sell it in 2025 for 10 times EBIT (instead of the 12 times he paid). This last point is important. For a growth stock, it is important to imagine that the stock's multiple may deserve to be elevated today but ought to come back down to Earth when the growth phase is over. In this case, Earth is a P/E of 15 and an EV/EBIT of 10. In all our looks at the future, we will assume the stock must eventually settle down at the end of the investor's holding period at 10 times EBIT. So, an investor can make a roughly 9% a year annual return in Tandy stock by buying at 12 times EBIT and holding for 10 years and then sells the stock at a typical EV/EBIT ratio if the company both grows EBIT by 7% a year and pays out some (40%) of its reported earnings in dividends. What if there are no dividend payments? This would subtract only about 1% a year from the annual return. Even if Tandy hoarded all its cash - which there is no reason to believe it will do because it has twice paid special dividends – an investor could make 8% a year in the stock over 10 years if EBIT grew just 7% a year. Since we will be discussing growth in the next section – we won't bother discussing how Tandy might grow 7% a year over the next 10 years. Rather, we will only say here that such a 7% growth rate is within reason. And so, the stock could return 8% a year even if bought at an EV/EBIT of 12 right now.



Tandy is cheaper than all reasonable comparisons

In fact, this may be what the buyers of PetSmart are counting on in that case. PetSmart was recently taken private. It is a category killer in the pet supply retail – especially premium dog food – business. Tandy is even more dominant in leather than PetSmart is in pet supplies. Tandy's moat is certainly wider than PetSmart's. PetSmart was a bigger and more liquid stock. It was a good target for institutions. So, they are not direct peers in many ways. But the two businesses have a lot of similarities in terms of competitive position. PetSmart went private at a price of 12 times EBIT. Tandy now trades for 7 times EBIT.

These two examples – the theoretical argument saying that Tandy stock could return 8% to 9% a year over 10 years even if bought at an EV/EBIT of 12 as long as it grows earnings by 7% a year and the PetSmart acquisition – both support the idea of a 12 times EBIT valuation for Tandy. That would value the stock at $14.50 a share. That is probably an honest appraisal. It is not a conservative appraisal. It is as likely to be too high as too low. Of course, Tandy does not trade for anywhere near $14.50 a share. Today, you can buy the stock for $9. That gives about a 35% margin of safety. The appraisal of $14.50 a share can be wrong by as much as one third ($4.83 a share) and still be higher than today's stock price.

There are two better ways to consider the margin of safety in Tandy. One is to draw a line in the sand at 10 times EBIT. Tandy can earn a return on equity of almost 20%

a year without using debt. And it has a much wider moat than almost any other business around. It certainly has the widest moat among retailers. This makes Tandy an above average business. Since an average business tends to trade around 10 times EBIT or a P/E of 15 – Tandy should be worth more than10 times EBIT. Pretend instead – for the sake of added safety – Tandy is merely worth what an average business is worth. Valued as an average business, Tandy's $12 million of EBIT should give an EV of $120 million or a stock price of $12.19 a share. Round that down to $12 a share. That is a line in the sand. Tandy is worth no less than $12 a share. And yet it trades for no more than $9 a share.

The other way to consider margin of safety is to look at peers. We always provide a comparison with 5 peers in a Singular Diligence report. Tandy has very few good peers. The only relevant peers are the publicly traded Majestic Wine (8.4 times EBIT), Games Workshop (9.9 times EBIT), Michael Companies (13.2 times EBIT) and the recently gone private PetSmart. So, there you have an EV/EBIT range of 8 times on the low end and 13 times on the high end. Meanwhile, Tandy trades for 7 times EBIT. Tandy is not worse than these peers on average. Certainly, Tandy is not worse than all of these peers taken together. And yet it trades below the bottom range of the group. This tells us that Tandy is relatively undervalued. So, Tandy is undervalued both relative to its peers and relative to a normal valuation of 10 times EBIT and a P/E of 15. The exact margin of safety will be calculated in the back of this issue as always. But, precision is not important. Whether Tandy has a margin of safety of 25% or 35% is not what matters. What matters is that Tandy is cheap compared to every possible comparison it can reasonably be put against.

GROWTH

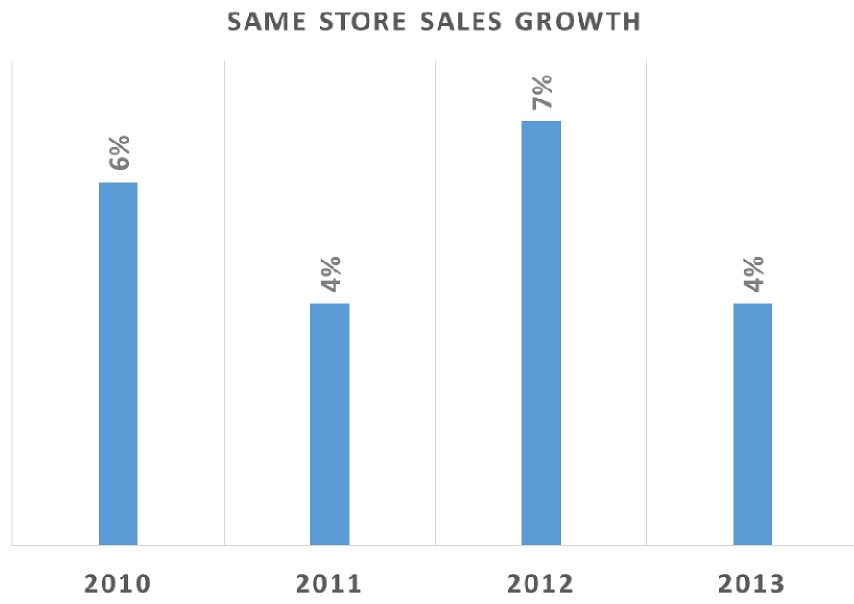
Tandy Should Have No Problem Doubling Its Sales within 10 Years

Leathercrafting is not a growth business. But Tandy dominates leathercrafting retail. It is a niche. And it is a niche that Tandy has not fully filled yet. There are 3 ways that Tandy can expand to better fill the niche it dominates.

One, Tandy can complete the transition from small format stores to large format stores. Right now, the average Tandy location is 2,900 square feet. Tandy's large format stores are between 4,000 square feet and 6,000 square feet. If Tandy were to shift all of its small format stores to large format stores – it could increase its square footage of selling space by between 38% and 106%. Let's take the low end of that range as the most likely. Since 2009, Tandy has consistently shifted small format stores to large format stores. In 2010, Tandy relocated 9 stores to the bigger format. In 2011, it was 11 more stores. In 2012, 12 more stores. And in 2013, it was 12 more stores. About the same number – 12 to 15 stores – were planned for relocation in 2014. This was probably carried out. So, about 12 stores per year have been relocated to the bigger format as their leases expired on the old smaller format locations. It is almost certain that Tandy will relocate all of the smaller format stores over time. So, it is safe to assume an increase in the square footage per U.S. store of about 40% (from about 2,900 square feet today to something over 4,000 square feet at some point in the future). Larger stores may not achieve the same sales per square foot. But, the past numbers are encouraging on this point. Tandy does not provide sales per square foot data. But, it does give sales numbers. The period in which Tandy was opening very, very few new retail stores was 2008 through today. The retail sales figures for this period were very strong. The Great Recession year of 2008 had a negative 1% sales number. In 2009, sales grew 9%. In 2010, it was 14%. In 2011, it was 15%. Then 13% in 2012. And 9% in 2015. You can compare the number of relocated stores each year to the total store base to get some idea of the impact those upgrades to bigger store formats have on sales growth. Generally, Tandy has only relocated about 15% of the total store count each year. The store base is now about 80 stores with about 12 relocations per year in recent years. That means about 85% of the stores do not grow in size during any one year. Either same store sales growth at stores staying the same size must be growing nicely in the post-recession period or the format upgrades must boost sales quite a bit – or both. Tandy provides same store sales numbers. So, we can see that same store sales grew 6% in 2010 (while total sales grew 14%), 4% in 2011 (while total sales grew 15%), 7% in 2012 (while total sales grew 13%), and 4% in 2013 (while total sales grew 9%). Tandy's sales growth since The Great Recession has come from a combination of same store sales growth (often 4% to 7% a year) and an increase in square footage (with up to 15% of the store base being moved to bigger locations during the year). This combination drove 9% to 15% annual sales growth each and every year from 2009 through 2013. Whether Tandy can grow sales as much as it grows square footage is unclear. Most large format stores cannot sell as much per square foot as a small format store. However, Tandy certainly can – and most likely will – increase the square footage of its existing store base by another 40%. It could grow square footage quite a bit beyond that. Remember, the large format stores are between 4,000 and 6,000 square feet and we are assuming only a 4,000 square foot store average in this discussion. Over the next 10 years, it is not unreasonable to assume a 40% growth in the average square footage per store. This could boost sales by as much as 40%. Again, this is a low end estimate. The large format is 4,000 to 6,000 square feet. The average store size right now is just 2,900 square feet.

The second source of growth for Tandy is opening new stores in the U.S. The old Tandy had 350 stores in the U.S. More than two-thirds of them were unprofitable.

This Tandy has no interest in opening that many stores. It also has problems attracting enough managers to grow its much smaller store base. In this incarnation, Tandy's management has only ever discussed a final store count of between 100 and 120 in the U.S. That would leave a potential for about 20 to 40 more stores. Some of Tandy's existing stores are wholesale. This is a separate group. Tandy has no plans to ever expand the wholesale operations in the U.S. These stores provide good delivery time coverage around the country. That is about all Tandy needs from them. The economics of the wholesale business may be a bit poorer than the economics of the retail stores. However, the two business models have converged more and more as Tandy has re-grown the old retail store format it once had. The numbers referenced in this report generally treat the whole company – wholesale and retail – as one business. This sometimes has the effect of underestimating certain features of the actual retail stores. For example, we know retail store gross margins are higher than the companywide gross margins reported in Tandy's financial statements. Tandy plans to grow the retail stores – not the wholesale stores. So, we may underestimate the quality of the growth that is retail only. If so, it is a small and mostly unimportant underestimation. But, there is no reason to believe future growth will be less profitable than the existing store base. There are two reasons for this. One, future growth will be focused on retail not wholesale (at all). And two, Tandy is a small company with significant corporate costs per dollar of sales. Some of those costs scale well. It is hard to estimate exactly what does and doesn't scale. But it is generally safe to assume that if Tandy opens more retail stores over time – the growth in retail store sales should cause an even greater growth in corporate earnings. In other words, a 7% annual rate of sales growth is more likely to cause a 9% annual rate of earnings growth than something like a 5% annual rate of earnings growth. So, it is safe to use sales growth as a low end estimate of earnings growth – which is what we are doing here. So, Tandy can open another 20 to 40 stores in the U.S. That would provide a 25% to 50% growth potential. Tandy would only need to open 2 to 4 stores per year to achieve a 25% to 50% growth in the U.S. store base over the next 10 years. If Tandy can find managers, it can achieve this. The 10-K says only: "We expect to continue to open stores domestically but have not committed to a specific time frame."



Tandy's same store sales growth rebounded strongly coming out of The Great Recession

Finally, Tandy can open stores in other countries. Management has said it has found 20 countries with the right population sizes to each deliver $5 million to $6 million in sales. That means there is a $100 million addressable market out there. Tandy dominates the U.S. market. And, in many of those countries, competition is even weaker because competitors in the U.S. buy from Tandy for some of their needs – but competitor's overseas need to ship in some supplies to do this. You can find quite a few examples of this online where people in the U.K. or other countries complain about the delivery charge they pay on key leathercrafting items imported from the U.S. being as high as the price of the items themselves. International growth is speculative. Tandy has already opened stores in the U.K., Australia, and Spain. The U.K. and Australian stores are profitable. The Spanish store is about break even. Finally, Tandy can increase prices along with inflation. It has a long history of doing this. And as discussed earlier, Tandy clearly prices off of its input costs through cost plus pricing rather than off any competitors. Historically, inflation in the U.S. has been in the 2% to 4% range. This is a good enough assumption going forward. From this, we can see that Tandy has 4 sources of possible sales growth: 1) Square footage growth 2) New store growth 3) Inflation and 4) International growth. We will take the low end of these ranges and ignore international growth for the moment. At a minimum, the average store size should increase 3% a year over the next 10 years. At a minimum, the store count in the U.S. should grow 2% a year. And – again, at a minimum – retail prices should increase 2% a year over the next 10 years. This gives – in a simple additive approximation – 3% square footage growth plus 2% store growth plus 2% retail price growth equals 7% sales growth. All of these figures are from the lowest end of the reasonable range. And they ignore international growth. Even if square footage growth, new U.S. store openings, and inflation all come in at the low end of the range – Tandy could open new stores outside the U.S. and achieve greater than 7% sales growth. Also, if there are any economies of scale as Tandy's public company corporate overhead is spread and absorbed over a bigger store base – earnings could grow faster than profits. For these reasons, it is reasonable to expect Tandy's earnings to grow at least 7% a year. Tandy keeps its share count very close to unchanged in most years. So, without any share buybacks, it is reasonable to expect earnings per share will grow 7% a year over the next 10 years. In other words, Tandy's EPS will double in 10 years.

MISJUDGMENT

Are Tandy's Growth Days Over?

Tandy continuously opened new stores during the first part of the 2000s. Then, around 2008, Tandy stopped opening new stores. Management claims the main reason for this is the lack of people willing to become new managers. Tandy has trouble getting managers – who make $36,000 plus 25% of their store's EBIT – to join the company and undergo the necessary training and then change of location to their new store. The deal breaker is the move.

In 2013, Tandy's CEO said: "Really the only reason we haven't grown nationally has been we really had a tough time trying to hire managers. I think we spoke a little bit about this in the past. Normally when we hire somebody, we require them to move and for some reason, whatever it is, whenever we mention that to potential employees, that seems to be a deal killer for about 99% of them. People want jobs, want to work, but they don't want to move."

He went on to say: "If we could hire more people, we would probably open more stores. We would love to open six a year if we could but right now it's been pretty slow. So it will just remain to be seen whether or not we can get enough managers. We are going to continue to work at that. We have been doing some shows at junior colleges and we are going to do some shows at the colleges trying to recruit more managers….we will just continue trying to recruit more people. Internationally we do feel that long term we do want to continue to open and try and really push that hard. We feel like there's a lot of growth potential there. We don't have anything any new stores on the horizon but we're going to spend a lot of time there."

So is a lack of new manager recruits really the problem? Or is something fundamentally wrong with Tandy's growth model? The most likely explanation is the one that management offers. Tandy has successfully grown retail sales by between 9% and 15% annually in every year since 2008. It has done this while opening very few new stores. In fact, new store growth can only explain about 2% of that growth. The other 7% to 13% each year has to come from increasing same store sales and from relocating small format stores into new large format locations. This is done when the small format store's lease expires. The lack of new store managers put an end to new store openings. So Tandy found another way to grow. This suggests they are still committed to growth. It also suggests that it is not a lack of demand that is stopping growth – it really is a supply bottleneck caused by too few new store manager recruits.

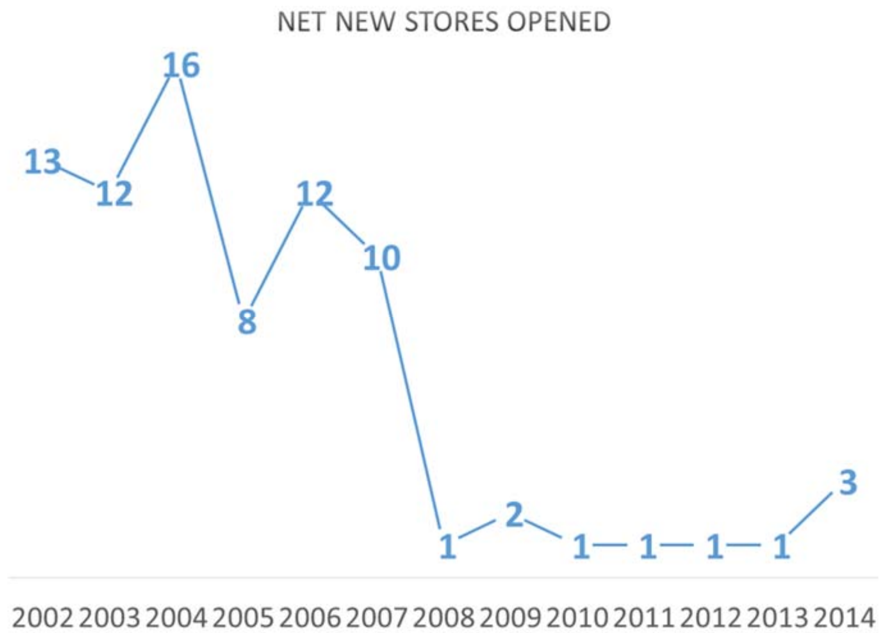
If that's true, why was Tandy able to grow in the past? How could it sometimes hire dozens of new store managers in a single year? The answer to this one is most likely that these managers worked for the old Tandy. Remember, the old Tandy once had about 350 stores in the U.S. They closed all of those stores. They fired every single one of those managers. So, there had to have been at least 350 former Tandy store managers in the U.S. These people didn't move to another country. They didn't die. They either found other jobs in the leathercrafting retail industry or they found employment in a different industry. Imagine they stayed in leathercrafting retail. How likely is it they could stay in the leathercrafting retail industry without rejoining the new Tandy?

The answer to that is very, very, very unlikely. This sounds surprising. It would be shocking to hear in most industries. When you fire someone, you expect that person can find a job at a competitor if there is sufficient demand and they are sufficiently skilled. You don't assume that by far their best chance for employment in the industry is rejoining your company. But that is definitely the case at Tandy. Tandy runs a huge number of the total leathercrafting retail stores in the U.S. At last count, the company had about 108 stores split between 79 retail stores and 29 wholesale stores. This requires about 108 managers then. Some managers underperform and are fired. Some managers retire each year for personal reasons. Even at a reasonably low churn rate, a company like Tandy would need 5 trainees in place at all times just to maintain the current store base. Tandy says in its 10-K that there may be "several hundred" competing leathercraft stores in the U.S. and Canada. They mean stores – actual locations – not chains. Tandy does not know the exact number – no one does. But let's assume this could mean 300 stores. If that's true – then at any one time the U.S. and Canada could need as many as say 400 managers of leathercraft retail stores. Tandy needs over 100 of those. So, Tandy would need more than 25% of the talent pool. This is all very arbitrary guessing – but it illustrates the situation roughly better than no guesses.

Employees below the store manager level make $10 a week. That's no more than $400 a week. It is certainly less than $20,000 a year. That is too low a salary level – especially with no bonuses – to keep such employees in the industry gaining experience and working their way up the ranks into management levels and above. Basically, there are entry level positions that pay $10 an hour. And then there are a few hundred store managers around all of the U.S. and Canada. The way Tandy talks about recruiting managers – not promoting associates – suggests that the pool of management talent should be judged separately from the total pool of employees. The actual employee pool is pretty small too. Each manager only has 2-4 people reporting to him. By the way, this situation is not unique to Tandy. Other leather stores often have small format locations. Many don't have a large number of employees in one place.

There are two big differences between Tandy and everyone else. One, most of the other leather stores are single location businesses. This means they don't need new managers – ever. A family business often dies due to a lack of new management if it can't pass the business on to the next generation of the family. Hiring from the outside is very hard for a single location retailer. A location will often be run by the person who founded it. This will often be both the owner and operator. So, former Tandy employees would not find it as easy to get employed elsewhere in the industry as you might think. Store manager churn is probably low. Most importantly, Tandy was – in all its incarnations – the only leathercraft retailer who opened large numbers of stores. Competitors generally do not open any new locations. This means Tandy is the only organization that has a sizeable store manager trainee program. And it is the only organization that has ever had much need for new hires for new locations.

Tandy's management has talked about this hiring problem for a long time. In fact, they discussed reasons for sprucing up some of their stores in 2010. One of those reasons was very surprising: nicer stores might attract new managers. This is what Tandy's CEO said in 2010: "We've had some problems for years trying to hire. And some of that, I think, goes with the fact that our stores have normally not been in very good locations – high crime areas, rundown looking. We're just trying to upgrade those units trying to



In all the years since 2007, Tandy has added a measly 10 stores to its chain

make sure that we have a little more appeal, to be able to hire people a little faster. Obviously, we also require our people to move anywhere once we hire them. So we're going to get back to that point where we're opening stores again."

Tandy's CFO spoke to Quan. She sounded committed to continued growth: "Plan right now: move remaining small retail stores to larger locations (4,000 to 5,000 square feet). Also intention to open more stores in the U.S. (because) we think that there are still around 20 cities or metropolitan areas where there could be additional stores."

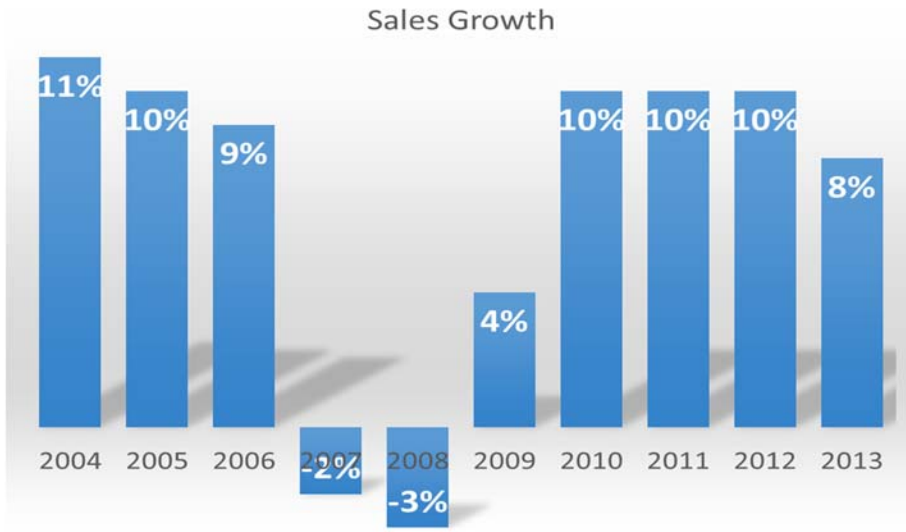
It's clear that a large number of the stores Tandy opened between 2000 and 2007 used former Tandy store managers as the managers of those stores. They basically rehired people from the old Tandy organization. In 2008, the company mentioned that it had to fire managers at 8 of the stores that were unprofitable. The total loss of all the unprofitable stores was small. So, it is not a large area of concern to have – in a bad time for the economy – about 8% of the store count being unprofitable. Many chains have more unprofitable stores than that. But firing 8 managers would completely deplete Tandy's trainee pool for at least a year. They also mentioned retirements around that same time. This could explain some of the difficulty Tandy has had opening new stores in the U.S. Another guess – a speculative one, but a well-informed speculation – is that as much as half of Tandy's success in opening its first 50 or so retail stores in the 2000s probably came from the pool of former store managers left from the collapse of the leathercraft retail industry's management positions. It is important to always keep in mind that the old Tandy once had 350 stores and as many as one-third of these were profitable. That means there were something like 100 to 120 people in the U.S. who had once run a profitable leathercraft retail store for Tandy. When the Leather Factory bought the old Tandy name and started up the concept – it was natural for these former store managers to join the new Tandy. However, Tandy's growth phase exhausted this supply of former Tandy managers. The old Tandy never had a history – outside of about a decade in the 1960s and 1970s – of rapidly adding only profitable new stores. There is no reason to believe that all the people running unprofitable Tandy locations were good managers. And there is no reason to believe Tandy can grow its companywide manager count as rapidly as it did in the years after The Leather Factory resurrected the concept. But, it may be possible for Tandy to improve its trainee program in some way to – over the course of a decade or so – add 2 to 4 net new managers a year to the company. If Tandy can do this, it can eventually reach its stated goal of 100 to 120 retail store locations. From all of the above, we can't be one hundred percent certain that Tandy's only reason for not opening new stores is a lack of new store management trainees. However, that has always been the reason the company has given for why store openings slowed. The company has always said that getting new trainees to agree to move anywhere in the country is difficult. This is understandable considering the guaranteed salary is only $36,000 a year (and it was once even lower). Much of the circumstantial evidence supports what the company says. It is reasonable to believe that people are very reluctant to move to take a store manager job at Tandy. And it is likely that Tandy's success in recruiting early on was driven in part by the large pool of former Tandy store managers rejoining the resurrected concept. It is possible we have misjudged Tandy's future growth prospects. It's possible there is another reason why new store openings have stalled to almost zero. However, the explanation that the company gives is reasonable. And there is no evidence against the explanation. For this reason, it is best to accept the explanation that Tandy has stopped opening new stores simply because Tandy can't get people to take a store manager job. If people start taking store manager jobs – Tandy will then start opening new stores again.

CONCLUSION

Tandy is a Growth Stock That May Be Capable of Providing 10% Annual Returns for the Next 10 Years

Tandy is priced at a little over 7 times EBIT. A normal stock trades around 10 times EBIT. And – over the last 10 years – Tandy has grown faster than a "normal" stock. As explained in the growth section of this report – Tandy seems capable of growing sales by 7% a year for as long as 10 years. This can happen because Tandy's average store size is now just 2,900 square feet while the company's large format stores are over 4,000 square feet. So, there is room for many of the stores in the chain to relocate to larger locations and thereby ring up higher sales. Stores with more inventory have higher sales. Some Tandy stores are in such small format locations that they have a limit to the amount of inventory they might want to keep on hand. This can be fixed through upgrades. So, the average store in the chain can grow from 2,900 square feet to over 4,000 square feet. Tandy has almost 110 stores right now. But, about 30 of those stores are wholesale stores. The company's retail chain – which has just 80 locations – may be able to one day grow to 100 or even 120 locations. Management has repeated this over and over again. When Tandy's CFO spoke to Quan, she said much the same thing Tandy has always said about the final store count the U.S. can support. So, Tandy may be able to add as many as 20 to 40 more stores in the U.S. Over the next 10 years, there will also be inflation. It may be very low. A number like 2% a year would be low. But even this low rate of inflation compounds over a 10 year period. For example, if there is 2% a year inflation between 2015 and 2025, an item that now costs $10 at Tandy in 2015 would cost $12.22 in 2025. Tandy does not set prices versus its competition. Tandy prices its products off the cost of its merchandise. The company has been successful passing on inflation in the past. It has a dominant position in the leathercraft retail niche. This wide moat should allow Tandy to pass on inflation in the future. Finally, Tandy may be able to grow internationally. There is no reason why the opportunity for leathercrafting retail in other countries should be beyond Tandy's ability to penetrate. But, since Tandy has never really had a successful international retail business – this part of the next decade's growth is speculative. Even taking a low end estimate of square footage growth, store count growth, and inflation passed along to customers – Tandy should be able to grow sales by about 7% a year for up to the next 10 years. This is an important figure to keep in mind. Tandy may be able to grow its earnings a bit faster than its sales if it can grow its corporate overhead costs slower than its retail sales. The company may also make profits in other countries – we don't really quantify that potential here. Tandy's management has said that there are about 20 countries with $5 million or more of potential sales for Tandy available in that market. Tandy makes about an 11% EBIT margin. So, in theory, 20 countries each with a $5 million sales potential for Tandy could be worth as much as $11 million in profit one day. This is very speculative. And we don't consider it in this report. But, it is worth keeping in mind that the theoretical business opportunity outside the U.S. is actually about the same size as the entire U.S. business is doing in 2015. So, there is at least theoretically plenty of foreign sales potential. It is unclear if Tandy will ever tap this potential. And it may take Tandy much, much longer than 10 years to fully penetrate foreign markets. We really only take our analysis out about 10 years here. That is a good, long holding period even for someone who considers himself a "buy and hold" investor. We certainly hope you will buy Tandy and you will hold it for at least the next 10 years.

Here's why. Tandy now trades at just a smidge over 7 times EBIT. A normal stock – one with normal growth potential, normal safety, and normal "sentiment" toward the stock from traders – often trades around 10 times EBIT. That is – if the company doesn't use leverage – the equivalent of a P/E of 15. That is a normal P/E for a normal U.S. public company. Tandy trades at about a 30% discount to normal right now. Imagine you buy Tandy stock today at about 7 times EBIT. You hold the stock for 10 years. In those 10 years, Tandy achieves 7% annual EBIT growth. This is not as great a stretch as it sounds. Tandy grew sales faster than 7% in 2004, 2005, 2006, 2010, 2011, 2012, and 2013. The company does not increase its share count over time. So, as long as sales can grow at close to 7% a year and earnings don't grow any slower than sales – that is, corporate costs don't balloon faster than retail sales – the company can grow EPS by 7% a year. So, let's say EBIT grows 7% a year from 2015 to 2025. Now, if Tandy – which would then be a bigger company with a history of 7% a year growth over the last decade – is priced like a normal stock it would trade at 10 times EBIT. But, consider this. It takes only a 7.25% annual growth rate over 10 years to double a starting value. So, for every one dollar of EBIT Tandy has today it could have two dollars of EBIT in 2025 if it grew earnings by 7.25% for a full decade. There is no guarantee Tandy will do this. Many things can go wrong. Not getting enough new managers is the most likely problem. Also, over expanding by opening too many unprofitable stores would be another problem. Other than these two potential problems, there is little to stop Tandy from growing earnings by a rate like 7.25% a year. Tandy controls its own destiny. The company may not double its earnings in 10 years. But, if Tandy fails to double its earnings in 10 years – it is probably because Tandy itself made a misstep, not because of actions taken by some competitor. So, Tandy's stock should be twice as valuable in 10 years as it is now. But, Tandy's stock is trading at about a 30% discount to "normal" right now. A normal stock trades around 10 times EBIT in normal times. Tandy trades around 7 times EBIT today. So, every $100 of intrinsic value in Tandy stock only costs you about $70 in the stock market. If Tandy can grow sales just over 7% a year – it can double its value in 10 years. That means every $100 of intrinsic value in Tandy's stock as of



Except for the 2007-2009 Great Recession, Tandy was able to grow sales by more than 7% a year

2015 should become $200 of intrinsic value in Tandy's stock as of 2025. But, you don't have to pay $100 for $100 of intrinsic value to buy Tandy. You only have to pay $70 right now. That's because you can buy Tandy at 7 times EBIT while a normal stock trades for 10 times EBIT. This means, you have the opportunity to pay about $70 today for something that should be worth $200 in 2025. An asset that grows in value from $70 today to $200 in 10 years is compounding at a rate of 11% a year. That is a good estimate of what Tandy's stock can do. But, it's an underestimate. It does not include the dividends received while holding the stock. It's easy for an investor to ignore this because Tandy has only paid 2 special dividends – 75 cents per share in 2010 and 25 cents per share in 2012 – so far. But, Tandy does not need to retain all of its earnings if it grows sales only 7% a year. Over the last 5 years, Tandy has paid out $1 per share in special dividends. It has also built up about 50 cents per share in excess cash. Here we are talking cash above the $5 million in cash minimum management likes to keep on hand. So, Tandy's actual capacity to pay a dividend might be something between $1 and $1.50 spread over 5 years. As Tandy grows, this capacity to pay a dividend would grow too. Let's ignore that. Instead, let's take the low end of that range and use $1 divided by 5 years equals 20 cents per year. We can then assume that Tandy will – through special dividends, maybe a regular dividend, even perhaps (though it's very unlikely to do this) a share buyback or two – return about 20 cents per share to shareholders each year. In other words, about $2 per share over the 10 years. As I write this, Tandy is trading at $8.64 per share. A dividend – even if it's not a regular dividend – that averages out to 20 cents per share per year over 10 years would add a 2.3% annual return to Tandy stock. This means that if Tandy grows sales by 7% a year over 10 years, an investor who buys the stock today and holds it for a full 10 years might actually see returns closer to 11% to 13% a year. Those are growth stock type returns. Tandy is both a growth stock and a "franchise" stock. It is a retailer. And retailers rarely have perfect moats. But Tandy has about as wide a moat as a retailer can. At today's price of $8.64 a share and an expected holding period of a full 10 years – an investor who buys Tandy stock today should be able to compound his money at 10% a year. Very few stocks offer safety and a good shot at 10% annual returns over a full decade. That is what makes Tandy a good buy and hold investment.

Tandy Leather Factory (NASDAQ: TLF)
Appraisal: $14.50

Margin of Safety: 41%

Owner Earnings	(in millions)
Pre-tax Owner Earnings	
EBIT	$11.96
+ Adjustment	$0.00
= Pre-tax Owner Earnings	$11.96

Business Value

Tandy's business value is $144 million.

- Pre-tax owner earnings are $12 million
- Fair multiple = 12x pre-tax owner earnings
- $12 million * 12 = $144 million

Fair Multiple

Tandy's business is worth at least 12x pre-tax owner earnings

- Quan thinks: "Investors can make 8% or 9% return over the next 10 years by buying Tandy at 12 times pre-tax owner earnings"

Share Value

Tandy's stock is worth $14.50 a share

- Business value is $144 million
- Net cash is $5 million
    - Cash: $10.6 million
    - Debt: $5.6 million
    - $10.6 million - $5.6 million = $5 million
- Equity value is $149 million
- $144 million + $5 million = $149 million
- Equity Value = $14.50/share
    - 10.25 million outstanding shares
    - $149 million / 10.25 million = $14.50

Margin of Safety

Tandy stock has a 41% margin of safety.

- Business Value = $144 million
- Enterprise Value = $85 million
- Discount = $59 million ($144 million - $85 million)
- Margin of Safety = 41% ($59 million / $144 million)

	EV/Sales	EV/Gross	EV/EBITDA	EV/EBIT	EV/Owner
Majestic Wine	0.73	3.17	6.91	8.51	8.42
Games Workshop	1.23	1.76	6.76	9.07	9.92
Michael Companies	1.76	4.40	11.32	13.33	13.22
International Speedway	2.48	5.34	8.32	15.59	15.59
Harley-Davidson	2.84	7.24	12.10	13.79	13.79
Minimum	0.73	1.76	6.76	8.51	8.42
Maximum	2.84	7.24	12.10	15.59	15.59
Median	1.76	4.40	8.32	13.33	13.22
Mean	1.81	4.38	9.08	12.06	12.19
Standard Deviation	0.87	2.09	2.49	3.11	2.94
Variation	48%	48%	27%	26%	24%
Tandy	1.02	1.64	6.37	7.14	7.14
Tandy (Appraisal Price)	1.71	2.76	10.71	12.00	12.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).