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A.H. Belo: Hidden Value Or Value Trap?

Mar 12 2013, 07:20
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| about: AHC, includes: BLC, GCI, LEE, MEG, MNI, WPO

Disclosure: I am long MNI. **(More...)**

On the surface, A.H. Belo (AHC) seems to be a relatively easy company to analyze. In 2008, the company was spun-off from the Belo Corp. (BLC) The main business is four newspapers: The Dallas Morning News, The Providence Journal, The Denton Record-Chronicle and The Press-Enterprise. What complicates the analysis is that AHC also received valuable unencumbered real estate assets ($100 million +), a 3.3% ownership stake in Classified Ventures (CV) and a huge unfunded pension liability ($145 million). The purpose of this article is to look at the company as both a "sum of the parts" investment idea and as a going concern investment idea. The four main areas I am going to look at are:

1. Liquidation of real estate
2. Funding of Pension Plan
3. Monetization of Classified Ventures
4. Newspaper Business

Real Estate Portfolio

As a starting point, what might attract investors to AHC is the unencumbered real estate the company owns. Every opportunity management gets, it highlights the hidden value of this real estate. In fact, in each of the last two annual Investor Days, it has devoted a significant amount of time detailing the assets for sale and the estimated value. Over the last three years, the company has received about $11 million in proceeds from asset sales, with most of that occurring in 2010. The company is currently marketing $73 million worth of properties and expects to receive pre-tax proceeds of $68 million (approximately $3 a share). Management has stated publicly numerous times that it will not accept "fire sale" prices for the assets and the hope to reward investors for their patience. Patience will certainly be required since it has typically taken 20-30 months from the time the properties were marketed for sale and actual closing of a transaction.

Below is a table of the real estate for sale and management's estimate of fair value. According to management, the fair value has been determined by outside third parties. What is important to understand is that 40% of the estimated $73 million in gross proceeds is made up of just one property, the Press-Enterprise building in Riverside, California. Most of the analysis of AHC that we have seen, simply takes the company's $73 million estimated valuation and compares it to the company's $82 million enterprise value and sees a huge opportunity for shareholders. However, investors need to understand that 50% of that valuation can be assigned to just two properties, the previously mentioned Press-Enterprise Building and the South Plant property in Dallas. Because of the size and limited use for these types of properties, there is a limited number of natural buyers and therefore the timing of the sales is virtually unknowable and very difficult to handicap. While it is possible that the company will sell the properties within the next two years, investors must be willing to wait for an undetermined amount of time to receive any benefit. We think some investors are underestimating the timing of these transactions. Remember, while real estate markets are improving, the number of sales AHC has done in the last two years has been minimal. In the future, I will assess the likelihood of the sale of these properties.

While the ability of AHC to sell those two properties in a timely manner is difficult to determine, I do believe that there are other assets that the company can sell within a year. For example, the company is also marketing a total of 6 parking lots in Dallas and Rhode Island for a total of $14 million. The company has sold parking lots in the past and I believe there are a significant number of potential buyers for this kind of simple, income producing property. The other two Dallas/Denton properties valued at around $4 million seem like candidates for sales this year. One is under contract and the other is located in an area of healthy economic activity. Taken together, these sales would bring in perhaps $16-17 million after commissions. The company has guided that it intends to make $44 million in pension contributions over the next two years. I believe that the most likely use of any proceeds from the sale of these smaller properties would be to help make those payments. From an investor standpoint, while there would be no immediate return of cash to them, the sales would reduce the pension liability and could eventually accrete to the equity value of the company. It would also free up future cash flow for dividend support. In today's investment environment, investors seem to "wait until it happens" to revalue a company. While there is a significant amount of hidden real estate value in the shares, investors should not expect a smooth recognition in its value in the stock price.

% of Total	Estimated Value (in MM)	
		California
41%	$30	Press-Enterprise Building
0%	$.20	Banning Bureau
	$30	Total
		Rhode Island
14%	$10	Providence Journal Building
7%	$5	3 Parking lots
6%	$4	Vacant facility
	$19	Total

		Dallas/Denton
14%	$10	South Plant
3%	$2	Original South Plant
12%	$9	3 parking lots
3%	$2	Denton Chronicle building
	$23	Total
100%	$72	Total

Pension Funding Status

While in many instances the funded status of a company's pension plan is not a large concern for investment analysis purposes, in the case of AHC it has been a major focus. In 2008, when Belo split into two companies, Belo Corp. and A. H. Belo, AHC assumed a $145 million unfunded pension liability. For a company with an enterprise value of only $80 million, this is a significant burden. Because the company was generating significant amounts of free cash flow and had a substantial cash balance, it was assumed that the under-funding could be easily handled over time. However, several events, such as the major recession and the Federal Reserve's response of reducing interest rates to near zero, significantly altered that assumption. But unlike debt that has a fixed maturity and could cause a "liquidity" event, the pension liability is mostly just a drain on free cash flow for now and not likely to create a sudden problem for the company. In fact, the company has several remedies at its disposal to offset some of the liability risk. For example, offering participants buyouts can reduce the gross liability more than the offsetting assets, resulting in a net reduction in the liability.

Falling discount rate has negatively impacted AHC's pension liability.

Without going into a lengthy, arcane discussion of pension accounting, the Federal Reserve's near zero interest rate policy has had a very negative impact on the pension liabilities of most corporations. As interest rates have dropped, the discount rate used to determine pension liabilities has also dropped. This has the impact of increasing the GAAP pension liability on the balance sheet. In the case of AHC, the discount rate has dropped from 5.33% in 2010 to 4.2% in 2011 to 3.7% in 2012. This has resulted in a pension liability that is larger than anticipated a few years ago even though AHC has made considerable payments to the plan.

For example, in the table below, I have summarized AHC management's estimates for payments to the pension plan from the 2011 and 2012 analyst presentations. In 2011, management estimated that AHC would have to make a total of $52.7 million worth of pension plan payments between 2012 and 2017 to fully fund the pension plan. This was based on the assumption that the 5.33% discount rate used in 2011 would remain stable throughout the period. However, because interest rates continued to decline, the company was forced to use a discount rate of 4.2%. The result was that the unfunded pension liability increased from $132 million at the end of 2010 to $145 million at the end of 2011. As the table below shows, had the company been able to use the 5.33% discount rate in 2011, the liability would have only been $91 million. This increase was in spite of the company contributing $32.7 million to the plan instead of the $19.20 million it had originally estimated. In fact, the company now estimates contributing a total of $85 million to the plan to bring it to fully funded status, $33 million above the original estimate.

Lower discount rate boosts pension payments ($ figures in MM)

	2011	2012	2013	2014	2015	2016	2017	Total 2012-2017
2011 Presentation	$55.30	$19.20	$12.30	$11.50	$7.50	$2.20	$ -	$52.70
2012 Presentation		$32.70	$21.10	$23.30	$17.50	$15.30	$5.30	$85.20

Discount Rate	2011 Presentation	Discount Rate	2012 Presentation
5.00%	$147.00	3.5%	$187.00
5.33%	**$132.00**	3.8%	$171.00
5.66%	$118.00	**4.2%**	**$145.00**
6.00%	$105.00	4.8%	$117.00
		5.3%	**$91.00**

There is good news on the pension front however. First of all, since the plan is frozen, there will be no increase in the gross liability due to the fact that there will be no new accruals of additional benefit obligations. Second, in spite of the discount rate used to calculate the liability declining from 4.2% to 3.7% in 2012, the underfunded portion of the plan actually declined to $122 million from $145 million. Part of the reduction was the result of 889 plan participants accepting a buyout. This resulted in a net $5 million reduction in the liability ($10 million in payments reducing the liability by $15 million). If interest rates and the discount rate can remain flat, the gross amount of the liability will not increase (assuming positive investment performance of the plan assets). In fact, if interest rates and the discount rate would rise, the gross amount of the liability would fall. So in a sense, AHC is a play on rising interest rates.

Therefore, I would expect that, unlike the last two years in which $88 million in cash contributions barely impacted the net pension liability, the expected $44 million in contributions over the next two years and additional employee buyouts should reduce the net pension liability substantially. A company that has no debt or pension liability usually sees the equity value of the company rise as free cash flow accumulates on the balance sheet and eventually it is reflected in the enterprise value. It is unclear how long it will take for investors to revalue the equity of AHC as the pension liability is reduced. In any event, the tide seems to be changing in the company's favor as progress is made.

Classified Ventures Valuation

Another hidden asset is Classified Ventures. AHC owns 3.3% of CV. CV is a joint venture between, AHC, Belo Corp., Gannett (GCI), The McClatchy Company (MNI), The Washington Post (WPO) and the Tribune Company (TRBAA). The principal businesses are cars.com, apartments.com and homegain.com. In 2012, CV generated $433 million in revenue, $97 in EBITDA and $88 million in net income. Free cash flow was approximately $67 million. AHC received $2.5 million in dividends from the venture in 2012. The venture has consistently grown revenue and net income. While this is a valuable asset, it will be difficult for AHC to realize its value

Company	Ownership
AHC	3.3%
BLC	3.3%
WPO	16.5%
GCI	23.6%
MNI	25.6%
Tribune	27.7%
Total	100.0%

AHC is mostly a token investor in CV. Therefore, the ability of the company to monetize its value for the benefit of its shareholders is subject to the whims of its other partners and not in the company's control. The good news is that the largest owner of the joint venture, the Tribune Company, recently emerged from bankruptcy. In addition, the McClatchy Company, which owns 25.6% of CV, is struggling under a heavy debt load and large pension expenses. I believe that this motivates these owners in the joint venture to pursue various ways to monetize at least part of their investments in CV.

Looking at the financials of CV, it is clearly a very valuable asset. Using simple back of the envelope-type valuation metrics, the venture could be worth between $700 million (12 X $60 million in fully taxed net income) and $1.0 billion (10 X EV/EBITDA). The actual valuation of CV is certainly a matter of debate and goes beyond the scope of this article, but I feel that it is certainly worth a minimum of $700-$800 million. AHC's share of that valuation would be approximately $25 million or 30% of the current enterprise value of the company.

What is unclear is just how AHC shareholders would be able to realize that value. Other than to simply sell its ownership stake back to the other joint venture partners, there is really no way for AHC management to proactively help its shareholders. AHC's ownership stake and the monetization of it is completely in control of Gannett, McClatchy and Tribune. While the majority of the joint partners (MNI and TRBAA) would seem to have sufficient motivation to unlock CV's value, I do not think that a transaction is imminent, nor would it be simple. If the partners chose to IPO the venture, AHC could either sell its stake as part of the IPO, liquidate those shares in the future or eventually spin out its shares to AHC shareholders in the form of a dividend. Undoubtedly however, any formal announcement that the partners are pursuing a liquidity event for CV would be viewed as a positive for AHC shareholders.

Classified Ventures, LLC
Consolidated Statements of Operations
Years Ended December 31, 2012, 2011 and 2010

(in thousands of dollars)	2012	2011	2010
Operating revenue			
Net revenue	$ 353,624	$ 300,931	$ 256,866
Net revenue Affiliate Investor	79,613	70,923	64,103
Total net operating revenue	433,237	371,854	320,969
Operating expenses			
Product support, technology and operations	102,892	88,302	78,036
Marketing and sales	188,375	163,277	141,245
General and administrative	34,239	32,311	32,058
Affiliate revenue share	19,808	15,185	13,176
Total operating expenses	345,314	299,075	264,515
Operating income	87,923	72,779	56,454
Other income (loss)			
Interest income	—	12	72
Gain (loss) on investments	908	(26)	841
Income from continuing operations	88,831	72,765	57,367
Discontinued operations			
(Loss) from discontinued operations (including goodwill impairment charges of $11,513 in 2010)	(749)	(316)	(12,121)
Net income	88,082	72,449	45,246

(click to enlarge)

Classified Ventures, LLC

Consolidated Balance Sheets

December 31, 2012 and 2011

(in thousands of dollars)	2012	2011
Assets		
Current assets		
Cash and cash equivalents	$ 19,059	$ 30,882
Restricted cash	—	45,253
Marketable securities held in trust	2,267	2,280
Accounts receivable, net of allowance for doubtful accounts of $1,858 and $1,818, respectively	64,248	51,252
Affiliate Investor accounts receivable	8,522	8,147
Prepaid expenses & other current assets	7,240	5,801
Total current assets	101,336	143,615
Property and equipment, net of accumulated depreciation	19,906	17,252
Marketable securities held in trust, less current portion	8,832	8,137
Goodwill	15,868	15,868
Investment	5,002	—
Definite lived intangible assets	343	601
Total assets	$ 151,287	$ 185,473
Liabilities and Members' Equity		
Current liabilities		
Accounts payable	$ 9,550	$ 9,270
Accrued compensation and related costs	13,426	12,125
Accrued expenses & other current liabilities	21,812	25,090
Dividend payable	—	45,253
Deferred revenue	852	1,723
Current portion deferred Long Term Incentive Plan	2,267	2,280
Total current liabilities	47,907	95,741
Deferred Long Term Incentive Plan, less current portion	8,104	7,649
Deferred rent	3,940	4,829
Total liabilities	59,951	108,219
Commitments and contingencies (Note 16)		
Members' equity	91,336	77,254
Total liabilities and members' equity	$ 151,287	$ 185,473

(click to enlarge)

Classified Ventures, LLC

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Classified Ventures, LLC
Consolidated Statements of Cash Flows
Years Ended December 31, 2012, 2011 and 2010

(in thousands of dollars)	2012	2011	2010
Cash flows from operating activities			
Net income	$ 88,082	$ 72,449	$ 45,246
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	9,300	9,099	8,974
Goodwill impairment charges	—	—	11,513
Deferred compensation	3,031	2,405	2,216
Loss on disposition of property and equipment	15	—	—
Loss (gain) on trading securities related to deferred compensation	(908)	26	(841)
Provision for accounts receivable	2,453	1,302	2,120
Purchase of trading securities related to deferred compensation plan	(2,363)	(2,755)	(2,217)
Change in operating assets and liabilities			
Accounts receivable	(15,824)	(12,888)	(6,663)
Prepaid expenses and other current assets	(1,439)	92	1,536
Accounts payable	(363)	(3,044)	(5,774)
Accrued expenses and other current liabilities	(2,601)	5,397	3,808
Deferred revenue	(871)	804	(1,084)
Deferred rent	(889)	(822)	(1,146)
Other long term liabilities	—	(8)	632
Net cash provided by operating activities	77,623	72,057	58,320
Cash flows from investing activities			
Change in restricted cash	45,253	(18,884)	(26,369)
Purchase of patent	—	—	(150)
Proceeds from the sale of marketable securities	42	—	—
Purchase of investment	(5,002)	—	—
Purchase of property and equipment	(10,486)	(5,926)	(8,916)
Net cash provided by / (used in) investing activities	29,807	(24,810)	(35,435)
Cash flows from financing activities			
Dividend paid to investors	(119,253)	(49,126)	(68,631)
Business acquisition earnout payment	—	—	(1,138)
Net cash used in financing activities	(119,253)	(49,126)	(69,769)
Net decrease in cash	(11,823)	(1,879)	(46,884)
Cash and cash equivalents			
Beginning of years	30,882	32,761	79,645
End of years	$ 19,059	$ 30,882	$ 32,761
Supplemental disclosure of noncash investing and financing activities			
Purchases of property, plant and equipment in accrued liabilities and accounts payable at the end of the years	$ 1,635	$ 367	$ 269
Dividends declared but not paid	—	18,874	26,369

(click to enlarge)

Source: 10K

Newspaper Business

While there is clearly hidden value in the shares of AHC, the bottom line is that anyone investing in the company in the hopes of realizing it must also invest in the struggling newspaper business. In his latest shareholder letter, Warren Buffett lays out the reasons why he has been buying newspapers (28 dailies at a cost of $344 million and counting) and explains how they can remain relevant and competitive. I agree with his assessment that newspapers can continue to "reign supreme in the delivery of local news." I have always maintained that this is an area that nationally focused websites and news organizations would have difficulty breaking into. While it is relatively easy for any major news organization to publish a news story about national politics or economics and cover it in more detail than a local paper, it is nearly impossible for that same news organization to follow politics or other news at the local level. Newspapers like The Dallas Morning News have a significant edge when it comes to understanding what its readers are interested in (for example, city council and school board meetings and high school sports) and how it provides coverage of those activities. However, unlike most of the newspapers that

Warren Buffett is buying, AHC's newspapers have significant competition for local news from several very strong television stations, including BLC in Dallas (WFAA Channel 8), which used to be part of the same company. Therefore, it is much more difficult for AHC to capture and monetize local readership than a newspaper in a smaller town that does not have local TV stations. The financial results over the past several years highlight this problem.

Advertising and circulation trends.

In spite of its best efforts, management has not been able to overcome the industry specific and general economic realities to stem the steady decline in revenue and EBITDA. Since 2010, revenue has declined from $487 million to $440 million in 2012 and an estimated $441 million in 2013. EBITDA has declined from $56 million in 2010 to an expected $37-41 million in 2013. Advertising revenue declined by $52 million over that time, while circulation revenue only declined by $5 million and printing and distribution actually increased by $10 million. The reasons for the decline in advertising revenue are well documented and there is no need to rehash them here. For readers who are interested in learning more about AHC's plan to stem the declines they can go here to see the 2012 Investor Day presentation. Even though the local economy has been much stronger than the rest of the country, revenue has at The Dallas Morning News has declined over 10% in the last two years. This highlights how difficult it is to maintain revenue for a newspaper that is widely known and respected for its excellence in news coverage has today. Since The Dallas Morning News represents over 60% of AHC's revenue, it has by far the most impact on the financial health of the company.

	Years Ended December 31, 2012	Percentage Change	2011	Percentage Change	2010
Advertising and marketing services	$ 258,223	(8.6)%	$ 282,621	(8.9)%	$ 310,309
Circulation	136,506	(2.4)%	139,892	(0.8)%	141,091
Printing and distribution	45,317	16.2 %	38,990	8.6 %	35,908
	$ 440,046	(4.6)%	$ 461,503	(5.3)%	$ 487,308

(click to enlarge)

	Years Ended December 31, 2012	Percentage Change	2011	Percentage Change	2010
The Dallas Morning News	$ 280,924	(6.1)%	$ 299,131	(4.8)%	$ 314,049
The Providence Journal [a]	93,766	(1.4)%	95,065	(4.8)%	99,849
The Press-Enterprise	65,356	(2.9)%	67,307	(8.3)%	73,410
Total net operating revenues	$ 440,046	(4.6)%	$ 461,503	(5.3)%	$ 487,308

(a) Revenue reported for *The Providence Journal* in 2012 includes $3,737 due to the change in the circulation model used as described below.

(click to enlarge)

Source:10K

There is some good news on the circulation front that could indicate that stabilization of revenue is getting near. One place investors should look to get a feel for the health of a newspaper is the trend in circulation of the Sunday paper. This is the most important day for newspapers because circulation is the largest and advertisers use it as a promotional tool. Also, since it is only a weekly publication, it doesn't compete with the timeliness of daily news events and readers use it for other purposes. Readers should find more value in the Sunday paper than the daily paper and circulation trends would reflect AHC's ability to remain relevant to their readers. As shown below Sunday circulation has been stable at The Dallas Morning News and has actually increased at the Press-Enterprise. These are promising signs. If AHC can keep its readership stable, it has a better chance of slowing the reduction in advertising dollars. I continue to believe that newspapers will leak revenue to other online forms of media. In addition, the paywall business model is still in flux so future circulation revenues are hard to predict as well. But the company has seen at least a small amount of success in this area.

Newspaper	2012 Daily Circulation (a)	2012 Sunday Circulation	2011 Daily Circulation (a)	2011 Sunday Circulation	2010 Daily Circulation (a)	2010 Sunday Circulation
The Dallas Morning News Group						
The Dallas Morning News (b)	267,058	372,930	265,371	374,653	262,227	373,815
Niche publications (b) (c)	120,299	327,719	174,712	—	187,442	—
Total	387,357	700,649	440,083	374,653	449,669	373,815
The Providence Journal Group						
The Providence Journal (d)	88,974	119,199	94,357	129,024	101,123	137,339
Niche publications (d)	24,310	—	23,938	—	—	—
Total	113,284	119,199	118,295	129,024	101,123	137,339
The Press-Enterprise Group						
The Press-Enterprise (e)	127,350	151,642	112,228	129,409	109,079	112,357
Niche publications (e)	15,710	—	15,862	—	10,786	—
Total	143,060	151,642	128,090	129,409	119,865	112,357

(click to enlarge)

Source: 10K

Cash flow model

Since 2010, AHC's large cash balance of $86 million has been reduced by $50 million as a combination of higher than expected pension contributions and a combination of a weak economy and strong competition impacted revenue and cash flows. I do not believe that investors will start to mark to market the value AHC's hidden assets until the newspaper business shows signs of stabilizing.

Cash Flow Model (all $ figures in MM)

	2010	2011	2012	2013E	2014E	2015E	2016E	2017E
Revenue	$487	$462	$440	$440	$440	$440	$440	$440
EBITDA	$56	$48	$42	$39	$39	$39	$39	$39
CFO	$61	$38	$32	$32	$32	$32	$32	$32
CV DIV		$2	$0	$2	$2	$2	$2	$2
CAP EX	$11	$9	$11	$9	$9	$9	$9	$9
PENSION		$55	$33	$21	$23	$18	$15	$5

DIVIDEND	$-	$5	$11	$5	$5	$5	$5	$5
change in cash			($23)	($1)	($5)	$2	$5	$19
Cash	$86	$57	$34	$33	$28	$30	$35	$54

Source: 10K & estimates

Dividend coverage

In a yield starved world, some investors may be attracted to the 4.5% dividend yield. However, due to the large pension contributions, AHC has not been able to pay the dividend out of free cash flow. The $70 million that AHC generated in cash from operations, plus the CV dividend, was consumed by $20 million in capital expenditures and $88 million in pension contributions. As the cash flow model above shows, just assuming the company can achieve its 2013 guidance and maintains it for the next 5 years, the current dividend is barely covered by cash flow after these expenses. Of course this is a simplistic analysis and the actual cash flow could be altered by working capital changes, but for this discussion I believe it is a reasonable starting point. While this cash flow model may seem conservative to some because it assumes no improvement in pension funding possibilities or revenue and cash flow, it also doesn't contemplate the continued deterioration of the company's revenue either. Both scenarios should be modeled for some perspective of risk/reward, but that is for investors to do themselves. This article should be just a starting point for further analysis. All in all, it does appear that the current dividend is "safe" for now, but I would not expect another "extraordinary dividend" payment of $0.24 per share that occurred last year.

Summary

With a current enterprise value of about $80 million and hidden assets with values approaching $100 million, it appears as though investors are getting the newspaper business for free. Because of the difficulty of determining the timing of those transactions, I think investors should view an investment in AHC as an investment in a newspaper company with optionality to those monetization events. AHC is also a call option on rising interest rates, which would reduce the pension liability and free up some of that potential $15-$20 million in free cash flow (ex-pension) for dividends or stock buybacks. If AHC can eventually eliminate its pension funding problem and can continue to generate CFO near $30 million and free cash flow of $15-$20 million, the newspaper business alone could be worth two to three times the current market price. It is disappointing that revenue at the Dallas Morning News (63% of revenue) has continued to decline in spite of the fact that the local economy has performed much better than the rest of the country and the paper provides high quality local news coverage. This fact shows how competitive the newspaper/television market is for local news and ad dollars. Until there is stabilization in this paper's advertising revenue, it will be difficult for investors to have confidence in the long term, which is mandatory for the "hidden asset" play to come to fruition.

While Warren Buffett has been extremely active in acquiring newspapers and has shown interest in Lee Enterprises (LEE) and Media General (MEG), I doubt that he would be the catalyst that would help investors close the NAV discount. Warren never pays "fair price" for anything and is unlikely to assign full value to those hidden assets in his bid, providing him for some upside. Warren is also famous for receiving extremely favorable terms with his investments, usually in the form of high coupon and dilutive preferreds.

While most investors today want a sound bite investment thesis like "rising interest rate play" or "improving macro play" or "hidden asset play", the truth is an investment in AHC today requires patience, faith and facing the fact that part of the investment thesis relies on unknowable outcomes. These attributes are not common in today's typical investor. However, AHC provides patient and risk tolerant investors with the potential for "time arbitrage" rewards if management can stabilize the business and achieve the potential monetization events in a reasonable time frame. It is up to each individual to decide what discount from NAV they are willing to accept for that potential.

Additional disclosure: I may initiate a position within the next 72 hours.