CONTRARIAN STOCKS

Cutera Inc

Not my usual type of stock pick

Generally speaking, I have two kinds of investments. Firstly, I look for "out-of-favour" companies that do have positive attributes to them. Secondly, I look for companies with a moat that are going through a spot of bother.

It's very rare for me to speculate on a company with no earnings, no book value and a sketchy track record.

However, I feel, in this case, Cutera is worth considering as an intelligent, speculative play. To be clear, this type of speculation is not something I partake in often and there are many risks in putting money into a speculative security such as Cutera.

The essence of the thesis comes down to a few simple points:

1. New management with a proven track record.
2. Convertible notes expiring in the next 7 years.
3. High short interest.

These points will be explained in more detail below. I feel there are still risks to consider in this business, though, which are as follows and which will also be explained in more detail:

1. Lack of profitability.
2. Lawsuits against past management.
3. Bad blood between ex-management and the board.

Cutera has made money for both bulls and bears in its tumultuous history. As we will see, this would have made a wonderful short just two years ago. Now, it's too cheap to be ignored.

Inconclusion, you will see poor governance, shoddy financials and a generally distasteful business – but it's cheap and there's a potential catalyst which means that I, as an analyst, am bullish in the future of Cutera.

Buy - Overweight

NASDAQ: CUTR

Price: $3.5

Price target: $10

Date: 15/10/2023

Asset management

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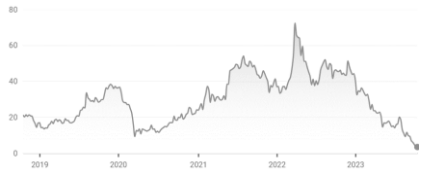
Price Performance



Brief Metrics (ttm)

P/E: n/a

P/B: n/a

P/S: 0.28x

EV/EBITDA: n/a

ROE: n/a

Debt/Equity: n/a

*Source: Google Finance, Stock Analysis

Share Data

Price: $3.5

Shares outstanding: 20m

Market cap: $68m

EPS (ttm): n/a

Dividend yield: n/a

*Source: Finviz

IMPORTANT: Please see the back page for important disclosures. It is important you note that none of the contents of this piece is financial advice and it is purely an educational piece.

Overview

Cutera, formed in 1998, is a provider of both aesthetic and dermatology solutions.

These solutions include Secret Pro (Dermal Remodelling), truSculpt flex (Muscle Sculpting), excel V+ (Vascular and Pigmentation Treatments), enlighten (Pico Technology), excel HR (Hair Removal), excel V (Vascular), Secret RF (Dermal Remodelling Inside Out), truScuplt Id (Body sculpting), truSculpt 3D (Body Sculpting and xeo (All of the Above regarding aesthetics).

Just a month ago, Cutera announced the launch of a new skin resurfacing and revitalization platform called "Secret Duo."

Essentially, you can split the Cutera business into two segments:

1. Cutera Core (systems, consumables, skincare and service) - develops and manufactures energy-based systems for medical practitioners in addition to distributing third-party manufactured skincare products in Japan.
2. AviClear – prescription-free, drug-free laser treatment for mild to severe acne.

It should be noted that roughly 51% of Cutera's revenues come from North America, 26% from Japan and 15% from Australia.

As people aim to look better in this age of "social media" and slim, sexy bodies, Cutera's business becomes more valuable. The issue, as you'll see is not the products, but the rapid expansion without a clear plan that ex-management are largely responsible for.

Risks

In the 10K, there are a couple of risks that I feel are worth pointing out to analysts of Cutera.

The first risk that I think should be noted is the "anti-takeover provisions" included in the Company's certificate of incorporation. Provisions include:

1. authorizing "blank check" preferred stock, which could be issued by the Company's board of directors without stockholder approval and may contain voting, liquidation, dividend and other rights superior to its common stock;
2. limiting the liability of, and providing indemnification to, its directors and officers;
3. limiting the ability of its stockholders to call and bring business before special meetings;
4. requiring advance notice of stockholder proposals for business to be conducted at meetings of the Company's stockholders and for nominations of candidates for election to its board of directors; and
5. controlling the procedures for the conduct and scheduling of board of directors and stockholder meetings.

I don't think any of these provisions are too harmful but they could delay/ prevent hostile takeovers. This may/may not be a concern for prospective investors. Personally, I'm indifferent to a takeover but other analysts may feel differently.

The second risk to consider is one that relates to defects. If there are any defects in any of the products that the company manufactures, the reputation of the company may come under scrutiny. Intense, negative scrutiny in this field is usually the death of the business.

To me, it seems that the products are genuine and they do what they are intended to. In this way, this risk is negated but this risk is one that should always be monitored and scrutinised by any analyst.

A third risk that should be constantly checked is the "contingency" footnote in the 10K filing. Cutera mentioned that in Match 2023, Serendia LLC filed patent infringement complaints alleging infringement of six patents by the Secret RF and Secret Pro systems. Cutera distributes this product in the US on behalf of ILOODA Co. LTD, a Korean company.

Lawsuit

It's important you know of the class action that Johnston Fistel, LLP, have filed that involves Cutera shareholders who acquired seurities between February 2021 and May 2023. Cutera shareholders have until July 2023 to become a lead plaintiff.

Below is a quote from Johnston Fistel's website:

According to the lawsuit, defendants throughout the Class Period made false and/or misleading statements and/or failed to disclose that: (1) overstated the sustainability of Cutera's revenue growth; (2) failed to disclose significant conflicts among members of the Company's senior leadership and Board; (3) failed to disclose several material weaknesses in the Company's internal control over financial reporting; and (4) as a result of the foregoing, and the significant decline in the market value of the Company's common stock, Plaintiff and other members of the Class suffered significant damages. When the true details entered the market, the lawsuit claims that investors suffered damages.

Whilst it's all very interesting and it's a situation worth watching, I think current Cutera shareholders should not be overly worried. This is a historical situation with historical management. It shouldn't affect the underlying Cutera business.

Recent History

In the past year, there have been lots of allegations and confusion surrounding management and the board of directors.

For instance, in June 2023, activist investor J. Daniel Plants resigned from the board of directors due to disagreements with other members and the company. He had sat on the board for eight years. He wrote in his letter that there were "numerous and irreconcilable disagreements" with the board. Notice how he didn't say management.

In a Press Release dated April 12, 2023, it is mentioned (in November 2022) that Daniel Plants wanted the CEO position and "strongly recommended" the termination of Mr Mowry (then CEO). This wasn't the first instance of Mr Plant's attempt. In February 2021, he also tried to remove Mr Mowry. Both times, the Board declined him and decided to seek an external CEO.

In April 2023, CEO David Mowry was terminated for alleged violations of his employment contact despite him admitting (in January 2023) that he was planning on leaving. Chairman Plants was terminated for the same reason but remained on the board until June 2023. The reason given for the termination was because -

"Mr. Mowry and Mr. Plants issued a press release in which they disclosed – and blatantly mischaracterized in a defamatory manner – highly confidential internal deliberations of the Board in direct violation of their employment agreements and their fiduciary duties as directors and officers under Delaware law."

The result was a public square off with the board. Both Mowry and Plants announced they had filed a lawsuit against the directors in connection with their termination.

What I find so strange about this situation is it seems Plants has back-stabbed Mowry by trying to oust him (twice) only for them to both join forces against the board! I feel the whole truth hasn't been revealed to shareholders yet.

This debacle caused the initial sell-off of Cutera shares before the (Johnston Fistel) lawsuit dropped.

Truth be told, it's hard for an outsider to know exactly where the truth lies. Either the board are behaving badly or the ex-directors were behaving wrongly. My opinion is simple – completely wipe the slate clean and get rid of the existing board. (For your information, this process has already begun.)

Personally, I'm glad that there is new management in place. Mr Mowry was not a brilliant CEO and he was making many mistakes that can be seen in the financials below.

Other recent history worth noting was that Cutera failed to timely file their 10K due to "material weaknesses in its internal control over financial reporting." Cutera have since filed their 10K but its cause for concern.

Balance Sheet

There are problems with the financials of Cutera. Let's begin with the assets on the balance sheet.

It starts off in a straight-forward manner. $181m in cash and $42m in marketable investments – or about $223m in cash and equivalents.

The problem is when we hit the $53m in receivables and $69m in inventories. Firstly, both inventories and receivables are growing since year-end 2022 (by 8% and 15%, respectively). Never a positive sign for any analyst. Secondly, allowances for credit losses have also increased dramatically from about 6.5% to 9.4% - an increase of 45% in six months!

It's worth pointing out that inventories are stated at (roughly) FIFO – this means that under a period of inflation, profits are "maximised." For context, roughly 55% of the inventory is in raw materials, with about 40% in finished products. Eek!

Next we see $24.9m in "Other current assets and prepaid expenses." Thankfully, Note 5 to the financial statements explains them - $12m in deposits with vendors, $9.6m foreign tax receivable and prepayments of $3.3m.

Property and equipment stood at $65.5m, up from $40m at year-end 2022. More questionable accounting follows. $793k in leasehold improvements – no value. $2m in office equipment and furniture – you'd be lucky to get 30% back. $6m in machinery and equipment – let's be hopeful and say they can liquidate these assets for 50%. And then $26m in assets under construction. Huh?

From the 10K "materials used in the construction of the AviClear device have been classified as Assets under construction." So, not only are Cutera sitting on lots of inventory, not billing receivables efficiently, they're also spending cash on building more devices!

And then there's the issue with the $39m in AviClear devices. Sheesh. Except this line that makes the situation extremely odd (even more odd than it is already). "…the manufactured devices, including devices available for lease and devices placed in service, have been classified as AviClear devices." It's worth noting that these devices have useful lives of 7 years! To put this in perspective, office equipment usually has a useful life of 3 years.

I cannot work out the value of these devices. The conservative practice would be to write them down to zero. Let's do that.

The rest of the asset side of the balance sheet is a mess – goodwill, "other long-term assets" and a small, deferred tax asset. It's hopeless!

Ben Graham advises analysts to adjust assets and assume liabilities to be true. I'm happy to do this with the current liabilities and all but one of the long-term liabilities.

$418m of convertible notes! This is where the hope lies for the analyst. For context, the current market cap of Cutera is about $70m. Usually, investors dread convertible notes. Usually, it results in

the share price dramatically crashing and a death spiral often occurs as short sellers brutally attack the wounded share price.

In this case, the opposite will occur. The share price is so ridiculously low that if the company survives to see the conversion of the notes, the share price will actually increase! Basic mathematics will show you this – with a market cap of sub-$70m and $418m of convertible notes maturing at such high prices, the effect will be anti-dilutive. This unique situation is what drew me to buy shares initially.

As with many businesses I look at, Cutera runs a large accumulated deficit of close to $200m (a risky business from any financial standpoint) which means that book value is close to $(70)m. If Cutera goes bankrupt, shareholders get zilch. However, I don't think bankruptcy is likely to occur because of the large cash balances and lack of debt on the balance sheet.

Profitability and Cash Flows

As most of you will have figured, Cutera does not make a profit nor is it cash flow positive. These type of "fad" or "idea" companies are usually fantastic short ideas. In fact, if we were still in 2021 I'd probably be short Cutera. However, we're in late 2023 and the situation is very different.

The longer the company survives, the more chance the "buy-the-dippers" make a positive return on Cutera.

If we look at Cutera's last decade, it's been one of ups-and-downs:

$ in mm	Revenues	Gross Profit	Operating Profit	Net Income	OCF
2022	*252.4*	*139.8*	*-38.2*	*-82.3*	*-67.0*
2021	*231.3*	*133.1*	*1.8*	*2.1*	*1.2*
2020	*147.7*	*75.8*	*-22.8*	*-23.9*	*-16.9*
2019	*181.7*	*98.2*	*-12.1*	*-12.4*	*-2.2*
2018	*162.7*	*80.4*	*-13.4*	*-30.8*	*0.3*
2017	*151.5*	*86.1*	*11.1*	*30.0*	*14.3*
2016	*118.1*	*68.1*	*2.4*	*2.6*	*2.0*
2015	*94.8*	*54.3*	*-4.5*	*-4.4*	*-1.4*
2014	*78.1*	*43.4*	*-10.6*	*-10.6*	*-4.3*
2013	*74.5*	*41.9*	*-5.3*	*-4.7*	*3.5*

Revenues have increased impressively but margins have been consistently poor and this is shown by the lack of cash flow produced across the decade. I expect this trend to continue for the next few years – however, with Taylor Harris as CEO I expect losses to be leaner and cash flows to be more steady.

What you should keep any eye on is the cash burn of the company. So far, in the first half of 2023, cash balances have improved by roughly $35m, primarily due to proceeds coming from marketable investments. The truth is not so sweet, however – Cutera, in the first half of 2023, have had negative free cash flow of over $90m. This means that there is a large cost in maintaining business operations. Analyst should keep an eye on both figures. Cash burn and free cash flow (ex-SBC) are figures that are pretty hard to manipulate which makes them incredibly useful to an analyst's armoury.

Management

Taylor Harris (CEO) – Mr Harris was CFO of MyoKardia (2018-2020) before it was acquired by Bristol Myers Squibb. Prior to that, he was CFO of Zeltiq Aesthetics until that was acquired by Allergan PLC. Further, he was CFO of Thoratec Corporation which was acquired by St Jude Medical.

Mr Harris has also worked at JP Morgan Chase & Co for over a decade, including as a VP in the Healthcare Investment Banking department.

Clearly, Mr Harris is suited to this role at Cutera and well-abled to create value for shareholders. Ideally, shareholders would prefer for the convertible notes to mature and then an acquisition to take place. An acquisition at even two times the current market valuation may be a steal for the acquirer and a robbery of shareholders.

Jeffrey Jones (COO) – Mr Jones has served as VP of operations and Supply Chain for Sientra Inc. since 2019. Prior to that, he was VP of Quality and Commercial Operations at Earlens Corp from 2015-2019; as COO of Benvenue Medical from 2014-2015; as VP of Operations at Acclarent from 2009-2014; as COO of Reliant Technologies from 2004-2009, as COO of Lumend from 2001-2004; and as VP of Operations at EP Technologies from 1996-2001.

As Mr Harris only was chosen as CEO in the second half of 2023, there may be more additions to the management team. It is vitally important that Cutera have a fresh team with competency.

Brent Hauser (President, International) – In the last two weeks, Mr Hauser was made President, International, of Cutera and Mr Hauser will report directly to Mr Harris. Mr Hauser and Mr Harris have a relationship stemming from their time together at Zeltiq. Clearly, Mr Hauser is an able and competent business person for Mr Harris to call him back!

Perhaps it's more important to understand Mr Harris' vision for Cutera. He made some impressive statements earlier this year which I think should be thought about:

First and foremost, we must improve our product reliability and service levels, where we have seen a disappointing degradation in performance across the installed base of our capital systems…this dynamic occured concomitant with and may have been in part caused by the significant demand for and the production levels of AviClear.

Second, AviClear… we need to slow down, before we speed back up.

Mr Harris is absolutely correct. AviClear is a problem on the balance sheet and its one that any mediocre analyst will have spotted. The first problem is one I hadn't found in the financials but I'm glad that Mr Harris has brought it to light to both analysts and investors. Maintaining integrity from the outset, when dealing with a precarious position, is exactly what I like to see.

Board of Directors

Some analysts don't care to consider the board of directors for companies they look at. This is a foolish mistake. The board of directors are massively important to shareholders and are the shareholders' only line of defence. In an ideal world, management and the board of directors should hate each other. However, people love to take the easy option and don't like confrontation. Warren Buffett has written brilliantly on this topic in some of his historical letters.

About a week ago, Janet Widmann resigned from the board. Ms Widmann was a member of the Board since 2021 and became Chairman in April 2023. I find this to be very interesting given that she was made Chairman after the ex-CEO and ex-Chairman were terminated. Six months later, she's had enough? Something isn't quite adding up and perhaps this uncertainty is why there is so much short interest.

Greg Barett and Tim O'Shea are not nominated for re-election to the board. I find this interesting given that they have served on the board for such a long time (12 years and 19 years, respectively). What I really want to determine is whether it was their choice not to stand for re-election or whether Mr Harris asked them to not stand.

What I also find interesting is that three members of the board became directors in 2021 (including Janet Widmann who has now resigned) and four became directors in 2023. New directors are not an

issue given the situation explained in the “Recent History” section above. However, it’s the 2021 directors that concern me.

I think next year’s Proxy will be incredibly interesting and I urge any people following this company to read it. Right now, it does seem that the company is in “stall” mode but I’m confident in the new management. What I think you need to make sure is that the Board is completely independent of management and have no incentives to not act in the best interests of shareholders.

Setup

As you will have already read, Cutera’s share price is under large amounts of pressure. A market cap of sub $70m is ridiculously low. It’s worth noting that the average market cap between 2019 and 2022 was significantly above $500m.



This chart from stockcharts.com paints an interesting picture. Ever since the lawsuit was filed in May 2023, the share price has nosedived harder and faster. It’s also worth noting that short interest is closing on 5.5m shares or just under 30% of float! But unlike the share price, short interest has always been relatively high. For example, in November 2022, short interest was around 4.7m shares.

This high short interest could result in a rapid rise in the share price, if there are enough buyers in the market, as short sellers have to cover (I’m sure many of you will have heard of the GameStop saga where over 100% of float was shorted!). However, buying purely because of this setup would be a risky bet. The only reason I’m bringing it up is because alone with all of the other factors (new, experienced management and anti-dilutive convertible notes etc), it’s another reason to be bullish.

One of my favourite, most dear rules is never buy on new lows. Cutera is making new lows daily but, because I feel it is so detached from reality, I have not followed my rule in this rare case. There doesn't

seem to be any support and the technicals indicate more pain for shareholders. However, as I've explained, I'm not overly bothered.

My Final Thoughts

I think as Cutera consolidate their business and slow things down, cash flows will improve and the cash burn will be manageable. I don't see Cutera being profitable, nor do I see them ever being a "darling" company. These types of investments are for a certain type of people and I don't imagine many analysts will sing the praises of Cutera nor do I think many fund managers will want to dip their toes into such a revolting business.

This "toe-rage" of a business is an opportunity for those investors that are contrarian and those that favour the underdog. Once an ideal short, now becoming a favourable long, Cutera is a stock that has offered everything to everyone!

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