Overview

Lindblad Expeditions (NASDAQ: LIND) is an expedition cruise company, focused on small nature-oriented cruises, with 7 owned ships and 5 chartered ships. As the leader in this fragmented space, they had 2016 revenue of $242 million and a market cap of just $484 million. Having accessed public markets without the benefit of a traditional IPO, Lindblad is relatively overlooked for their size, but they have been rapidly growing and are well in middle of continuing their long-term growth plan. We believe that with their high growth and attractive underlying profitability, LIND should be valued at $20+ a share, rather than the present $10.74.

Adventure Travel vs. Regular Travel

Lindblad is a very different business from what comes to mind when you think of a cruise line. Standard cruise lines, such as Carnival or Norwegian, operate mega-ships that typically carry thousands of passengers. The size of the ships sharply limits their maneuverability and where they can dock. Their need to fill the mega-ships with passengers limits them to mass-market destinations and can lead to fierce competition on pricing. And since cruises are highly interchangeable, there is also intense competition on amenities, with each one attempting to outdo the next with over-the-top luxuries and on-board entertainment.

Lindblad, on the other hand, is offering a niche high-end experience, with travel to out-of-the-way inaccessible destinations, such as Antarctica, the Arctic, the Galápagos Islands, Alaska, and Baja California (off the coast of Mexico). With their small ships (ranging from 28-148 guest capacity), they are highly maneuverable and are able to bring their passengers up close to nature to really experience the exotic locations they visit. Lindblad's ships do not need to compete on over-the-top amenities and on-board entertainment. Instead, their ships are outfitted with fleets of Zodiacs (inflatable motorized boats to land ashore or get out onto the water and up close to, say, a whale), kayaks, underwater cameras, glass-bottomed boats, remotely operated vehicles, hydrophones (to listen to sea lions and other underwater marine creatures), scuba and snorkeling gear, etc. In addition, their flagship cruises include as many as 10-15 naturalists, researchers, historians, photographers, film crews, marine biologists, geologists, undersea specialists, and climatologists, and every cruise includes an on-board certified photo instructor.

The economics of the businesses differ vastly as well. Lindblad's itineraries average 9.6 days and $11,000 per person, compared to 7.3 days and about $1,800 per person for standard cruises. This premium pricing power gives Lindblad industry leading net yields of $976, compared to about $150-$250 for standard cruise lines. (Net yield measures net revenue divided by available guest nights. Net yield is affected by both pricing and occupancy.)

Standard cruise lines have to update their fleet of mega-ships on a steady basis, with a new ship costing in the $600-$700 million range on average. Lindblad, on the other hand, is competing based on the beauty of the outdoors, which they get for free, and has shown itself perfectly capable of commanding their premium prices even on fifty-year old ships (although they do have to spruce them up every now and then). The cost for a new ship for Lindblad is only $50-$150 million, depending on the size. This combination of less expensive, longer-lasting ships and premium pricing overcomes the small scale of their ships (maximum of 148 passengers, compared to an average of 3,000 passengers for standard cruise ships and up to 5,000+ for the largest ships) to give them an enviable ROIC (Return on re-Invested Capital) in the neighborhood of

20%. This compares quite favorably to the ROIC of standard cruise lines, which struggle to reach double digits.

Lindblad has an exclusive partnership with National Geographic to co-brand and co-market Lindblad's ships, and their ships include National Geographic researchers and photographers. The value for Lindblad in this exclusive partnership is difficult to overestimate. National Geographic's stamp of approval is highly trusted, and National Geographic is a naturally aligned partner, providing a low-cost avenue to reach the demographic that is most enthusiastic about Lindblad's offerings. Direct sales by Lindblad (mostly direct mailings and inbound requests through their website and telephone hotline) make up 39% of their sales and National Geographic brings in another 27%, for an impressive total of 66% of sales bypassing travel agents. National Geographic has renewed their partnership a number of times, with the latest renewal through 2025, and has an option to purchase a 5% equity stake in Lindblad from the CEO. National Geographic is highly invested in the success of the venture, and receives a commission on the portion of the business that they bring in directly as well as a royalty on most other net revenues, which combine to contribute upwards of $10 million annually to the continuation of National Geographic's mission.

Lindblad's trips appeal to an older, wealthier demographic, who crave and can afford such experiences, with the average age of their clientele being 57. This older demographic is the fastest growing demographic in the US and worldwide. And their wealthier clientele also gives Lindblad some downside protection in an economic downturn, compared to mass market cruise lines. Indeed, Lindblad's top line withstood the last recession relatively well, with revenue in 2009 down only about 10%. Although every demographic can be expected to spend less in a recession, the higher end demographic that Lindblad serves generally suffers less, and Lindblad is well-capitalized to weather any such storm.

Growth – Past and Future

The history of Lindblad Expeditions begins with Lars-Eric Lindblad who founded the adventure travel market with his pioneering tourist expedition to Antarctica in 1966, followed by his leading the first tourist expedition to the Galápagos in 1967. In 1969, Lars-Eric commissioned the first purpose-built expedition ship for adventure travel, and he continued to lead travelers to new and exotic destinations throughout his career.

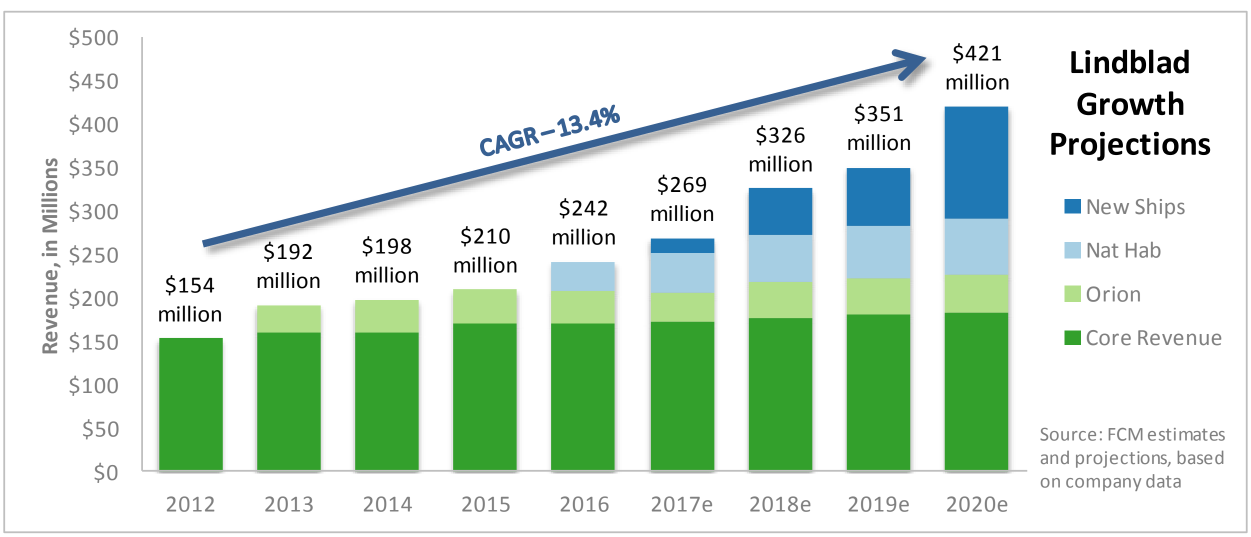
His son, Sven-Olof Lindblad, following in his father's footsteps, founded Lindblad Expeditions in 1979 and continues to lead the company today as CEO with a personal stake of 30% of outstanding shares. Over the years, Sven grew Lindblad Expeditions with ship purchases, ship builds, and ship charters and began partnering with National Geographic in 2004. By 2012, Lindblad had grown to a total of 5 owned ships and 4 chartered ships with revenue of $154 million.

In 2013, Lindblad purchased Orion Expedition Cruises, which consisted of a blue-water expedition vessel, renamed the National Geographic Orion, and its surrounding business, which was focused at the time on the Australian market. The Orion purchase cost a net of about $36 million (netting cash acquired, and accounting for the cost to fulfill existing book and renovate ship) and added about $38 million in annual revenue (24.5% growth) at a very attractive price. While Lindblad never disclosed net margins for the Orion by itself, based on definitive figures buried deep in SEC filings, we calculate that the Orion has a net margin of about 12.4%, using conservative assumptions. This is in-line with the rest of Lindblad's business, which is a useful sanity check. This also dovetails with management's disclosure that the Orion added about $8-$9 million of annual EBITDA, with significantly more anticipated in years ahead. Bottom line, Lindblad purchased the Orion income stream for a P/E of about 7.6, a highly attractive price.

At this point, with Lindblad operating their ships at full capacity, they chose to access new sources of capital through the public debt and equity markets. With this new growth capital, they intend to take the company to the next level through new ship builds as well as targeted acquisitions. Instead of a standard IPO, Lindblad chose to merge with a SPAC (Special Purpose Acquisition Corporation, essentially a public shell company that raises cash with the express purpose of buying an attractive enterprise). Not going through the standard IPO and roadshow process with the accompanying big bank sponsorship, although cheaper, no doubt contributes to Lindblad remaining relatively underfollowed for its size even today.

Lindblad began life as a public company in July 2015, with $194 million in cash and $175 million in long-term debt, due in 2021. This gave the company a strong balance sheet to pursue growth, with both its cash on hand and its ongoing free cash flow. Concurrent with going public, Lindblad laid out their growth plan of building brand-new expedition ships, purpose-built for their needs, with plans for a 100-person coastal vessel for mid-2017, another 100-person coastal vessel for mid-2018, and a 170-person blue-water ocean vessel for mid-2019. The first two coastal vessels were estimated to cost $40-$45 million and the latter blue-water ocean vessel was estimated at $130-135 million. In addition, they stated an openness to the right acquisition at the right price.

Since going public, Lindblad has begun executing on their growth plans. In May 2016, Lindblad acquired Nat Hab, which is to land what Lindblad is to water. Nat Hab specializes in land adventure expeditions, such as Northern Canada polar bear excursions, Alaskan grizzly bears tours, small-group Galápagos tours, and African safaris. Their demographics and economics (average age 57, small groups averaging 8-9 people, trips averaging 9.6 days and $8,500, direct sales of 86%) are very similar to Lindblad's. Nat Hab, too, has an exclusive partnership with the World Wildlife Fund, which has been extended through 2023. Lindblad paid a net of $16 million for 80% of Nat Hab, with the founder retaining 20% ownership and staying on to run Nat Hab as a separate subsidiary. Nat Hab had total 2016 revenue of $46.7 million and net economic earnings of $3.7 million, of which 80% accrues to Lindblad. That equates to paying an estimated P/E of about 5.4 for a profitable, rapidly growing (CAGR of 25% over the past 4 years), highly complementary business that added 22% growth to Lindblad's top line.



In regards to their new ship build program, they have also executed well and are on-target, with their first new vessel, the National Geographic Quest, having launched successfully on July 29, 2017, and their next vessel, the National Geographic Venture, in-line for a mid-2018 launch. Importantly, even as they have added the NG Quest and NG Venture to their Alaska itineraries and have seen extraordinarily strong demand for these brand-new ships, their present ships operating in the same areas and elsewhere have not seen any degradation in their bookings, reinforcing the company's core thesis that the demand is there to fill an increase in supply.

Also in 2017, Lindblad added a new charter ship to the newly opened market of Cuba. The NG Quest and Cuba combined add 14.8% to their revenue capacity. In 2018, they are on schedule to launch the NG Venture, adding 11.4% to their revenue capacity. And in 2019, they are on schedule to launch a new blue-water vessel. At 170 passengers, this would add about 17.4% to their revenue capacity.

Cruising has seen steady growth for decades. The niche of adventure travel, and particularly adventure cruises, has been seeing even greater growth, and is sharply supply-constrained. As one data point, the number of visitors to Antarctica over the last five years has grown by an annual rate of 11.3%, according to comprehensive statistics from the International Association of Antarctica Tour Operators. In this space, Lindblad Expeditions is the leader both in size and brand recognition, with a powerful boost from their National Geographic partnership. They are on a steady path of continued profitable growth, with high returns on capital employed.

Lindblad's balance sheet is strong. As of June 30, 2017, Lindblad has about $175 million in long-term debt due in 2020, at a rate of LIBOR + 4.5% (presently under 6%). At the same time, cash on the balance sheet remains high at $121 million. The business throws off good free cash flow, and we expect that they will be able to fund their current new ship build plan solely out of ongoing free cash flow. After all the planned spending for growth, Lindblad will remain in a similar balance sheet position to their present state and will be able to invest in additional new ships and acquisitions for many more years of profitable growth.

The adventure travel segment that Lindblad competes in is very fragmented, full of small, sub-size players, lacking economies of scale and operating leverage. It is ripe for consolidation, and Lindblad is eager to purchase ships or businesses that fit into the profile they're looking for, at an attractive price. With their strong balance sheet, they are able to pursue attractive acquisitions, on top of their organic growth plan. Normally, we are wary of companies who pursue acquisitions as a means to grow, as they usually overpay and focus more on expanding management's fiefdom than improving shareholder value. Lindblad, however, has a management that is highly aligned with shareholder interests, with the board and CEO owning more than 36% of company shares. And crucially, we believe that their purchase history with Orion and Nat Hab demonstrates that they can be trusted to not overpay.

ROIC

When investing in a capex-heavy company that is reinvesting capital to grow, it is of utmost importance to be certain that the growth the company is spending money on is profitable growth. And not just mildly profitable, but profitable enough to indeed be a wise use of the money. The measure of this is ROE (Return On Equity) or ROIC (Return On re-Invested Capital). In the very long term, return on a stock investment will by definition converge with the ROE. (Interestingly, studies show that although high-growth and low-growth companies tend to regress to the mean relatively rapidly, companies with high ROE tend to have elevated ROE for decades. This is because high initial ROE is generally due to structural advantages in the business model.) Management has projected ROIC to be 17-23% for each new ship, depending on the type of vessel. Given how crucial this figure is, it is important to cross-check management projections through a variety of methods.

First, we calculate the ROIC for their purchase of Orion. According to SEC filings, their purchase of Orion in April 2013 added $31.8 million in tour revenue for the year as well as an additional $6 million of tour revenue in 2014, the first full year. Although they purchased Orion with existing business already booked, we can reasonably assume that Orion will match company-wide gross margins of 50% going forward, for a gross profit of $18.9 million. Additional expenses included close to $3 million in annual depreciation and stable administrative expenses. We should also allocate a proportional amount of the selling and marketing costs, or $5.9 million, and assume a marginal tax rate of 5% (this number is conservative; cruise ships are tax-advantaged and generally pay virtually no taxes). Running the math, we calculate an increase in annual post-tax operating income of $9.5 million on the $36 million purchase price (including the cost to fulfill the existing book and renovate the ship), or a hefty 26.7% ROIC. This is higher than we would assume going forward, primarily because they bought Orion cheaply in a distressed sale.

Second, we look at their cost to replace the aging National Geographic Endeavour with the National Geographic Endeavour II in 2015. This was maintenance capex, not growth capex, and is similar in scale to the depreciation charges taken over the years, as one would expect to see. The purchase and renovation of the NG Endeavour II cost $33.4 million. Based on their gross yield of $1,142 and the ship producing revenue about 11 months each year, we calculate that the NG Endeavour II brings in about $32.7 million in annual revenue, with a proportionate amount of operating expenses. This equates to a ROIC of 7.7%. However, it is important to note that a similar ship that would be *added* to the fleet as growth capex would have significantly higher ROIC. Although cost of tours, depreciation, and selling & marketing expenses track revenue closely, there would be significant operating leverage in general & administrative expenses. Our calculations show that a similar ship at similar cost as growth capex would have at least 18% ROIC.

Third, we look at the National Geographic Quest. The NG Quest cost a total of $51.6 million. Because its launch from the shipyard was delayed for a month and Lindblad disclosed how much revenue was thereby lost, we are able to estimate annual revenue for the NG Quest as at least $34 million. Assuming gross margins of 55% on these more expensive itineraries (company-wide average is 50%), and proportional expenses with some operating leverage on the general & administrative portion, we calculate a ROIC of 16.1%.

Fourth, as a final check on our math, we look at the company wide return on fixed assets. In 2016, total fixed assets (adding depreciation back in) was about $207 million and normalized net income for the cruise segment (adding depreciation, non-economic amortization, and interest expense back in, net of tax benefits) was $33.2 million, equating to a return on assets of 16.0%.

We believe that Lindblad is at an inflection point, where they can generate significantly more revenue at the present level of overhead, taking advantage of increasing economies of scale. Taking all the data into account, we estimate that management projections of 17%+ ROIC on future re-investments are indeed reasonable. We consider any sustained ROIC above 15% to be good, and as previously mentioned, this compares well to mass-market cruise lines with ROIC of at most around 10%. Of course, with reasonable use of debt, ROE will be even higher.

Capital Structure and Valuation

One of the reasons that LIND is relatively overlooked is the way it came to market. Instead of a traditional IPO, it went public in July 2015 through being purchased by a SPAC (Special Purpose Acquisition Corporation), a blank check public company that raises cash to purchase an attractive enterprise, usually private companies, thereby taking them public. This back-door access to the public markets has some advantages, but doesn't bring the publicity and analyst coverage that the traditional IPO process generates. SPACs are notorious for overvaluing companies, but there are also many gems in the rough.

The SPAC process left LIND with an overhang of 15 million warrants with an exercise price of $11.50, exercisable until August 2020. Lindblad has been buying back warrants (and shares) over time, and as of June 30, 2017, there are 45,066,058 shares and 10,673,015 warrants outstanding. Although at present the warrants are anti-dilutive, it is still important to take them into account to reach a proper assessment of Lindblad's potential value, since the warrants will become immediately relevant if the stock price rises moderately.

The income statement is complex for such a small company, but we calculate that they have a present (post-Quest) annual run rate of $27.7 million in net income, and even more than that in free cash flow. Even at $20 a share (and accounting for the warrants on a net basis), this would value the company at a P/E of less than 36, which is not high at all for a highly profitable, fast growing company. At $15 a share, the P/E would be 25.7. At the present price of $10.74, and even if we count *all* the "phantom" shares, the P/E is still just 21.6. In actual reality, Lindblad is likely to continue to buy back warrants at present prices, eliminating much of this unwanted dilution.

Risks

There are a few main risks to the investment, none of which we estimate as insurmountable. The first risk is that of a serious marine accident by one of their ships. Although damaging to their reputation and certainly hurting their bottom line, we do believe that Lindblad is a strong enough company to recover from such an event if it were to occur. Insurance would cover some level of damages and Lindblad would have to cover the loss of revenue through continued growth. All in all, we estimate this to be unlikely to occur and recoverable even if it does.

Another risk, which will inevitably happen in the near or far future, is an economic downturn or recession. Lindblad will certainly be affected short-term by an economic downturn, but we estimate that they would be affected less than many may fear. Their performance in the last deep recession showed a remarkable resilience to the overall economic environment, and their supply-constrained business (in particular the niche of expensive expedition cruises) can manage some slack in demand without much harm, due to the present imbalance of supply and demand. We estimate that Lindblad will remain profitable throughout the business cycle, and their long-term prospects will remain unaffected. Indeed, to the extent that smaller sub-scale competitors would face financial hardship, Lindblad would possibly be able to take advantage to further grow their business through acquisitions at attractive prices.

Another risk would be poor execution or random ship breakdowns. Due to their relatively small size and lumpiness of revenues, a necessary ship repair can cause a significant temporary downturn in one quarter or year. Indeed, such happened in the first half of 2017, when a total of 10 (!) voyages were cancelled due to three unrelated mishaps. Although execution is definitely something we need to pay attention to as the company grows, in our estimation the 2017 confluence of events was not indicative of underlying management or fleet issues, and we give greater weight to the years of prior successful management under the same leadership. So although there may be temporary depressions in revenues and income, we expect the overall track to be upwards for the coming years.

The final risk, and in our opinion the most important, is the risk of overbuilding new capacity. At present, Lindblad and the rest of their industry niche are in severe under-supply of capacity, and the present ship building plans do not appear to be in danger of upsetting that imbalance. However, it is common for industries which were once in over-demand to aggressively build new supply only to end up with over-supply, with unfortunate effects for the economics of the entire industry. Although this is something we do not see a danger of in the near future, it is something we need to keep an eye on. This is one major reason why we would favor growth through acquisition and consolidation, *if* it can be had for the right price, such as Orion and Nat Hab.

Conclusion

The niche of adventure travel, and particularly adventure cruises, has been seeing strong growth, and is sharply supply-constrained. In this space, Lindblad Expeditions is the leader both in size and brand recognition, with a powerful boost from their National Geographic partnership. Their size and strong balance sheet positions them favorably for both organic growth and to consolidate this fragmented industry, which has a number of sub-size players lacking economies of scale and operating leverage.

Lindblad has a proven model for success and a well-laid out plan for expansion. Their diligent execution of their plan coupled with judicious acquisitions have put them on a steady path of continued profitable growth, with high returns on capital employed.

Despite all this, Lindblad Expeditions remain relatively underfollowed with virtually no mainstream analyst coverage. We believe that LIND is undervalued, with a favorable risk/reward profile. We first invested in June 2015, and we have recently begun adding to our position in the company, buying LIND for under $11. There is a case to be made to invest in the long-term warrants (LINDW) expiring in 2020, but the risk is sharply higher (with the distinct possibility of expiring worthless), and we intend for the majority of the fund's investment in Lindblad to be through the common stock.