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SIZING UP SMALL CAPS

Manna From Texas

By RHONDA BRAMMER

IN TEXAS, EVEN SMALL-CAPS have 10-gallon ambitions. A case very much in point: **Mannatech**. A relatively new company that went public six years ago, it operates in a kind of tributary -- backwater might be even more apt -- of the health-care industry. Yet while it may be obscure -- not a single analyst follows it -- the company boasts a solid balance sheet and soaring earnings, enjoys high returns on capital and throws off slugs of cash. Lucky shareholders certainly have no complaint: Its stock has rocketed from under \$2 in 2003 to a recent high of \$26. At Friday's close of \$20 and change, the company sports a stock-market value of \$550 million.

Already growing at a blistering pace -- sales last year hit \$295 million, up from \$191 million the year before and \$141 million in '02 -- the company, from its base in Coppell, Texas, is busily stepping up expansion of its budding empire, not only in the U.S., but in foreign markets, as well. Some 35% of revenues last year came from operations in Australia, Japan, Canada, New Zealand and the U.K. In September, Mannatech branched out into Korea, and it will enter Taiwan next month.

The fuel for Mannatech's explosive growth is no high-tech breakthrough or merchandising innovation, but, rather, a line of nutritional supplements, called glyconutrients. These supplements supply carbohydrates, or sugars, the company claims are necessary for optimal health and not found in adequate amounts in modern diets. Mannatech also offers skin-care and weight-management products.



Most Mannatech products include Ambrotose Complex.

Last year Mannatech earned \$19.6 million, or 71 cents a share, more than twice the 34 cents it netted in 2003. Book value weighs in at only about \$2 a share, but some \$1.60 of it is cash, and the company has barely a speck of long-term debt.

Because Mannatech outsources the manufacturing of its supplements, it can sharply boost sales with little or no investment simply by adding more sales people, virtually all of them independent contractors. Which is why it enjoys truly outsize returns on capital: In 2004, return on equity came in at a formidable 44%.

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But for all the surface flash, eye-popping financials and grand plans, Mannatech's allure steadily dims the more intensely one scrutinizes its provenance and how it makes its living.

More specifically, our skepticism grew as we examined the company's multilevel marketing structure, reviewed some of the extravagant claims of its sales people both here and abroad, and perused the complaints of the Texas attorney general's office about an earlier venture of Mannatech's chief exec, Samuel Caster.

A lot of the concerns sparked by our research into the company and its affairs find dramatic expression in a civil suit, filed in Los Angeles Superior Court, charging Mannatech and Caster with, among other things, "negligent misrepresentation" and "conspiracy to commit fraud." The company, let us hasten to add, denies all the allegations in that case and avers it deals severely with any misconduct by its sales associates.

Mannatech went public in February 1999 at \$8. In the first days of trading, the stock ran wild, hitting an intraday high of \$44.50. From there on, however, it was virtually all downhill. By May '01, shares were trading under \$1, and for the next two years, they never got above \$4 and change.

From the get-go, Mannatech's strategy has been two-pronged: to develop a proprietary line of supplements and a multilevel marketing organization to sell them. The hallmark of its multilevel marketing is that salespeople, called "associates," earn money not only by selling supplements, but also by recruiting other associates to sell supplements, who, in turn, are encouraged to recruit still more salespeople. In this fashion, the original associate builds what is called a downline network and, importantly, gets a financial cut from not only his own sales, but the sales of his entire network.

This is not Caster's first multilevel marketing venture. In the late 1980s, he headed up just such an enterprise, Eagle Shield, that was the source of run-ins with the consumer-protection division of the Texas attorney general's office.

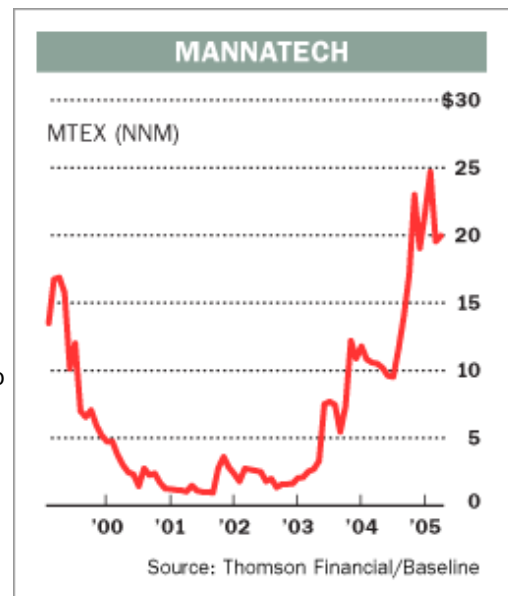
Eagle Shield's initial product -- based, the company claimed, on a new technology invented by the National Aeronautics and Space Administration -- was insulation for homes that bore the label Radiant Barrier and could, the company boasted, slash a consumer's utility bills by 18% to 40%.

In sharp disagreement, the attorney general's office maintained that the technology long predated NASA -- in fact, had been around since the 1940s -- and didn't work as advertised. In August 1988, Eagle Shield and Caster agreed, without admitting or denying wrongdoing, to a permanent injunction requiring them to prominently disclose they had no ties to NASA and to not claim Radiant Barrier cut utility bills by more than 3% to 8%.

In January 1991, the Texas AG's office was again stirred to action. This time the focus of its displeasure was the ElectroCat, a device that emitted "pulsed" vibrations and could, according to the company, rid farms and homes "of roaches, spiders, crickets, fleas, ticks, ants, mice, rats, gophers, moles, snakes and scorpions."

Baloney, said the attorney general's office, noting that the ElectroCat emitted "no measurable vibrations, pulsed or otherwise," and had no measurable effect on mice or bugs. "The device is a hoax," the AG declared, "and stands on the same scientific footing as a perpetual motion machine."

On Jan. 24, 1991, Caster and his multilevel marketing company agreed to the entry of a judgment against them and admitted that the ElectroCat, flat out, didn't work.



Asked about his difficulties with the Texas attorney general, Caster is philosophical. "It taught us how to appropriately validate claims," he responds. "It was a very good lesson in life."

Undaunted, Caster tried again and hit it big with Mannatech. Not the least of reasons for its success is that a whopping amount of Mannatech's business gets done over the Internet. Associates can both sell supplements and sign up recruits on-line. Going into biz takes nothing more than a home computer on the kitchen table. Importantly, Mannatech helps associates design Websites and offers to ship supplements directly to customers, all the while keeping track of an associate's commissions. What's more, an associate can monitor his whole downline network -- see who's drumming up business and who's not -- via computer.

The company's stock-in-trade supplements, often referred to by associates simply as glyconutrients, are based on something called Ambrotose Complex. Ambrotose is a proprietary blend of Manapol, a substance derived from the aloe vera plant, and other glyconutrients, which Mannatech contends support the immune system, the endocrine system and cell-to-cell communication. Ambrotose Complex is a key component in all but one of Mannatech's line of 30 products.

The ingredients in Ambrotose Complex are arabinogalactan (*larix decidua* gum), gum ghatti, gum tragacanth and, notably, Manapol aloe vera gel extract (inner-leaf gel).

The last-named ingredient, Manapol, is sold exclusively by Irving, Texas-based Carrington Labs (CARN), a company whose research for more than two decades has focused on the aloe vera plant. During that long span, as *Barron's* readers may well recall, Carrington has touted its aloe-based drugs as a cure for everything from cancer and AIDS to ulcerative colitis.

The gyrations in Carrington's stock have been spectacular -- in 1989-90, it bounced from \$12 to \$41 to \$4; in '96, from \$30 to \$50 to \$7. But, alas, Carrington's drugs, for all they induced bouts of speculative fever, were total duds as a treatment for AIDS, cancer or even colitis.

In only two of the past 10 years has Carrington been even marginally profitable. Its shares now fetch about \$4, and arguably its most successful product is the aloe-based Manapol it supplies to Mannatech, which last year chipped in 47% of Carrington's sales.

"SHORTLY AFTER BEING MARRIED, JACLYN WAS FACED WITH THE GREATEST CHALLENGE OF HER LIFE. THE excitement of being a newlywed was soon drowned out by the confinement to a wheelchair. Jaclyn's MS had beaten her, at least for the time being. A friend introduced her to Glyconutrients, so Jaclyn agreed to give them a try...within two weeks she was walking again. Truly a miracle!"

— From a Mannatech associates's Website

The Carrington connection, however, goes beyond that of buyer-supplier. Some of Carrington's key scientists and execs have signed

on with Mannatech and reaped very handsome rewards.

Eileen Vennum, who from 1988 to '96 was Carrington's director of regulatory affairs, is today a senior vice president of R&D at Mannatech. Bill McAnalley, who from '87 to '95 was a V.P. of R&D at Carrington, is today Mannatech's chief science officer.

Reginald McDaniel, who as a consultant did studies on aloe-based compounds for Carrington, served as Mannatech's medical director from '96 to '02. After Mannatech's IPO, he owned more than 500,000 shares, which today would be worth \$10 million.

Last December, when Mannatech shares were trading around \$20, McDaniel -- no longer on the payroll -- was allowed to buy 180,000 shares directly from chief exec Sam Caster at \$2.66 a share. On paper, it was a tidy \$3 million bequest. The sale, says Caster, was to enable McDaniel to "pursue his ongoing passion for the research of glyconutrients."

An upbeat Texan with a bit of drawl, the 54-year-old Caster credits McAnalley and McDaniel with having "pioneered the science of glycomics."

"Glyco" is the Greek word for sugar, he explains, not the sweet kind, sucrose, but rather sugars that come from plants, like mannose from the aloe vera. With its "significant patents," Mannatech is on the forefront of a "brand new area of nutrition," Caster insists. But while Mannatech does have some foreign patents, in the U.S., according to the 10-K, it "continues to face the risk of its patent protection for Ambrotose complex being ultimately denied."

Unlike Carrington, which wanted to market its products as drugs and suffered devastating rebuffs by the Food and Drug Administration, Mannatech is selling Ambrotose only as a food supplement and so needs no blessing from regulators. However, the company is strictly prohibited from claiming Ambrotose "treats" or "cures" anything. Moreover, the Federal Trade Commission requires Mannatech to have "adequate substantiation" for its claims, meaning they must be based on "competent and reliable scientific evidence."

Associates receive clear guidelines about what they can claim, Caster asserts, and the company disciplines or dismisses those who break the rules.

Yet even the most cursory visit to the Websites of Mannatech associates reveals that these sites are replete with the most astonishing of claims. For example, one such Website, with no readily visible disclaimer, tells with graphic visuals and somewhat primitive prose the remarkable story of Jaelyn, a young woman suffering from multiple sclerosis. She is shown first sitting in a wheelchair and then, in a second photo, working out on a treadmill.

The text accompanying those starkly contrasting photos reads: "Shortly after being married, Jaelyn was faced with the greatest challenge of her life. The excitement of being a newlywed was soon drowned out by the confinement to a wheelchair....A friend introduced her to glyconutrients....To everyone's amazement, Jaelyn became the fastest response to glyconutrients of anyone who has tried them with MS. The restoration of health usually takes several months with such a debilitating condition. For Jaelyn, within two weeks she was walking again."

Or jump to another Website and learn about Rikkea, born with cerebral palsy. The pitch comes presumably from her parents: "Our six-year-old daughter Rikkea could not walk or speak at the age of two due to brain damage caused by cerebral palsy....She was having seizures, constant drooling from the mouth....We were introduced to and gave her two capsules of glyconutrients a day in December 1998. After only one week, she got up and walked around the house!! She soon began speaking clearly in sentences too!!"

Close inspection of this site turns up a disclaimer, in small print, to the effect that the statements made have not been evaluated by the FDA and that Mannatech products are dietary supplements not intended to treat disease. But perhaps worth noting, this demur comes after pages and pages of testimonials about the remarkable effects of glyconutrients on a vast array of diseases, including arthritis, hepatitis, brain cancer, diabetes, subglottic hemangioma, prostate cancer and toxic-shock syndrome.

Here, as on a good many other associates' sites, people also can get info on the "amazing opportunity" to sell Mannatech's supplements. Such sites do double duty, by both selling the products and also recruiting foot soldiers for Mannatech's sales force.

The promotional spiel on this associate's site begins: "Think about this. If there is a product that could benefit every person on earth, is scientifically validated, is new, is essential like vitamins, is patented, and is only available from ONE company that has an upward business growth compared to that of Microsoft,

that equates to a very significant opportunity." Bill Gates, are you listening?

In spite of flagrant flouting of the rules by salespeople, Mannatech maintains that it complies with applicable laws and regulations. Caster makes a sharp distinction between the company and its associates, conceding that from time to time the latter may make improper claims. "We're enforcing our policies," he insists, "but there's only so much we can do."

The seemingly irrepressible inclination of some Mannatech associates to make extraordinary therapeutic claims for the supplements has irked some foreign regulators. In New Zealand, the Medical Devices Safety Authority notified Mannatech that its salespeople were making unwarranted claims after newspaper articles in early 2003 described how Stephen Nugent, a Mannatech employee with Ph.D.s in psychology and "naturopathic medicine," had extolled the virtues of the supplements before packed crowds in several cities.

Speaking to some 500 people in an Auckland ballroom, Nugent is reported to have referred repeatedly to breast and child cancer, cited medical studies supporting the company's theories and implied he could be more specific except for fear of running afoul of the government and its regulatory bodies

In addition, the New Zealand Press Association reported that Mannatech associates were allegedly claiming the supplements could treat HIV, cancer, cystic fibrosis, arthritis and Down syndrome.

Mannatech addressed the complaints from the New Zealand Medical Devices Safety Authority through its in-house "disciplinary procedure" and, as of last June, according to the 10-K, had satisfied the regulators.

In Australia, the Therapeutic Goods Administration continues to monitor the company and has required Mannatech to provide "compliance training" for associates for the next three years.

Symptomatic of what may have prompted such oversight were some dubious practices by a Mannatech associate, whose medical license was cancelled for two years in 2000 by the Australian Health Practitioner's Tribunal. According to the tribunal's report of its disciplinary action, the doctor, Ian Raddatz, who together with his wife had a sideline business selling Mannatech products, had told patients that the supplements could treat infertility, brain damage and cancer; had urged patients to use Mannatech supplements instead of their prescribed medications, and had tried to recruit a cancer patient's daughter as an associate, telling her: "These wonderful pills will...work wonders on your mother's cancer."

Even more egregious are the allegations at the heart of a lawsuit filed Nov. 1, 2004, in a Los Angeles Superior Court by Chie Sasaki, mother of a child with Tay-Sachs disease. She accuses a Mannatech associate, Caster and Mannatech itself of, among other things, intentional infliction of emotional distress, negligent misrepresentation and conspiracy to commit fraud.

The charges stem from the alleged actions of a Mannatech associate and Sherman Oaks chiropractor, Victoria Arcadi, who treated Sasaki's son, Yasuhiro, after he was diagnosed with Tay-Sachs, a fatal ailment most common among Ashkenazi Jews. Arcadi has denied all the charges against her.

According to court papers, after an initial chiropractic exam in September 1996, Arcadi recommended that Sasaki's son, then three years and nine months old, be given Mannatech supplements. His mother added them to a complicated diet she was already feeding him based on a high-calorie soy-based formula. By being fed nine times a day, the boy managed to gain several pounds.

His mother subsequently gave Arcadi pictures of the boy to show his weight gain, solely for the purpose of his treatment and expecting them to be kept confidential. Yet without oral or written consent, the complaint continues, in May 1997 Arcadi showed photographs of a naked Yasuhiro to several hundred people at a Mannatech demonstration seminar.

A month later, when Yasuhiro's mother discovered her son's photos were being widely used at Mannatech

sales meetings, she fired off a letter of protest directly to Samuel Caster, then Mannatech's president. According to the complaint, Mannatech and Caster denied responsibility.

In July 1997, the complaint continues, Yasuhiro's mother protested, on three separate occasions, to Arcadi, who, promised to protect Yasuhiro's privacy but did not return the photographs as requested.

A month later, Arcadi co-authored an article entitled "Case Study: Tay-Sachs Disease Improvement During Nutritional Supplementation" in the Journal of the American Nutraceutical Association, featuring Yasuhiro Sasaki and describing his dramatic improvement taking Mannatech supplements. Thanks apparently to the supplements, the authors reported, "the child is interacting with his environment and exhibiting physical and vocal communication."

Yet, according to the complaint, when the article was published in August 1997, Yasuhiro Sasaki was already dead.

After his death, his mother again demanded Mannatech, Caster and Arcadi stop using her son's likeness and story in marketing Mannatech products, and, according to the complaint, she was led to believe the objectionable distribution would stop.

But years later -- in March 2004, to be precise -- she received an e-mail from a woman in Mexico whose nephew was afflicted with Tay-Sachs. The woman had seen photographs depicting Yasuhiro's purported improvement using Mannatech products on a current Website, "with the clear inference," according to the complaint, "that Yasuhiro was alive and doing well some seven years after his actual death."

Caster adamantly denies that he or Mannatech had anything to do with distributing Yasuhiro's story or his photographs. "As a company, we never used the pictures," he stresses. But he concedes that some associates might still be using Yasuhiro's story and photos. "Once they get out there," he observes, "it's impossible to get them back."

So far, anyway, neither regulatory disapproval abroad nor wildly hyperbolic claims by associates on their Websites here have dampened the ardor of Mannatech users and associates (who often overlap) or slowed the company's vigorous growth.

And shareholders, as noted, have little reason to be displeased. Especially those shareholders who happen to be insiders. In the past 12 months, seven Mannatech insiders have sold more than 900,000 shares worth \$18 million.

Two of the biggest sellers were Eileen Venum and Bill McAnalley. Specifically, in just the past six months, Venum sold over 85,000 shares worth more than \$1.8 million; McAnalley sold 259,000 shares worth a cool \$5.5 million.

Venum is senior vice president of R&D at Mannatech. McAnalley is chief science officer, the company's R&D honcho. They are, pure and simple, Mannatech's top scientists, both named as inventors on a U.S. patent that is pending for Ambrotose Complex.

Nothing amiss in their selling stock, of course. But to a cynical eye, that they have sold in such quantity could easily be taken as hedging their bets.

E-mail comments to editors@barrons.com¹

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