August 30, 2019

Value Investor INSIGHT

The Leading Authority on Value Investing

Interesting Times

Successful investors usually distinguish themselves in difficult markets. Here's how five top managers are investing at a time when caution may be warranted.

While it turns out it isn't the ancient Chinese curse it was purported to be, the phrase "May you live in interesting times" does seem like a rather appropriate proverb for today's investing environment. The U.S. equity bull market is in its 11th year, interest rates globally are at historic lows, trade disputes are increasing in intensity, and tweets can move markets.

Given that backdrop, for this special report we call on a diverse set of investors – activist investors Christopher Kiper of Legion Partners and Glenn Welling of Engaged Capital, growth manager Dan Davidowitz of Polen Capital, and Chinese market experts Sean Huang and Adam Schwartz of the FM First China Fund – to describe how they're navigating today's rough investing seas to uncover mispriced opportunities.

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INVESTOR INSIGHT

Christopher Kiper
Legion Partners

"We're seeing what seem to be more dramatic short-term reactions to companies with bad news and that miss numbers."

Does whether we're at a late or early stage in a market cycle have much impact on your ability to find good activist investment ideas?

Chris Kiper: It really doesn't. There never seems to be a lack of companies that are underperforming for one reason or another and could benefit from activist intervention. A typical situation for us would be a company with a market cap between $250 million and $5 billion that has seen its stock decline by 50% or more over the prior 12 months for reasons we believe are fixable and where we believe our involvement can help. That's been as likely to occur when the market is high as when the market is low.

Our opportunities typically involve companies going through a transition. Everyone can screen for stocks that are cheap on headline numbers, but what's less visible to the algorithms is when a traditional business is just starting to give way to a new one, or a business model is changing for the better, or an acquisition is finally starting to pay off. You have to read the 10-Ks and proxy statements, dig through the investor presentations, and talk to management, competitors and experts in the industry to really understand what's happening. That continues to be our prime fishing ground and, again, it seems as well-stocked with ideas as ever.

It should be a positive for our business if investors increasingly conclude that equity markets are poised to not go up very much over the next several years. One family office we spoke with recently told us they were expecting no better than 5% average annual equity gains over the next five years. A strategy like ours where we act as our own catalyst – assuming of course that the catalysts we pursue are the right answers for the business – should be able to unlock a lot more value than that.

Do you find the trade conflicts today opening or closing potential opportunities?

CK: We are seeing in general what seem to be more dramatic short-term reactions to companies with bad news and that miss numbers. That's particularly true of companies sourcing their products from China. We've been looking at a lot of consumer-goods companies in that situation and think in many cases the near-term reaction is quite a bit overdone relative to the long-term impact. If the trade war with China gets worse, while it will take some time, companies will adjust their supply chains. If the trade war with China gets better, things will return more to normal. When the market reaction seems to price in negative news unreasonably far into the future, we think that's opening up a number of potential opportunities.

Why do you see prospects turning up for portfolio holding Primo Water [PRMW]?

CK: The company has dominant market shares in its three businesses. The first is a water vending business, where customers pay roughly 35 cents a gallon to refill their own containers with purified water from large Primo-owned vending machines. They have 90% market share in this business, with 23,000 of these machines mostly stationed in front of convenience stores and supermarkets across the U.S., but more prevalent in southern and western states.

The next big unit is an exchange water business, where people bring their empty five-gallon containers to one of nearly 13,000 locations in the U.S. – also typically at high-traffic retail locations – and exchange them for already-filled containers to take home. The cost for this is about $1.25 per gallon and Primo controls about 90% of the market.

The final business is selling water dispensers that run the gamut from $10 basic pumps to $300 dispensers with hot and cold water, coffee makers and maybe even a pet drinking bowl at the bottom. Key retail partners in this business are Home Depot, Walmart and Lowe's, and while selling dispensers at the moment doesn't make a lot of money, Primo dispensers are in 8,700 locations and have about a 70% market share.

One important aspect of our thesis is that the company is on the right side of current consumer preferences. The demand for clean, purified water is still growing. Only recently in the United States has consumption of water on a per-capita basis overtaken consumption of carbonated soft drinks. At the same time, people are increasingly concerned about the environmental impact of individual-use plastic water bottles and are looking for the types of alternatives Primo provides. We don't see either the health-related or environmental drivers of the business letting up any time soon.

We also see significant room for operating improvement. The company today is the result of a merger at the end of 2016 that combined Primo's core exchange water business with the refill business of Glacier Water. At the time, management played up the potential to cross-sell locations. There wasn't much overlap in the location footprint, and there was perceived to be a lot of opportunity to generate incremental revenue and make the distribution operation more efficient. They've executed on precious little of that so far, which is something we're pushing them hard on to rectify.

On top of that we think there's considerable potential to expand the number of locations and to institute price increases. The company's products and services today are sold in 45,000 total locations, and management his said they think the addressable market is ultimately closer to

INVESTMENT SNAPSHOT

Primo Water
(Nasdaq: PRMW)

Business: Provision and servicing of multi-gallon purified bottled water and related dispensing equipment primarily sold at retail locations throughout the U.S. and Canada.

Share Information (@8/29/19):

Price	**12.18**
52-Week Range	10.70 – 20.60
Dividend Yield	0.0%
Market Cap	$477.7 million

Financials (TTM):

Revenue	$302.0 million
Operating Profit Margin	7.1%
Net Profit Margin	(-18.8%)

Valuation Metrics
(@8/29/19):

	PRMW	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E(Est.)	23.9	17.6

Largest Institutional Owners
(@6/30/19 or latest filing):

Company	% Owned
Capital Research & Mgmt	10.6%
Legion Partners	9.1%
Akre Capital	7.8%
Wellington Mgmt	7.2%
Nuveen Asset Mgmt	5.8%

Short Interest (as of 8/15/19):

Shares Short/Float	11.8%

PRMW PRICE HISTORY

THE BOTTOM LINE

The company has yet to capitalize on the merger that created it, says Chris Kiper, and has considerable potential in a secular-growth market to better cross-sell its services, expand its distribution and increase prices. Assuming a peer EV/EBITDA multiple on his estimates five years out, he believes the stock can more than triple from today's price.

Sources: Company reports, other publicly available information

250,000. On pricing, as demand for purified water increases and single-use bottles fall further out of favor, Primo should have some ability to charge higher prices – especially on the refill side of the business – while still remaining quite cost competitive with alternatives.

How do you see all this translating to upside for the stock from today's price of around $12.20?

CK: The company's latest projections for the current year are $315 million in revenue and $57 million of EBITDA. Net debt is just under $190 million, which results in an enterprise value today of $650 million. That values the stock at around 11.5x EV/EBITDA.

With healthy end-user demand, better pricing and expanded distribution, we think the company can increase its top line at 6-9% per year. EBITDA margins, around 18% today, we believe within five years can be 22-23%. Three to four years out the company can be debt free through the use of cash flows shielded by a substantial tax-loss balance. All that would translate into something on the order of $100 million in EBITDA five years out. Put a peer 14x EV/EBITDA multiple on that and we think over that time this could be a $40 stock.

We recently filed that we had taken our ownership in the company to 9.1% of the total shares outstanding. We believe this should be a multi-year compounder and expect to be very active with the board and the management team to deliver on that promise.

Describe the positive transition you believe is underway at SVMK Inc. [SVMK], the parent company of SurveyMonkey.

Sagar Gupta: This is an online-survey company that provides what it calls "experience management solutions" that help organizations engage with and solicit feedback from their customers and employees. The idea is that in addition to seeing what people are doing, SurveyMonkey provides the tools to help you understand why they're doing it as well.

The transition involves the company's recent investment in building out a suite of enterprise-grade solutions and the expansion of its sales force to cultivate the top 10% of the heaviest users. The platform has been naturally viral in that people get exposed to quick surveys and then some percentage go on to use them in their own work. That's driven significant organic growth – there are now more than 17 million registered users on the platform – at very low cost. Most upgrades to paid services, which generate run-rate annual revenues today of $300 million, have been user initiated and done online. The sales force is meant to engage the biggest users now and upgrade them to even more valuable offerings.

We think the secular tailwinds behind experience management solutions are quite significant. Given the choices customers have to find and buy almost anything, there's a higher premium than ever on understanding what people want and getting the customer experience right. We've seen research from PwC that says that 32% of all customers will walk away from a brand they love after just one bad experience.

We actually as a firm have an annual subscription plan with SurveyMonkey that we use for market research. It has built a consumer panel of two million people that subscribers can access on a per-usage basis. For example, we did a survey of 650 Bed Bath & Beyond customers when we were doing due diligence on the company. We ended up getting a lot of valuable insight at a cost of a few thousand bucks. Had we hired a consultant or traditional research firm to do pretty much the same thing it probably would have cost $50,000.

On the employee-engagement side, the cost of employee turnover is a long-standing and increasing problem. One representative example the company cites for how their products can help address that is a program they did with Celadon, which is a truckload shipper based in Indianapolis. Celadon was having an issue with drivers leaving within the first 90 days of employment. Working with SurveyMonkey, they automated the collection of driver feedback as new drivers came on board and following up at 30, 60 and 90 day intervals. Problems were heard and actively followed up on right away. The company credits the program with helping improve driver retention by nearly 70% in the first year, with a significant positive impact on profitability.

What's your activist agenda here?

SG: We'd like to see the company improve its financial disclosure – in particular on the economics of the user base as it transitions from free to low-tier to enterprise – and be more proactive in general with its investor base. We also want them to think more about developing strategic relationships with the other large tech platforms. They do some of that today, but as an example we could imagine that a broader partnership with a social network like LinkedIn and its over 500 million users would generate significant mutual benefit. As is often the case, there are also some governance and compensation changes we recommend. One would be that they do away with staggered board membership and elect all directors annually.

INVESTMENT SNAPSHOT

SVMK Inc.
(Nasdaq: SVMK)

Business: Provider of online survey platform used by organizations of all sizes to elicit customer, employee and market feedback that can inform strategic and operating decisions.

Share Information (@8/29/19):

Price	**17.11**
52-Week Range	10.05 – 20.00
Dividend Yield	0.0%
Market Cap	$2.28 billion

Financials (TTM):

Revenue	$276.9 million
Operating Profit Margin	(-51.5%)
Net Profit Margin	(-59.2%)

Valuation Metrics
(@8/29/19):

	SVMK	S&P 500
P/E (TTM)	n/a	22.5
Forward P/E (Est.)	n/a	17.6

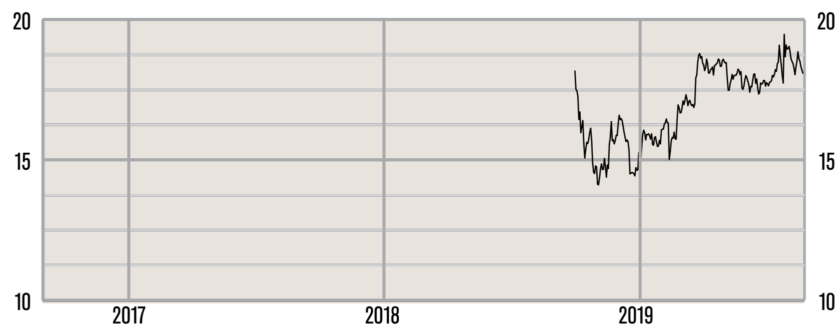
Largest Institutional Owners
(@6/30/19 or latest filing):

Company	% Owned
Wellington Mgmt	9.2%
Fidelity Mgmt & Research	5.8%
Tiger Global Mgmt	5.4%
Vanguard Group	5.1%
Capital Research & Mgmt	3.4%

Short Interest (as of 8/15/19):

Shares Short/Float	5.3%

SVMK PRICE HISTORY



THE BOTTOM LINE

Having invested in developing a suite of enterprise products and in a sales force to upsell users to take advantage of them, the company is poised to grow more rapidly and profitably, says Sagar Gupta. If accelerated revenue growth were recognized by the market as he believes it could be, the stock on his 2020 estimates would trade at closer to $30.

Sources: Company reports, other publicly available information

With the shares at a recent $17.10, how are you looking at valuation?

SG: If enterprise sales continue to ramp up as we expect, we think this goes from a relatively low-growth company to one that can generate 25% or so annual top-line growth for some time. We estimate free cash flow margins by next year will be roughly 20%, and there should be operating leverage in the model from there as average ticket sizes increase. To give a sense of the potential upside, SurveyMonkey's current average annual revenue per enterprise user today is around $9,000. For direct competitor Qualtrics – which SAP within the past year acquired for $8 billion in cash – that number is closer to $40,000.

What's a business with this growth profile worth? The stock today trades for around 6.5x forward consensus revenues. Recent IPOs like Slack Technologies and Zoom Video go for 20-30x forward revenues, and while those companies may be growing somewhat faster than SVMK, they're following the same basic go-to-market strategy in upselling organic and viral in-bound customers to more lucrative paid plans. This "self-serve" dynamic within the SaaS has enabled high growth at enviable profit margins, hence the high multiples. SAP paid 14x revenues for Qualtrics. Even if we use 10x revenue on our estimate of 2020 sales for SVMK, this would be a $30 stock.

Do you think the company is likely to eventually be sold?

SG: Salesforce bought shares in SVMK at the IPO and recently increased its stake. We can't imagine Oracle didn't take notice of SAP's purchase of Qualtrics. And Microsoft is a close partner today. We certainly believe the company has a viable strategy to go it alone, but we also think it has a tremendous amount of strategic value and would therefore make a very attractive sale candidate. VII

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