Q4 2018 | Issue 14

Hidden Value Stocks

small caps with little or no coverage

From ValueWalk

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Joe Frankenfield **Saga Partners**

To start, could you describe your background?

I have a pretty unconventional background compared to most investment managers in that I started my career as a corporate banking underwriter. I've always been interested in how the economy works and figuring out what made companies tick. The businesses I covered were typically middle market companies, usually with revenues of less than $100 million. My job was to analyze their risk and help finance whatever their business needs may have been. I typically worked directly with the CEO's or CFO's, getting to ask them about their operations, opportunities, risks, etc., which I found interesting and thought was great being a pretty green 22-year-old straight out of school.

It was 2010, and the economy was still coming out of the recession. The outlook was uncertain, and many companies were struggling to cash flow as demand was soft across most sectors. Credit was tight, and as senior lenders we were one of the best, aka cheapest, source of capital, assuming we would open up our pocket books. It was a pretty eye-opening experience seeing companies troubled with heavy debt loads just trying to get by, and probably one of the reasons I have such a strong aversion to leverage.

Investing was just a natural progression to my interest in understanding businesses. At the time, many publicly traded companies were selling for a fraction of what they did only a few years earlier. I've always been a big saver and the concept of laying out money today to get more money back in the future appealed to me. I wanted my money to work for me instead of working for my money. I obviously knew about Warren Buffett after studying business and finance in school, but it wasn't until after I graduated and started having real money to invest that I got really interested. Once I started reading Berkshire Hathaway's shareholder letters, there was no going back. Like many others, the way Buffett wrote about business and investing just clicked with me. I started to study everything I could find on Buffett and other successful investors. I was addicted. I found myself spending nights and weekends studying the market.

As a kid, I loved solving puzzles, and I thought of investing like a puzzle, searching in the nooks and crannies of the market trying to find companies selling for less than their intrinsic value. I couldn't learn fast enough as I continually read as much as I could on industries and companies. I made a lot of mistakes but fortunately had a lot of success as I continued to learn.

I always thought I'd like to start my own business one day and as I spent more time investing my portfolio with a good amount of success, I started to think I could invest full time, potentially letting other people invest alongside me. I wanted to get real-world experience working closer to the investment management industry and fortunately got an opportunity to work in sell-side equity research covering the transportation and logistics sector.

I was excited about the opportunity to turn my hobby of analyzing the value of companies into my full-time job. However, I quickly realized there were significant conflicts of interest between sell-side analyst incentives and how I thought money should be managed. Most sell-side analysts are compensated on getting their hedge fund and mutual fund clients to trade with their brokerage as much as possible. The more clients traded the more money they made. It created a very short-term outlook.

A lot of time and effort was spent forecasting a company's quarterly earnings per share to the exact cent and predicting how shares would trade around those quarterly earnings. This really clashed with my longer-term philosophy. I was more concerned if a business was good or bad instead of how the stock would trade over the next week or quarter. Worse yet, there were a lot of restrictions on investing in your personal account, so it was difficult for me to manage my own investments, plus the hours were so long that I had little time to do much research outside the few stocks I covered. I knew early on that I wanted to break out on my own as soon as possible.

Before leaving the security of the corporate world to start on my own, I wanted to make sure I could support myself with my savings. With enough savings, I would not be dependent on making fees off the portfolio. If I were to manage a portfolio, I wanted to focus on getting the best possible returns, not pressured to raise assets under management. After a few years and thanks to a fairly frugal lifestyle and compounding my savings at high rates, I was able to break out on my own in 2016. The final step was getting the thumbs up from my then girlfriend, and now wife, who thankfully could not have been more supportive.

The timing was pretty serendipitous. At the time my current partner, Michael Nowacki, was already managing money at his own investment advisory but he wanted to consolidate and focus on one main strategy. We were corresponding back and forth about investing and business strategy, and it was clear we shared a very similar investment philosophy and values. He actually wrote a book about the investment strategy of some of the greatest investors titled, Forever Investing, which perfectly lined up with how I thought and wanted to manage money.

After a while, we decided we would make a strong team by partnering together. While I think the best investment ideas rarely come from typical investment committees, having a brilliant partner to help manage the portfolio has been one of the best decisions I've made since going out on my own. Between the two of us, we can cover more ground, toss ideas back and forth, and get alternative viewpoints. It's imperative to find the right person to partner with, and I, fortunately, found that with Michael. We joined up and started working together in 2016, launching the Saga Portfolio at the beginning of 2017 with about $6 million coming mostly from close family and friends.

Can you give us some more insight into Saga's investment philosophy?

There are two main principles behind our philosophy. 1) Stocks are little pieces of a business and 2) trying to buy these little pieces for less than they're worth.

We try to think like business owners by taking a much longer-term outlook. In our opinion, one of the most significant difficulties for most investors in publicly traded stocks is the fact there is always a quoted price available and the ability to sell shares back every day. It makes people focus on the short-term and feel pressured to act which can lead to irrational behavior. An owner of a private business does not care about the day-to-day value of their company, but the typical Wall Street analyst is judged by whether they can predict where a stock will trade within the next quarter or year. It becomes more of a game of mass psychology instead of business analysis, trying to guess what other people will guess the price of a stock will be next quarter.

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A very long-term investment horizon forces us to invest in high-quality companies. There are many different ways to make money in the market, but I think a lot of value investors start with the Ben Graham method of buying companies at low multiples but quickly realize they own bad businesses that remain "undervalued" indefinitely. If you had to own a company for at least 10 years, you would be less focused about a quick pop in its multiple and be more concerned if it was a great business growing intrinsic value.

I believe Bruce Flatt, the CEO of Brookfield Asset Management once said, "we'd rather earn a 12% to 15% net return over 20 years than a 25% return over three." That is a pretty good creed for how we think about investments within the Saga Portfolio.

You're on the lookout for stocks with a wide moat. How do you define the 'moat' and what qualities are you looking for?

Over the long run, a stock will return pretty close to what the underlying business earns on its capital. In a competitive economy, when a company makes a lot of money providing some product or service on the capital it invested, another company will try to enter the market and compete away any excess returns. We are looking for companies that are more immune to this threat because it is protected by some type of moat.

A moat is merely a company's competitive advantage versus potential competitors. When looking at a company we ask ourselves, why can't someone else do the same thing? Why is it differentiated? It essentially comes down to barriers to entry which could be customer captivity through habit, switching or search costs, network effects, being a low-cost provider, or having economies of scale. Once you establish a company has some sort of moat, the next question is how defensible are these barriers to entry?

What process do you use to determine if a company has a strong moat or not?

Most of our analysis revolves around qualitative analysis which is later supported by more quantitative measures. I think moats can only be determined qualitatively. A moat may be reflected in the numbers by high returns on capital, but historic results can be a bad proxy for the future if competitive dynamics are shifting or if a company may be underearning the actual value it creates for whatever reason.

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Trying to determine if a company has a strong moat requires putting yourself in the customers' shoes. Thinking about what motivates a customer to buy or use a particular product or service from a specific company is one of the most important questions to answer. How much value does the company create and why can't someone else do the same thing? For every business, we have to understand the different competitive dynamics at play and what motivates the customer. This is key to analyzing moats.

While management in itself is not a moat, it is probably one of the more underrated qualitative investment variables. The CEO has enormous power to either create or destroy shareholder value. Similar to clients in our portfolio handing us their money to allocate, we must have the same trust in our company's management when we purchase ownership in their business. We will never invest in a company that has management with questionable integrity. We feel much more conviction in an investment if the company with a strong track record has had the same management over the last 10-20 years and has much of their net worth invested in the company.

You've also referenced 'four filters' any investment has to pass before making it into your portfolio. What are these filters and why did you decide on these criteria?

A strong competitive advantage is just one of your 'four filters' ever investment has to pass before making into the Saga portfolio. Can you talk about the other three?

The value of any investment is all the cash that can be taken out of the asset, so our job is trying to predict future cash flows. With a bond which has a contractual coupon and principal payments this analysis is much easier, but with a company where shareholders are the last in line to receive any "coupons" or dividends, the job is much more uncertain. Since there is a vast range of probabilistic values, we have found if a company meets these four filters, the degree of uncertainty declines a lot.

The four filters are a business that will be around and thriving in ten plus years, has a growing competitive advantage, has high caliber management aligned with shareholders, and obviously selling for an attractive price.

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Few companies meet all four filters because if there is a predictable business likely to earn a high return on capital for many years and strong shareholder-aligned management, the market will likely value the company at a price that discounts potential excess returns. Applying these filters is a check to make sure we think long and hard before making an active investment decision. We will likely miss out on many opportunities because it won't make the cut, but it also means we should have fewer losers.

One of the companies you own is Platform Specialty Products (PAH). Can you talk a bit about how this investment fits into your strategy?

Platform Specialty Products is an exciting situation because there have been a lot of moving parts since its founding. At a high level, it exhibits all the characteristics we look for in an investment. It is run by a talented manager with a proven track record. Its chairman Martin Franklin has much of his net worth invested in the company. Its core business requires little capital to grow, is protected by barriers to entry via close customer relationships, and is selling for an attractive valuation.

Part of the mis-valuation may be attributed to the company's previous mismanagement and high leverage. They started as a special purpose acquisition company (SPAC) in 2013 to acquire and consolidate specialty chemical companies. The prior CEO overpaid for a few acquisitions, most notably Arysta, using a lot of debt. When an industry slowdown hit in 2015, combined with a leveraged balance sheet, cash flow took a big hit and shares fell.

A new CEO started in early 2016 and has since turned the company around. He had a solid track record running a similar type of company called Sigma-Aldrich. He suspended further acquisitions at Platform and refocused on consolidating the large, disparate operating companies. Most recently, Platform is selling the Agricultural segment, roughly half the business, at the end of this year and using proceeds to pay down debt.

The remaining segment provides specialty chemicals for surface treatments and electronic assembly. The economics of this business are extremely attractive. Its products are part of integrated customer processes generally tailored to meet specific requirements. They typically play an essential role in the end product but only represent a small proportion of total end material costs. Overall it is a high margin business with sticky customer relationships and low capital needs.

What about valuation?

The end markets that Platform serves will likely grow sales in the low to mid-single digits organically, and operating income should grow at about twice that rate in the high single-digit range. Platform earns high returns on capital, which provide strong cash flows. Management has the opportunity to add value allocating cash flow either to bolt-on acquisitions or share repurchases which should enhance the high single-digit organic growth. From a valuation standpoint, Platform is selling for about 11-12x next year's expected free cash flow which looks very attractive for a business that can grow high single digits organically, has strong cash generation, and a more moderate leverage profile.

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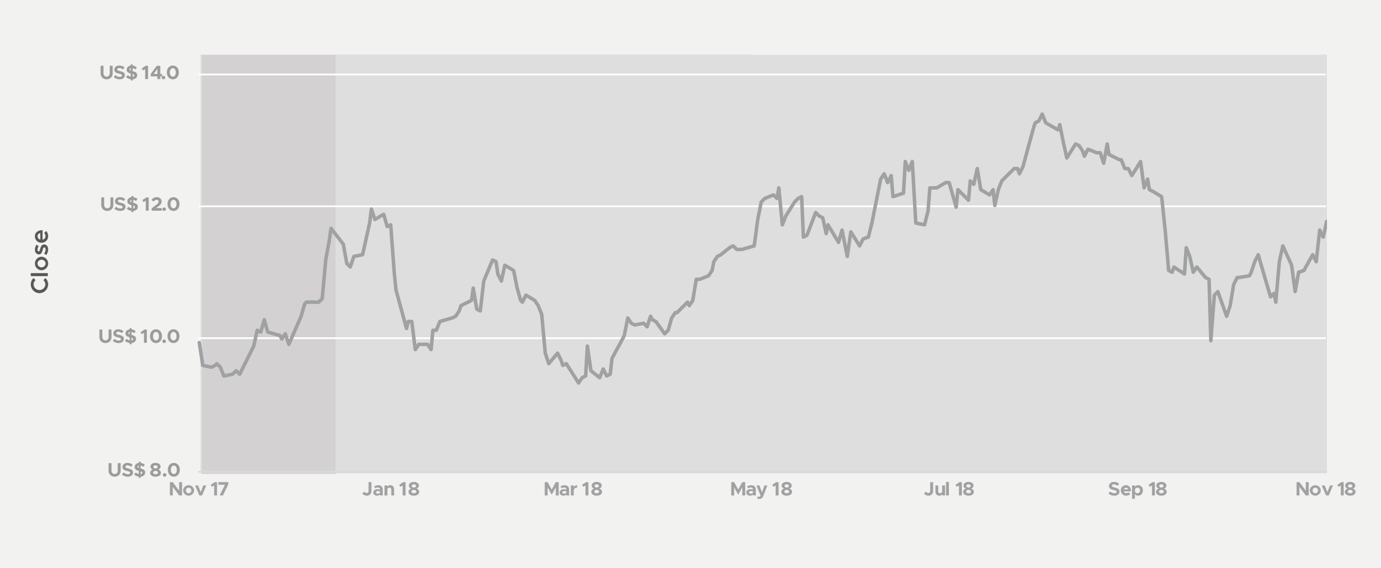
Platform Specialty Products Corporation (PAH), inc.



Share Information December 7,2018

Market Cap.	P/E (forward)	EV/EBITDA	Dividend Yield
$3.2bn	12.3	16.7	N/A
Average Volume (3m)	**P/B**	**ROIC**	**Debt to Equity (net)**
1.5m	1.6	-4%	251%

Data Source: Morningstar

Another stock you like is The Trade Desk. How does this fit into each of your four filters?

The Trade Desk (TTD) is one of those investment opportunities that only come around once in a long while and is an excellent example of a company that sells at a higher multiple relative to current earnings but is very undervalued.

It is a software platform that supports companies purchasing digital advertisements. The Trade Desk serves advertising customers by providing ad price discovery tailored to specific advertisers using programmatic data. There were many different players in the space, but The Trade Desk has emerged as the largest independent demand-side ad platform today.

Its platform business model benefits from a virtuous cycle where it adds value the larger it gets by growing the network of connected buyers and sellers, increasing transparency, and enabling more accurate price discovery for buyers who want to make better data-driven decisions. The company is essentially aggregating, analyzing, and valuing the fragmented digital media space that lies outside the Google and Facebook walled gardens. It has established barriers to entry through its operating leverage economies of scale and strengthening customer retention through its network. We also love the fact that it is founder-led and the CEO has nearly his entire net worth invested in the company.

And what do you think the company could ultimately be worth?

This is a great example of a company that sells at a relatively high multiple to current earnings and cash flow but is significantly undervalued. Platform businesses create value by connecting producers and consumers within their network. Their economic characteristics typically lead to an operating model that is capital light and very scalable. Because margins increase as their networks grow, there tends to be a winner take all competitive dynamic with only one or two platforms typically dominating an industry as a market matures. As the largest independent digital advertising demand-side platform, we believe The Trade Desk has a very high probability of being the end-state winner in this space, and the opportunity in this space is enormous.

To give a high-level view of the addressable market, global advertising spend is expected to reach $1 trillion over the next 10 years. This includes everything from newspapers, billboards, to tv commercials. Increasingly, more of that ad spend is going towards digital outlets such as cell phones, computers, and connected TVs. Global digital ad spend was $229 billion in 2017 and is expected to reach nearly half of total ad spend by 2021 and almost all digital advertising is expected to be purchased programmatically over a platform like the Trade Desk.

The Trade Desk is benefitting from high industry growth of ~20%, plus taking market share as it continues to establish itself as the dominant platform. If you look at their current market cap of $5 billion to $6 billion, it looks high relative to the $75 million in expected earnings this year. However, if The Trade Desk is the dominant platform in 10 years and just a small share of the global advertising pie goes across their platform, it will be worth multiples of their current valuation. It would be useless to calculate their intrinsic value to the exact dollar but just using reasonable assumptions provides a lot of potential upside and little downside baked into its current price.

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Saga Partners: Stock Idea One

TRUPANION (TRUP)

Your first stock pick is Trupanion. Let's start at the beginning. What does this company do?

Trupanion provides medical insurance for cats and dogs in the U.S. and Canada. The current CEO founded the company in Canada in 2000 and entered the U.S. in 2008. Since then it has grown to be the second largest pet insurer in North America.

While it is technically an insurance company in that it pools and redistributes risk, its business performs more like a subscription service model like Costco. Because pet insurance claims are very predictable, uncorrelated, and typically low dollar amounts, Trupanion can accurately predict its monthly costs and operate on a cash flow basis. It charges customers their expected claims plus a 30% margin and can continually adjust pricing for new pets as costs change throughout the year, with existing pets locked into their price for one year. This means Trupanion carries less float, doesn't have investment or interest rate risk, and can adjust premiums as costs change.

What first attracted you to the opportunity here?

We are constantly searching for new ideas, and part of that process includes following a few other investment managers we think align with our philosophy. This hasn't been a source of any ideas in the Saga Portfolio before, but we like to see what other managers we respect are doing. Around mid-2017 we noticed that several of the funds we like to follow held Trupanion which sparked our original interest, and we started following the company. We are not usually fans of insurance companies because they are typically very competitive commodity-like businesses, and on the surface, Trupanion is easy to pass up because it didn't have GAAP earnings, but that is when we started following the company.

Can you give us some more detail on how this fits into your four filters? For example, what makes you think Trupanion will be around in 10 years?

It helps to give a little background on the industry. Pet insurance in the U.S. is massively underpenetrated if you compare it to other western European countries. In the U.S., only about 1.5% to 2.0% of pets have insurance while it's 5% in France and Denmark, 14% in Norway, 25% in the UK, and 40% in Switzerland. Even Australia and South Africa have 5% to 10% penetration rates.

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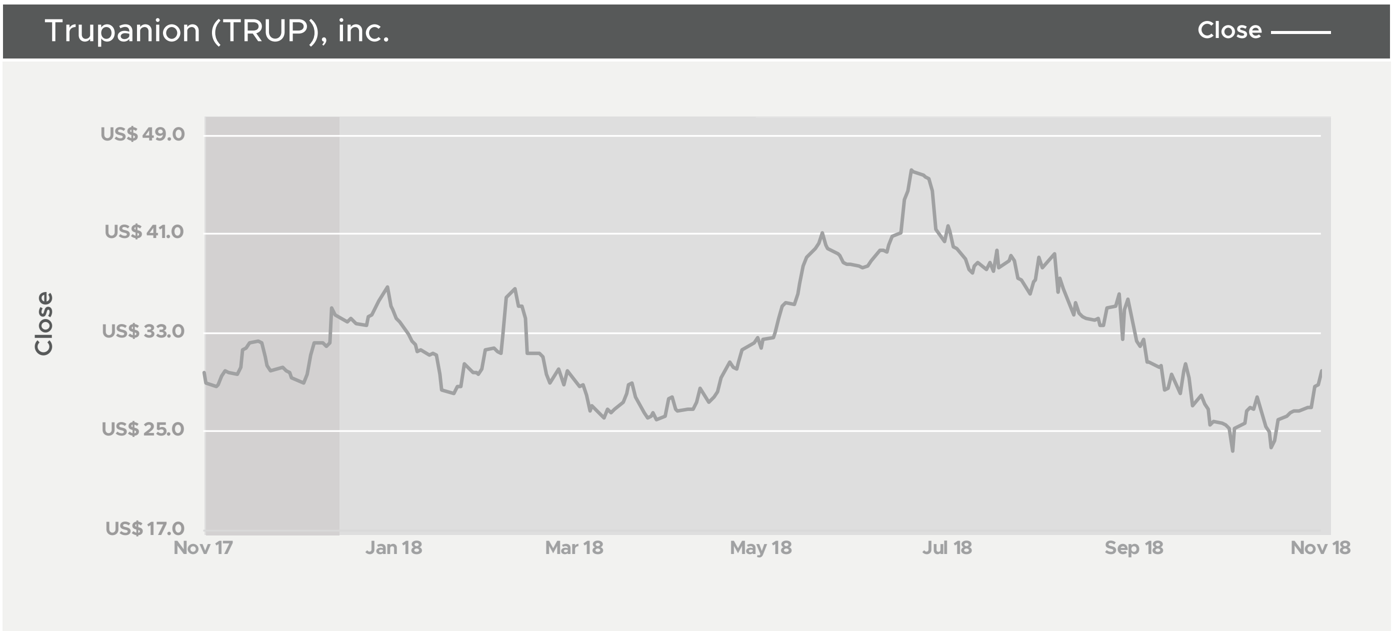
So, the question is why is there such a large discrepancy when the U.S. has typically been a leader in financial services?

It's not because disposable income is lower, or U.S. pet owners love their pets less. The answer is comprehensive medical insurance for pets came to the UK and Western Europe in the 1970s but did not come to the U.S. until 2008.

In the U.S., pet insurers historically set premiums at a low price point but excluded many of the conditions pets were most likely to have. The result was a lousy product with angry pet owners and vets reluctant to recommend insurance. While Nationwide is currently the largest U.S. pet insurer and has been around since the early 1980s, Trupanion was the first company to offer comprehensive coverage including hereditary and congenital conditions, which are the conditions pets are most likely to have.

If you use other developed countries as a proxy for future pet insurance penetration rates in the U.S., it's reasonable to expect demand for pet insurance to have a long runway of growth going forward. The winners in insurance businesses are going to be companies that have some franchise based on providing a specialized product, managerial talent, or better distribution. We think Trupanion checks all three boxes. There will be competitors that try to copy Trupanion's product offering, but we believe it has a strong head start that gives it a growing competitive advantage.



Share Information December 7,2018

Market Cap. $890m	**P/E (forward)** 116	**EV/EBITDA** 264	**Dividend Yield** N/A
Average Volume (3m) 342,138	**P/B** 7	**ROIC (ttm)** -2%	**Debt to Equity (net)** 6.70%

Data Source: Morningstar

Can you give our readers some more insight into this competitive advantage?

Trupanion's competitive advantage comes from a combination of being the low-cost operator, their proprietary data, and having a better distribution model.

The core strategy is to be the low-cost provider. It is committed to having the lowest cost to administer and the lowest cost to acquire new customers, which is very difficult for any new or existing company to copy. Being the low-cost provider does not necessarily mean their product is the cheapest in the market. It means that Trupanion can consistently use a higher percentage of customers' monthly premiums toward paying veterinary invoices.

Trupanion pays ~70% of premiums collected to veterinary claims vs. the industry average of ~50% to 60%, meaning their value proposition is about 10% to 20% better than competitors. Trupanion's insurance may cost more than products with exclusions, but it delivers an overall better value proposition to pet owners. Competitors may underprice policies at times to boost short-term growth but that is not likely a sustainable strategy.

One reason Trupanion can price insurance at a lower mark up is that they underwrite their own insurance risk while most competitors outsource it to a third party. By vertically integrating they can remove up to 20% of frictional costs.

Current scale and data collected over the past 15 years help Trupanion price policies more accurately. It has a proprietary database that breaks down 1.2 million different price categories, giving them the ability to price policies down to specific zip codes and sometimes even to vet hospitals while Nationwide and other competitors still price policies by state. Even though companies like Nationwide have been in the market longer, it does not have pricing data going farther back because they did not offer comprehensive coverage.

Distribution and customer acquisition costs are vital parts of an insurer's business model. Historically, U.S. pet insurers unsuccessfully used a more direct to consumer strategy. Trupanion has a different approach that uses a contracted sales forces called territory partners that build relationships directly with veterinarians. This was the primary strategy used in the UK and has so far been very successful for Trupanion with nearly 50% of new customers coming from vet referrals.

Territory partners are a big advantage. Trupanion is the only U.S. pet insurer with a national salesforce. Veterinary hospitals are very fragmented, and typically owner operated. It usually takes years to develop relationships with vets before they become comfortable referring pet owners. It would be challenging and time consuming for a competitor to try and replicate Trupanion's salesforce.

What is the company doing to keep the moat wide?

Trupanion has about 500,000 dogs and cats insured. They are expected to reach their target operating margins at scale, which is somewhere between 650,000 to 750,000 pets. This should happen in the next two to three years.

Once a business becomes a low-cost provider at scale, it has a choice between either keeping prices higher and making more money or sharing some of the cost advantages with its customer. Trupanion has committed to maintaining its value proposition, by always targeting a 70% payout of premiums collected. Passing on the cost advantage to customers strengthens its brand and customers know they are getting the best value when they sign up. It creates the powerful virtuous cycle that we love to find where a company shares its economies of scale with customers, leading to higher demand and therefore greater economies of scale.

It's essential for Trupanion to strengthen its relationship with vets and customers continually and one way they've tried to do this is by improving the legacy insurance reimbursement model which was slow, inefficient, and created a bad customer experience. The legacy reimbursement model required customers to pay 100% of vet costs out of pocket, then submit a claim and wait for it to get approved and reimbursed. Some pet operations can be costly and too much for customers to pay upfront. So, Trupanion created some software called Trupanion Express that integrates with a vets practice management software to enable direct payment by Trupanion to vets.

Overall is removes friction and eliminates pain points for both vets and pet owners. Vets benefit because they can move forward with providing care for a sick pet, reduces non-paid accounts receivable, and saves them credit card transaction fees which can add up to a lot of money for large charges. Pet owners benefit because it reduces their upfront out of pocket costs and removes having to submit a claim and waiting for the insurance company to respond. Trupanion benefits because it collects more data to improve their pricing models further and strengthen the relationship with vets, improving referral and conversion rates of new customers. It's a win-win-win service that helps widen Trupanion's moat.

Do you think Trupanion's management is up to the task?

In any company we invest in, we are looking for exceptional management and Trupanion is no exception. Darryl Rawlings is the CEO and started Trupanion in 2000 by insuring his dog. He has a clear vision and goal of becoming the most extensive and best pet insurer in the world. Usually, company annual shareholder letters are more marketing brochures, but Darryl writes out detailed letters that explain how he thinks about the business, its goals, opportunities, problems, etc.

From a value creation perspective, I think Trupanion's track record is a good indication of Darryl's abilities. He created Trupanion from scratch in an industry that is hard to differentiate. As long as current management runs Trupanion, we have a strong conviction about its long-term potential.

Does Darryl Rawlings still own a stake in the business?

The CEO owns ~7% of outstanding shares and makes up the majority of his net worth and other insiders hold ~3%. Management has taken the owner mentality a step further by providing an incentive program that grants shares to all employees based on its calculation in intrinsic value growth each year. We like companies that are aligned with shareholders and are fans of paying for performance.

The company isn't profitable at this stage, so how are you valuing the equity?

On the surface, it's easy to pass on Trupanion since they do not report GAAP earnings and trade at a price to book value of ~7x -- at least this is what we thought when Trupanion first came across our desk. A deeper dive into their financials and a better understanding of how their business works, however, shows that GAAP earnings and book value are poor proxies when trying to value Trupanion. What you need to do, like with any investment, is estimate its expected cash flows.

The important financial metrics to wrap your head around when looking at Trupanion are the lifetime value of a pet and the pet acquisitions costs. Understanding these numbers helps investors analyze the current operating cash flows and expected returns on reinvested cash flows.

> *"In 2017, the lifetime value of an average pet was $727 with an average life of 73 months. Trupanion spent $152 to acquire new pets, providing a 36% IRR on their customer acquisition costs. So, for every dollar Trupanion spends on customer acquisition costs, they expect a 36% annual return on their money during the life of that customer.*

In 2017, the lifetime value of an average pet was $727 with an average life of 73 months. Trupanion spent $152 to acquire new pets, providing a 36% IRR on their customer acquisition costs. So, for every dollar Trupanion spends on customer acquisition costs, they expect a 36% annual return on their money during the life of that customer. In other words, Trupanion should be reinvesting every dollar they can as long as they can maintain a high return on their investment.

Trupanion's entire cost structure is based on what they will look like when they reach scale at 650,000-750,000 pets, at which point they should have operating margins before customer acquisition costs of ~15%. They should achieve scale in the next two to three years based on historical growth in pets enrolled. If you project out expected average revenue per pet and apply operating margins at scale, Trupanion could have an adjusted operating income between $60 million to $90 million in just two to three years. If you account for about 2% average share dilution per year, current shares are trading at 11x to 15x on its ~$950 million market cap.

Remember adjusted operating income is before customer acquisition costs. We hope and expect Trupanion will be able to reinvest the $60 million to $90 million in operating income in customer acquisition costs at high rates of return to fuel further growth at scale.

It seems that the market is not willing to wait for Trupanion's growth to materialize. The stock is 43.5% below its 52-week high and around 39% of its shares are out on loan to short sellers. Is this something you're concerned about?

Shares have been somewhat volatile over the last year which provided an opportunity for us to start a position recently. There have been some short thesis articles published recently that may have contributed to recent share declines. In general, I think the market can underappreciate companies that can reinvest earnings at a high rate indefinitely. Wall Street analysts typically don't look much farther out than two, maybe three years when valuing a company.

If you value a company using simple discounted cash flows, even a slower growth company will likely have over 80% of its discounted cash flow value come after three years. For a high growth company requiring a lot of cash flow investment in the near term, the market does a poor job of calculating what the earnings power of a high growth company will be 10 years down the road.

Amazon is an excellent example of this and a fascinating case study. If you go back just 15 years, Amazon was trading for a market cap of $21 billion and had sales and earnings of $2.3 billion and $4 million. If you bought shares in 2003 for $50 and held them today, you would have earned a 26% compounded return. Let's say in 2003 you required a long-term return of 15% on all your investments. Amazon's fair value to you would have been about $210 per share or over 4x the going price. That would have valued Amazon at $84 billion or 37x its sales. Of course, hindsight is always 20/20, and we're not claiming Trupanion is the next Amazon by any means, but it does show how companies that can compound growth for many years can be very undervalued by the market even when at the time it appears to be trading at higher multiples. You have to make sure you find the few companies that can compound growth for many years.

Many of the bears say that Trupanion is an insurance company and should be valued like one relative to its book value. Our view is that any asset should be evaluated based on its estimated future cash flows. Using book value as a valuation proxy for a slower growth insurance company with a lot of float can make sense, but not so much for Trupanion.

Most insurance companies have slower growth, competing in saturated markets. Float and the investment return on that float plays a more prominent role for many insurers where the time between premiums received and claims paid out can be very long such as with life insurance. These companies will typically underwrite insurance at breakeven, or a combined ratio of 100%, with earnings coming from the investment gains generated from the float.

Trupanion, on the other hand, has a lot of clarity into monthly claims which are typically uncorrelated, lower dollar amounts, and higher frequency. They do not have unpaid liabilities because they usually pay claims within 45 days, if not immediately through Trupanion Express. Trupanion doesn't underwrite insurance at a 100% combined ratio. They underwrite it so that 70% of premiums are paid out to vets in the month the premiums are received, which should provide a 15% operating margin at scale. While many insurance analysts may disagree with taking this approach, we think valuing Trupanion on their expected cash flows and earning power is the more practical way to go.

What about debt?

Trupanion has a net cash position. As an insurance company, it has to maintain certain risk-adjusted capital requirements.

What's your bull/bear price target for the stock?

I like to think more in terms of the expected returns the underlying company can earn and where the valuation may move around the company's earnings power. The most important thing is to get the fundamentals right and then shares will eventually take care of themselves.

Management has stated they think revenues can grow between 20% to 30% over the long-term. That type of growth for any company is pretty impressive, but it is in line with historical trends, and with only 1% to 2% penetration rates in the U.S., the industry has a lot of potentially untapped demand.

If you look farther out, you can make reasonable assumptions to see if these types of growth rates are realistic.

> *"Let's say in 10 years from now, 4% to 5% of the 200 million U.S. cats and dogs have pet insurance, and Trupanion has somewhere between 25% to 40% market share, in line with current market share and their share of new pet sign-ups in more mature markets. In this scenario, Trupanion will insure between 2 million to 4 million cats and dogs, growing pet count between 15% to 23% per year from current levels. If average monthly revenue per pet grows between 5% to 7% annually, compounded annual revenue growth would be 20% to 30% over the next 10 years.*

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And finally, what the possible risks to your thesis?

The biggest risk is if Trupanion can't execute. Pet insurance in the U.S. is an untapped market right now and it's very important for Trupanion to continue to provide the highest value, widen their moat, and execute. It sounds easy, and Trupanion has made it look relatively easy since they entered the U.S. in 2008, but it is definitely not a certainty.

If Trupanion does not achieve top-line growth rates, results will be less attractive but even if the long-term growth is 10% to 15% over the next 10 years, shares should still perform ok. We typically do not like to forecast 20% growth rates far out into the future, but management has the track record since going public on achieving the goals they set.

In their first annual letter in 2014, management said they plan on being cash flow positive by the second or third quarter of 2016, which they did achieve in the second quarter of 2016. It's very helpful to go back to read what management said over the years and see what actually happened. This gives us greater conviction that Trupanion can execute.

Saga Partners: Stock Idea Two

LGI HOMES (LGIH)

Your second pick is the Texas-based homebuilder LGI Homes. This stock has lost nearly 50% over the last year. What's behind the decline?

We started following LGI at the beginning of 2017 when it was getting beaten up by the market for somewhat similar reasons that it is now. You never really know what the market is doing or thinking, or what it will do or think next month, but all housing-related stocks have gotten beaten in recent months. There's a lot of concern surrounding rising interest rates, wage and building materials inflation, and general fear we're near the end of a cycle. LGI gets wrapped up with the rest of the industry so its shares have gotten beat up as well.

And you think the market has overreacted here?

There are few industries that the market dislikes more than the housing industry. Shareholders got burned in the last recession, and I'm sure there are fears that a similar scenario may play out in the next downturn.

If you look at longer-term housing trends, there was overbuilding for several years leading up to the great recession, then significant underbuilding following the downturn, particularly in the markets LGI serves for lower-priced homes. What we see today is a lack of housing inventory as new household formation continues to grow.

If you take a step back, there is a lack of inventory and higher home price inflation, meaning there is greater demand for more supply which should benefit homebuilders. Rising interest rates are a modest headwind to home affordability, but mortgage rates are still far below historical levels and higher rates could actually help a company like LGI which builds lower priced homes.

We are not thematic investors and are not making a cyclical call on the housing industry, but we do see indicators for fundamental demand of new homes. Housing-related stocks tend to trade in step with each other over the short term which is often based on a lot of different macro-level monthly data where investors can sometimes miss the forest from the trees. Our investment in LGI is not a call on the housing market but based on the specific company. It just so happens LGI was beaten down with the rest of housing stocks which provided an attractive opportunity.

So, why LGI over the rest of the industry. What makes you think it will be around 10 years from now?

From a product perspective, I have high conviction that there will be demand for new homes in 10 and 20 years from now. The question is who will be building those homes and how profitable will those companies be?

Homebuilding is a challenging industry. If you look at the largest homebuilders like D.R. Horton, Lennar, or PulteGroup, returns on capital have been pretty lackluster if averaged out since the recession. What gives us greater conviction on LGI is their niche operating model, successful track record, and the CEO who is only 47 years old and started the company with his dad in the 90s. When I look out 10 years from now, I have a high conviction that LGI will be much larger and more profitable than it is today despite any potential cyclical downturns.

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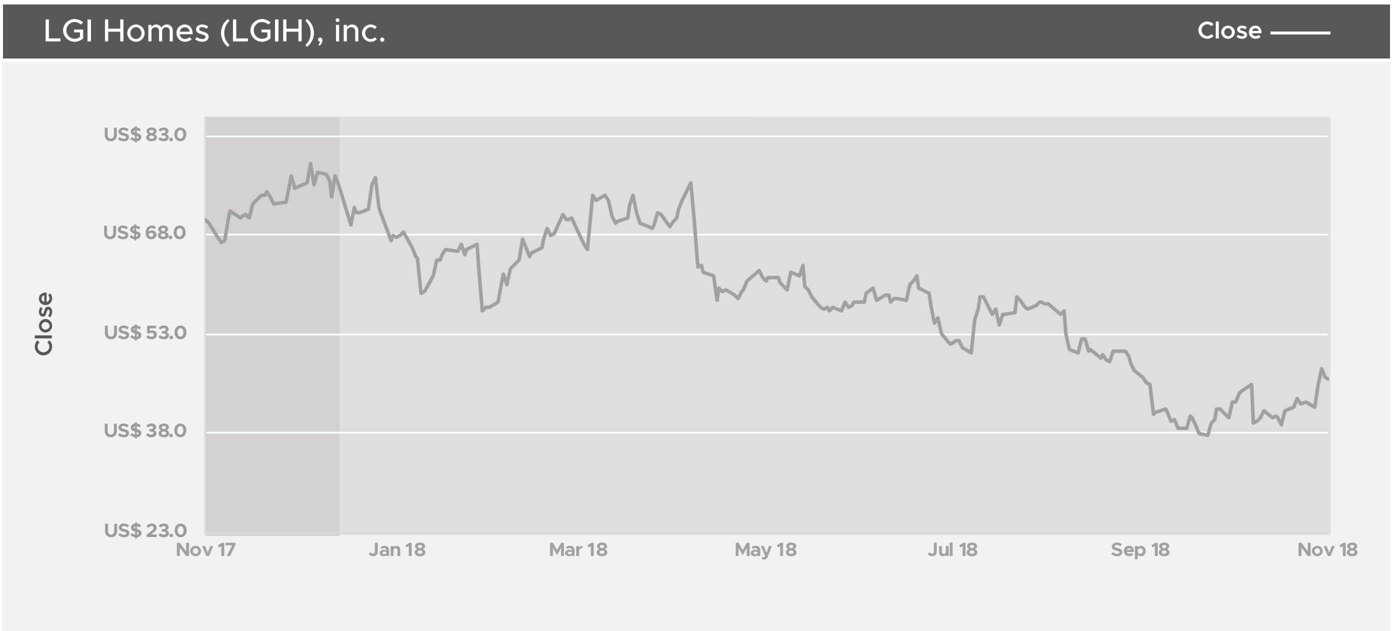
Can you give us some more insight into the company's niche operating model?

Like I mentioned, homebuilding is a difficult business. It is a fragmented, cyclical industry that is fairly capital intensive and has low barriers to entry. Larger builders may have some scale benefits or brand recognition, although they are only modest at best. The industry has many of the economic characteristics that we do not like as long-term owners. Although it is difficult to create a competitive advantage, LGI has proven to be an exception as a low-cost producer. It has had industry-leading growth, margins, returns on capital and was the only top 200 builder to grow during the 2008 recession. The company has never taken an inventory impairment despite going through the worst housing downturn in a generation. The business reminds me of a trucking company I covered as an equity analyst called Old Dominion Freight Lines. Trucking is a tough business, but Old Dominion was a best in class industry leading operator that has provided ridiculous shareholder returns over the last 20 years.



Share Information December 7,2018

Market Cap.	P/E (forward)	EV/EBITDA	Dividend Yield
$1bn	9.8	7.8	N/A
Average Volume (3m)	**P/B**	**ROIC (ttm)**	**Debt to Equity (net)**
303,066	1.7	12.30%	96%

Data Source: Morningstar

LGI builds standardized, move-in ready homes at attractive price points for entry-level home buyers. The company buys lower cost land just outside urban areas that often qualifies for a USDA Rural Development Loan where the homebuyer does not have to put any money down. Before LGI starts a new community, it does extensive research to determine the number of rental households within driving distance to the development and does marketing tests to evaluate the demand opportunity. Instead of using brokers or realtors, the company uses a direct sales and marketing strategy by sending brochures/pamphlets that focus on converting apartment renters to homeowners. It's not uncommon that owning an LGI home with greater amenities is cheaper than renting an apartment. This unique operating model provides a cost structure with lower COGS and higher inventory turnover which provides very attractive returns on capital.

Why do you think this competitive advantage is sustainable?

LGI's model of buying cheap land outside urban areas, pre-building low-cost standardized homes, and using a direct marketing approach is unique, but with limited economies of scale, competitors could copy their strategy in theory. Being a low-cost operator is not as strong of a moat than having big economies of scale or a network effect, but if competitors wanted to copy LGI, it would mean established homebuilders would have to completely restructure their culture and operating processes, which is not easy to do. It's somewhat similar to how auto insurers continued to use their agency model instead of copying Geico's lower cost direct marketing model. It would require spending a lot of money, resources, and building out a sales force.

Even if competitors started to incorporate LGI's strategy successfully, the market for first-time homebuyers is enormous. The top five home builders are only expected to make up about 12% of housing starts this year. LGI is expected to build 6,000-7,000 homes in 2018 which is less than 1% of single-family housing starts this year. This is not a winner take all industry. There's plenty of space for multiple players.

The best thing LGI can do is stick to their core competency. They have found an exceptionally successful homebuilding model and are effective at executing it. There are some scale benefits as they grow larger. SG&A continues to fall as a percent of sales. They also have the opportunity to build some brand awareness as a high quality, lower priced home builder which could help drive more demand.

Moving on to management. You mentioned the current CEO's father started the business?

The current CEO's father started LGI Homes in 1995 as a land developer specializing in residential sites located outside of urban centers. In the early 2000s, the father-son team thought builders were too focused on the product instead of on the customers, so they entered the homebuilding business in 2003.

Eric Lipar has been CEO since 2009 and has bootstrapped LGI by raising private equity capital in its early days to going public in 2013. Simply looking at LGI's track record is impressive. Eric Lipar has done a pretty remarkable job building the company.

What's the level of insider ownership?

Eric's dad is retired but still owns 5% of shares and Eric owns 10% of the company. With LGI's market cap current trading around $1 billion, Eric's shares are worth about $100 million which is significant relative to his $3 million total compensation for 2017. It's pretty clear that Eric lives and breathes LGI. We feel our money is in good hands with him at the helm.

Let's move on to valuation. Why do you like the stock at the current level?

LGI is a fairly capital-intensive, high growth company which has to reinvest profits to grow. If the company were to stop increasing unit volume, all profits would be able to be distributed to shareholders. If LGI stopped growing and maintained its current capacity of 6,000 to 7,000 homes per annum, it would have about $155 million in distributable profits this year or a 17% earnings yield.

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The question is how sustainable are these earnings and what are the reinvestment opportunities? Earnings could decline if we are near the end of a housing cycle. However, I shared our view earlier that there is a general lack of housing inventory available, especially for the markets it serves. LGI has never taken a write-down on its housing inventory and has earned over 30% return on equity since going public. They have a strong track record of growth and management wants LGI to become a top-five homebuilder. As long as LGI can reinvest cash at a 30% return, we hope it can grow indefinitely.

Since a lot of LGI's capital is tied up in its housing inventory, it's reasonable to use book value as a proxy for value. LGI is currently trading at 1.6x book value. If the company continues to earn 30% on equity and an investor bought shares at 1.6x book value, they would be earning nearly 20% on their investment at current prices. LGI has been able to grow book value per share at over 35% a year since going public, and while growth is likely to slow as LGI becomes a larger company the current valuation looks highly attractive.

What does the balance sheet look like?

LGI maintains a pretty solid balance sheet. They target a net debt to capitalization ratio around 50%. Leverage typically fall within this range which is driven by changes in inventory levels.

WIn the best case scenario, what's your price target?

That LGI continues to expand in their niche of the housing market and management continues to grow the company to become a top-five homebuilder. There seems to be plenty of opportunities for LGI to expand. If they continue to earn 30% on their equity and reinvest it at similar rates they should grow book value around 30% a year. Consensus estimates project LGI to increase both home unit and EPS around 15% in 2019 which is a significant decline from recent years. Management expects to grow community count between 20-30%. With shares trading at 6x earnings and 1.4x book value, LGI only has to have moderate growth over the long-term to provide pretty attractive shareholder returns.

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What are the major red flags you're looking for that could derail your thesis?

While we think the market is over-discounting a potential cyclical downturn, there is a risk that potential homebuyers put off purchasing a home if unemployment rates shot up. If we went through a depression like scenario, and LGI was stuck with a lot of housing inventory on their balance sheet, it would be difficult to sell those assets. But as I mentioned earlier, LGI has a well-capitalized balance sheet, and as long as they avoid worse case bankruptcy risk, they would likely have an opportunity to benefit from a downturn if they could buy land or properties at a discount.

LGI has not discounted their homes historically since they target a certain gross margin, but the critical metrics to follow are inventory levels through absorption rates and how gross margins trend over time.

And what happens if the company struggles to achieve its objectives? How much downside is there here?

The company has pretty high growth goals but also targets certain gross margins, so management is determined to grow profitably. If they fall short of their growth objectives, we see little downside over the long term based on where shares are currently trading. We never know what shares will do and they could drop more from current levels. If the company sticks to their strategy of converting renters into owners of affordable houses, it should do very well. There is obviously a risk that earnings might decline over the short-term, but we think it is much more likely that LGI will continue to grow over the next cycle.

Finally, how could rising interest rates impact the business?

Somewhat counterintuitively, LGI may benefit from higher interest rates or the next downturn. Higher rates increase the cost of homeownership, which can push people into more affordable housing categories such as LGI's.

LGI performed well during the last recession, though it was a much smaller company 10 years ago. It remained profitable, never took an inventory write-down, and was the only top 200 homebuilder to grow. LGI was even able to buy land at desirable prices from Lennar during the downturn.

People may prefer renting over owning if they are less confident about their employment, but if owning one of LGI's homes is cheaper than renting, it still provides a strong value proposition.