The Blue Chips Investor Letter

Spring 2021

"The natural state of the value investor is one of skepticism."

Howard Marks

Statement from the Chair

Chair of the Investment Committee: Austin Wang

Our intro quote comes from Howard Marks' recent memo "Something of Value", where Marks refers to the skeptical stance many traditional value investors took when looking at high growth tech companies but concludes that value and growth investing should never have been viewed as different at all. Amidst the low interest rate environment, uncertain COVID recovery projections, and sky-high valuations across a multitude of high-growth industries – finding traditional value investments proved to be quite the challenge. It is easy for a skeptical value investor to take a high growth company, projected their cash flows for five to ten years, throw on a two percent terminal growth rate, and claim they are overvalued or lack a high margin of safety. However, truly high-quality growth companies do not behave in the way we often project they do. A company like Visa or Microsoft has seen double digit growth for decades – a two percent terminal growth rate certainly would not have done them justice. In today's day and age, high prices may be justified by the fact that companies can scale more frictionlessly and build deeper moats than ever before. As skeptical value investors, it is more important than ever to question what a company's competitive advantage will look like in a future that could be wildly different from the present and develop strong conviction around the economic moats of our investments.

Over the past few years, our club's approach to investing has evolved as more of our members became interested in higher growth companies rather than deep value investments. Last Spring, our sectors pitched several high growth companies such as Trupanion, a leading provider of pet insurance, and Butterfly Network, a medical device company that recently went public through a SPAC. When looking at such businesses, we focused on understanding whether we had differentiated views on underlying business quality. While Trupanion was a leader in an attractive and rapidly growing market, we were not convinced that their access to historical pet data constituted a moat against other insurance companies entering the space. Similarly, we were extremely impressed by Butterfly Networks leading ultrasound technology. However, as students without scientific backgrounds, we could not develop strong conviction for investing in a business where technological superiority was their primary competitive advantage. ICOMM invested in two companies from the special situations sector, Discovery and Cognyte, based largely on their long-term growth runways and non-fundamentals-related price declines.

In the case of Discovery, the Archegos liquidation resulted in a sharp price decline and a unique investment opportunity. However, Discovery's stock price saw an enormous rally after the transition to a digital streaming model, and it was a very real possibility that Discovery was significantly overvalued prior to the liquidation. ICOMM's questions centered around the true growth opportunity for Discovery's new streaming platform amidst a highly competitive market, and the claim that Discovery's content library constituted a significant economic moat. Ultimately, we took the stance that Discovery's new streaming platform had significantly better economics than their cable model, and Discovery's difficult-to-replicate reality TV library would allow their streaming service to grow by targeting a niche customer base of middle age Americans.

We saw a buying opportunity in Cognyte, a security analytics company with a unique focus on government clients, after a spinoff from Verint in February 2021 resulted in significant forced selling by large-cap funds. Like many other software companies, Cognyte boasted an attractive land-and-expand model that would drive growth. Since much of Cognyte's value was driven by the cross-selling and potential price increases, it was imperative for us to understand whether Cognyte's switching costs were truly insurmountable. Veterans from the SSG sector were able to provide helpful insights into the difficulties associated with changing military security software, enabling ICOMM to develop strong conviction in the company's land-and-expand prospects. Cognyte was a case study on the importance of diversity in investment teams and underscores the importance of bringing a variety of different viewpoints into our organization.

In what is hopefully our last virtual quarter, we were extremely happy with the engagement we saw from the club. TBC's new sector leaders and analysts started their tenure in a difficult-to-navigate virtual environment, but the pitch quality and sector engagement we saw was truly phenomenal. This quarter, we also brought back the TBC mentorship program and had numerous upperclassmen volunteer to mentor TBC's largest ever analyst class. Transitioning back to in-person meetings while maintaining the safety of our club members will be a challenge, but our entire leadership board is optimistic.

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Spring Pitches

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MarineMax (NYSE: HZO)

Consumer Sector Leader: Aarsh Kak

Company Overview

MarineMax is the largest recreational boat, yacht, and super yacht retailer in the world. The company focuses on selling both new and used recreational boats, and specializes in premium brands and luxury yachts. HZO has 100 retail locations worldwide (77 of which are domestic) with 8,000 boat slips. While they offer 25 premium brands, such as Sea Ray, Mastercraft, Azimut, Ocean Alexander, and more, they enjoy exclusive contracts with 6 luxury yacht industry giants. In addition to selling boats, they also sell marine products, accessories, and parts, while providing repairs, maintenance, slip and storage services, insurance, brokerage sales, and a yacht charter business.

Investment Thesis

The Consumers Sector recommended a BUY in HZO for the following reasons

1. **Long Term Impact from COVID-19**

The boating industry experienced a sharp increase in demand for boats due to COVID-19 and we believe that this spike will lead to future demand for boats to be above historic averages. Nearly a third of first-time boat buyers purchase a new boat within 2 years. We believe this portion should be even higher for MarineMax customers since the company focuses on higher end boats, where buyers are more likely to be able to afford to buy a new boat after a few years. While the pandemic level of boat sales is not sustainable, we believe that HZO will see increased demand compared to pre-pandemic levels. Additionally, HZO has been focusing on expanding its higher margin businesses which include repairs and maintenance. HZO should be able to continue to profit from the new customers through these other services.

2. **Acquisitions and Consolidations of Marina Properties**

The boat retailing industry is highly fragmented and HZO has been able to take advantage of this through acquiring smaller marinas. Through acquisition, they have been able to expand into more geographies, consolidate properties, and to expanded into the premium yacht space. Acquisition have made MarineMax a better company and management has proven that they can take advantage of cost synergies. Based on management's track record and HZO's position as the largest player in a fragmented industry, we believe that MarineMax will continue to use acquisitions to become a stronger company. These acquisitions lead into the next thesis point, HZO's competitive advantages in the boat retailing industry.

3. **Competitive Advantages Compared to Industry Peers**

As the largest boat retailer, MarineMax has significantly higher gross margins than the average marinas and compared to the next largest peer, One Water suggesting that HZO enjoys economies of scale. Since boat manufactures grant exclusive regional agreements to marinas, HZO is able to use their economies of scale to be the exclusive dealer of many of the most popular high-end boat models. Additionally, as the largest player they have invested more than peers in developing a MarineMax ecosystem for customers, which increases switching costs for customers. MarineMax recently released an app that allows customers to schedule maintenance, washes, and fuel fill-ups for boats. This is unique in the boat retailing industry.

Key Risks and Considerations

1. Susceptibility to Manufacturer Control

Brunsiwck accounted for 33% of MarineMax's revenue in FY2020. Currently, MarineMax has exclusive agreements with Brunswick where MarineMax is the only retailer who can sell certain models (such as the Sea Ray and Boston Whaler) in designated geographies. The main risk comes from Brunswick preventing MarineMax from dealing with certain boat manufacturers who are competitors for Brunswick. There is no history of this happening, however it is a possibility. This is partially mitigated by the fact MarineMax is the largest seller of Brunswick boats and MarineMax is able to collect data from dealerships that is valuable for Brunswick's R&D.

2. High Exposure to Macroeconomic Factors

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Boat sales are highly correlated to macroeconomic factors as boats are luxury goods. For example, HZO was greatly impacted by the 2008 recession, the downturn caused net income for HZO to be negative for four consecutive years. MarineMax has been trying to become more recession resilient by focusing on premium boats and yachts, which tend to be less volatile during recessions. Through acquisitions, HZO is less exposed to economic factors as it was in 2008, but since it is a boat company it is still a large risk.

3. Geographic Concentration in Florida

Slightly over half of HZO's revenue has come from Florida over the last three years. This is more of a factor being in the boating industry since Florida has the largest market for recreational boats. The geographic concentration poses a risk, however, current population projections for Florida are favorable for HZO. Also, MarineMax has been diversifying through acquisition with the recent purchase of SkipperBud allowing them to expand their presence on the West Coast and Great Lakes.

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Decision: NO PURCHASE

Consumers Investment Committee Representative: Niralee Shah

The Consumers Sector pitched MarineMax Inc. (NYSE: HZO) on Wednesday, May 12th, 2021 in General Meeting as a buy. The Investment Committee (ICOMM) decided not to buy HZO. Our reasons are as follows:

FIRST: The business operates in an extremely cyclical industry, and we were not presented with enough evidence to believe the company is not currently at the peak of the cycle, especially given the anomaly that FY2020 was with regards to their sales. They are still in the process in recovering from the cyclical trough in 2008 when they lost 90% of their value due to a significant shift in consumer spending.

SECOND: We are not convinced by the competitive advantages cited by the sector. Part of the thesis hinges on the network effects the company exhibits as a result of their app development, but the business model does not display the two-sided market necessary for network effects to exist. Another key element of the thesis was management's ability to effectively deploy capital, which we are skeptical about as well. HZO depends on the large number of acquisitions it makes to grow, however oftentimes the acquisitions don't seem to have a material impact on their business. Their ROIC has been steadily below their WACC for the past 10 years before 2020. Not only does this pose questions about management's ability to make strategic acquisitions, but also makes us wonder about whether HZO has any organic growth prospects.

THIRD: At the time of pitch, the margin of safety was insufficient. HZO's price had grown by over 300% in the last year due to the company's exceptional performance in FY2020 as a result of COVID related tailwinds. However, we are unconvinced that 2020 was not an anomaly and that the company's strength in sales will remain long term. Thus, we see no argument that there was a fundamental mispricing. The sectors assumptions regarding revenue growth and margin expansion in the model seemed too aggressive to us, as they implied that revenues would grow in the same way into perpetuity that they did in 2020.

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TBC

Atlantica Sustainable Infrastructure (NASDAQ: AY)

Natural Resources Sector Leader: Karol Mukhamediyeva

Company Overview

Atlantica Sustainable Infrastructure is a UK based company which owns a range of renewable, natural gas, and water utility assets across Europe and North and South America. AY has a diversified portfolio, and their business sector breakdown is 72% Renewables, 14% Efficient Natural Gas, 11% Transmission and Transport, and 3% Water. Similar to most other power generation companies, AY earns revenue through Power Purchasing Agreements (PPAs) which provide stable contracts that have a weighted average contracted life of 17 years. Atlantica owns 28 stable contracted assets which include 1,166 miles of electric transmission lines and 1,591 MW of renewable generation.

Investment Thesis

The Natural Resources Sector recommends a BUY in AY for the following reasons:

1. Solid Business Fundamentals: Atlantica has very diverse revenue streams as a result of owning 28 contracted assets across a variety of business sectors and geographic locations. In addition, long-term PPAs ensure that AY has stable revenue which allows for consistent dividend growth. Atlantica has paid out a dividend for 6 consecutive years. In the most recent fiscal year, AY had a dividend yield of 5.1% which has been increasing over the past 4 years and has grown at a CAGR of 12% between 2018 and 2020. By having stable and diverse revenue streams, Atlantica can support consistent dividend payouts.
2. Strong Debt Position and Risk Insulation: Atlantica's self-amortizing and non-recourse project debt insulates their financing options from project risks. The company's project debt amortizes completely before contract expiration which means AY does not have large principal payouts at the end of the debt period. Also, their project debt is secured in subsidiaries that the company holds equity in, so the project debt only affects the subsidiaries and poses little risk to AY as a whole. While Atlantica currently has $5,238M in project debt, they plan on a $1.9B debt reduction over the next 5 years to decrease their debt to a more manageable amount of $3,361M. Even though their debt is self-amortizing, AY has no-near term debt maturities and only has $28M in principal repayments over the next 4 years. Finally, they have more than $750M in corporate liquidity which is beneficial for financing growth opportunities.
3. Advantageous Growth Opportunities: Atlantica's multi-continental presence and diversity in revenue generation gives the company a strong foothold in multiple sectors with high growth outlooks. Compared to competitors, such as Avangrid (NYSE: AGR) and CenterPoint Energy (NYSE: CNP), Atlantica has a larger geographic presence which insulates AY from risks due to changing foreign regulations. Atlantica benefits from favorable industry trends as well. Within the United States, developments at the state and federal level indicate continued and growing incentives for renewable energy investment. Globally, many other countries are moving towards increased reliance on renewable energy and sustainable alternatives. For instance, European ESG regulations are steering greater investment towards the Green Energy sector. Atlantica also benefits from organic growth opportunities, and they already anticipate spending $300M on reinvestment in 2021. AY owns 3 transmission lines in Peru and Chile, and there is minimal cost to connect new customers to lines, so they can expand existing assets and generate low-to-no cost revenue growth.

Key Risks and Considerations

1. Highly Leveraged: At first glance, Atlantica has a total of $5,362.8M corporate and project debt, and such high levels of debt increase AY's risk profile and may make it more difficult to raise capital for future investments and acquisitions. However, AY has self-amortizing and non-recourse project debt and a plan to reduce debt by $1.9B over the next 5 years. While their debt load is substantial, Atlantica can insulate themselves from the associated risks.
2. Foreign Government Instability: Since Atlantica has assets in many countries, AY is subject to global tensions, foreign rules/regulations, and may be delayed by protests and political unrest. To mitigate such risks, Atlantica has a team dedicated to regulation and compliance issues, and they maintain a strong social connection with the countries they operate in. For example, Atlantica donated $336K in 2019 to local Peruvian communities.

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3. Reliance on Third Parties for Supplies: Atlantica's projects frequently rely on supply of services, equipment, and software that is often subcontracted, so if local suppliers experience delays or if there are supply chain issues, Atlantica can be negatively impacted. However, AY has ample cash reserves at each location to help expedite repairs and the purchase of necessary supplies if needed.

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Decision: No Purchase

Natural Resources Investment Committee Representative: Frank Li

The Natural Resources Sector pitched Atlantica Sustainable Infrastructure (NASDAQ: AY) on Wednesday, May 5th, 2021 in General Meeting as a buy. The Investment Committee (ICOMM) decided to not purchase AY. Our reasons are as follows:

FIRST: We recognize that AY is a fundamentally solid business that owns and operates a diversified portfolio of renewable, natural gas, and water utility assets around the world. As the majority of its revenues are secured by long-term Power Purchase Agreements that fully cover project-level debt obligations, AY is—to a certain degree—insulated from individual project and commodity price risks. Furthermore, we appreciate AY's focus on ESG priorities and also note that AY will benefit from favorable industry trends, such as electrification in South America as well as growth in renewable energy investments in both Europe and the Americas.

However, we are concerned with the surprisingly unattractive economic fundamentals of the business. Based on the sector's calculation, AY has a ROIC ranging from 3.9% to 4.6% in the past three years, which is considerably lower than the 6.2% WACC estimated by the sector. Moreover, considering the highly acquisitive nature of AY's business, we are uncomfortable with the relatively low clarity we have into the criteria based on which AY's Management evaluates potential investments, their target return rates, and future project pipelines in general.

SECOND: We also find the capital allocation policy of management to be potentially unsustainable. AY paid out $169m in dividends for FY2020 and has consistently increased its dividend pay out in the past years. However, the company has had net incomes that are far lower than its dividend payouts, and have been seemingly financing its dividend through debt and equity raises, which is clearly not ideal given AY's business economics discussed above.

THIRD: Based on our discussion with the sector and their valuation model, when we correctly project out AY's capital expenditures taking into account the potential consistent stream of acquisitions in the future, it seems that much of the value of AY's business is already captured in its price. This may be due to the salience of the secular trends toward renewable energy and the resulting increasing investments in the sector, which leave AY fairly valued at best.

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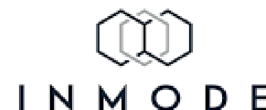
InMode Aesthetics (NASDAQ: INMD)

Healthcare Sector Leader: Alexander Prakash



Company Overview

InMode is an Israeli medical device company that designs, manufactures, and markets cosmetic surgery systems. Its main products are used for face and body contouring and other aesthetic procedures like skin tightening and permanent hair reduction. Using a patented type of radiofrequency ("RF") technology, they offer less invasive, quicker, and cheaper alternatives to traditional procedures like plastic surgery. InMode is also developing alternative uses for RF technology, including women's health, TMJ, and ophthalmology. The company sells both surgical workstations and one-time consumables needed for each operation. About ¼ of InMode's revenues come from outside the U.S. The firm was founded in 2008 and went public in 2019.

Investment Thesis

1. Latent pricing power. The workstation-consumables model is analogous to the razor-razorblades strategy of locking-in customers with an upfront purchase and then generating recurring revenues from sales of necessary but expendable items. This model works well on doctors because of their high switching costs. They don't want to learn redundant surgical techniques, so they only use one company's machine for each type of operation; moreover, the threat of malpractice litigation makes them highly risk-averse, so they hesitate to replace their existing brand and re-learn a different workstation. Thus, once InMode establishes its reputation and acquires a solid installed base, it can comfortably raise prices on consumables.

   The firm's unique value-add gives it further pricing power. RF technology is both cheaper and higher quality (less invasive and quicker) than traditional medical aesthetics procedures, in many cases. Along with appealing to existing customers, RF also expands the medical aesthetics market. To give one example, it attracts young patients who dislike the downtime and scarring of plastic surgery. InMode's patents uniquely capture these benefits. The firm's proprietary technologies – bipolar energy, micro needling, and curved applicators – outperform both competing RF and traditional methods, according to independent, peer-reviewed studies; surveys of online customer reviews; and our interviews with doctors.

   Quantitatively, the firm performs well. It grows quickly (with a 73% four-year revenue CAGR) and earns high, stable margins (with 85% gross profit) and consistently strong returns (return on capital > 20%). This good performance, despite being a small company in a competitive field with powerful incumbents, suggests that InMode sells an attractive product.

2. Favorable industry trends. Growing demand for aesthetic surgeries, especially the type InMode offers, will help the firm build a large customer base. The global medical aesthetics market is expanding quickly, with an 11% projected five-year CAGR, driven by growing discretionary income in the developing world and an aging population in the developed world. Notably, demand for non-invasive aesthetic treatments, like InMode's, is expected to see even stronger growth, with a 14% eight-year CAGR. This is due to growing appreciation for the advantages of minimally invasive procedures and the expanded market they can reach. Although COVID was a short-term headwind, a year of Zoom proved a net boost to demand for aesthetic procedures, at least in InMode's largest markets, like the U.S. Such industry tailwinds will help this early-stage company secure a large installed base to monetize over time.

3. Additional use-cases. InMode's RF technology has several potential medical uses aside from aesthetics. The company already offers RF-enabled women's health products, e.g. for vaginal rejuvenation. This is a young, rapidly growing market. Notably, studies suggest InMode's product is far safer than competing, laser-based devices – in fact, in March 2018 the FDA warned against energy-based vaginal rejuvenation technologies, causing most products to be recalled on safety grounds. InMode's devices, however, were not affected because regulators were comfortable with the safety of the underlying RF technology. RF has the potential to transform other medical markets as well. InMode is in various stages of exploring and commercializing use-cases in TMJ, ophthalmology, snoring, and ED.

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The firm's extensive experience with RF, its relevant patents, and its singular focus on RF technology give it a competitive advantage in exploring these growth areas. Although these possibilities are very difficult to value, we believe the market does not appreciate RF's potential as more than just an aesthetics technology.

Key Risks and Considerations

1. Litigation. Marcus Aurelius value published a short thesis on InMode. They highlight litigation caused by accidents with the company's machines and allege management is hiding its products' safety risks from customers and regulators. They argue that the company has co-opted doctors with stock payments, thereby suppressing bad publicity and distorting academic research. They also label InMode's CEO an "IPO artist" and are skeptical of the value of its proprietary RF technology.

2. Limited recurring revenues. Currently, only 10% of InMode's revenues come from sales of consumables and 90% come from machine sales. Machines, which are analogous to razors, are purchased once by a doctor and then used for many years. However, our thesis about customer monetization requires InMode to make most of its money from "razorblades." We expect the proportion of recurring revenues to increase markedly as the installed base grows and InMode leverages its pricing power on consumables. However, our estimates of unit economics suggest that the firm's revenues may stabilize at a lower level than current growth rates suggest.

3. Excess cash. The company holds a lot of excess cash on its balance sheet. This is surprising for a growth-stage company, which should be capital-hungry. When combined with a surprisingly low R&D expense, the high cash balance suggests that the firm may face declining incremental returns to investment, which contradicts our high-growth thesis. Alternatively, the cash, which management has discussed on earnings calls, could also reflect distortions due to Israeli tax law which make it harder to allocate capital but ultimately don't handicap the company's growth potential.

4. Competition. The medical devices market has many large firms with marketing and R&D muscle that InMode cannot match. Although none of the giants offer RF-enabled devices, other firms do compete with InMode in this niche. A possible mitigant is that InMode is an attractive acquisition candidate because of its small size and unique patents.

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Decision: No Buy

Healthcare Investment Committee Representative: Roger Shen

The Healthcare Sector pitched InMode (Nasdaq: INMD) on Wednesday, May 5, in General Meeting as a buy. The Investment Committee (ICOMM) decided not to buy InMode. Our reasons are as follows:

There are a number of concerns with InMode as an investment that are just quite difficult to quantify.

FIRST: InMode has had 12 lawsuits regarding InMode's products severely burning patients or even damaging nerve tissue--as well as management potentially breaking laws such as failure to report paying doctors to promote products and up to potentially fraudulent FDA reporting. The sector argued that these lawsuits and potential future lawsuits are not a major risk to InMode because InMode can simply argue that the blame lies with the doctor and not the company. From our perspective, there are two possible outcomes for InMode regarding its prevalence of adverse events and associated legal troubles. One possibility is that InMode gets destroyed by a future class action lawsuit and/or a major product recall. In such an event, InMode as an investment has no value. The other possibility is somewhat in line with the sector's argument--these lawsuits and potential future lawsuits pose no real legal threat to InMode because InMode can blame any problems on the doctor. However, the second order effect of this possibility is that doctors will become less willing to use InMode's products. If usage of InMode's products have a history for adverse events (whether it was the doctor's fault or not), and InMode has a history of throwing the doctor under the bus, then the risk associated with using an InMode product is quite high from a lawsuit-risk-averse doctor's perspective. Therefore, neither outcome from InMode's legal troubles is attractive as an investment.

SECOND: There are some real issues with InMode's business model and competitive dynamics. The sector argued that there are high switching costs due to doctor's being forced to learn new procedures for different medical devices as well as the razor-blade model for InMode's machines and consumables. We agree that in the short run, these may serve as a short-term switching cost competitive advantage. However, roughly 90% of InMode's current revenue is actually coming from the sale of machinery rather than consumables due to InMode being in a rapid growth stage. The problem is that when InMode reaches a steady state mature stage in its lifecycle, its sale of machinery could potentially be significantly less than growth implied by the current market valuation. InMode's machines have a useful life of roughly 7 years which implies that the average customer at most will only buy an additional machine once every 7 years. Thus, as the sector argues, it's imperative that InMode has the potential to raise prices significantly on its consumables. However, in order to do so, InMode must have high long-term switching costs as well. This is where we disagree. The sector pointed out that competing RFAL devices (i.e. Morpheus 8, Vivace, Thermage) are rather undifferentiated and do quite similar things. Moreover, the sector also found that the procedures and training for competing devices are all relatively similar. Thus, in the long run, it may not actually be that difficult for a doctor using an InMode device to switch to a rival product should InMode raise the prices on its consumables. This potential price competition and loss of installed base is unacceptable from a valuation standpoint.

Finally, the sector argues for economies of scope for alternative applications of InMode's already developed RFAL technology. This could be quite an attractive investment opportunity if successful. However, there are a number of barriers to successful expansion into alternative applications including InMode's current reputation for burning/nerve damage, gaining regulatory approval, alarmingly low R&D expenditure, and competition with pre-existing treatments (for example, Viagra vs. a significantly more invasive RF treatment). There's simply too much uncertainty, given what we know, regarding the probabilities of successful penetration into alternative markets.

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THIRD: It's important to reflect on the risk/reward profile for this investment. There may very well be a chance that we're wrong about this company. Maybe InMode's legal concerns are overblown, switching costs are higher than we give credit for, and InMode successfully enters alternative markets. If all three of these things are true, InMode could be a good investment. However, the risk for this company includes a number of unacceptable potential outcomes. The risk of a class action or product recall due to InMode being fraudulent or committing crimes is one that we're not willing to take. The risk of InMode being potentially price competitive on consumables in steady state is another that we're not willing to take given the market price. Thus, in summary, even if there may be a chance for decent upside, the downside potential for InMode does not fit within our club's investment philosophy.

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American Tower (NYSE: AMT)

Communications Sector Leader: Cody Tracey

Company Overview

Founded in 1995, American Tower is one of the largest global real estate investment trusts (REITs) and a leading independent owner, operator, and developer of multitenant communications real estate. AMT's primary business is the leasing of space on communications sites to wireless service providers, radio and television broadcast companies, wireless data providers, government agencies and municipalities, and other tenants.. AMT's communications real estate portfolio of approximately 186,000 communications sites includes more than 43,000 in the United States and Canada, nearly 76,000 in Asia-Pacific, approximately 20,000 in Africa, more than 5,300 in Europe, and nearly 42,000 in Latin America.

Investment Thesis

The Communications Sector recommends a BUY in AMT for the following reasons:

1. International Growth: International growth in 4G / 5G represents a large runway of opportunity for AMT. A large majority of international markets that AMT operates in have yet to build out robust 4G infrastructure, resulting in an opportunity for AMT to continue to dominate internationally and increase market share. AMT has recently made several significant acquisitions to expand into international markets, with the $9.4Bn acquisition of Telxius among the largest. It is reasonable to expect that AMT's dominant position will allow it to capitalize on these acquisitions and push international tenancy ratios towards their U.S. towers, resulting in an improvement in margins and ROIC.
2. Financial Strength Relative to Peers: Relative to peers, AMT operates a fundamentally stronger balance sheet while also pursuing high ROIC businesses relative to peers. SBA Communications and Crown Castle have shifted to less profitable small cells and fiber, while AMT has maintained strength in Macro Towers and their DAS nodes. While competitors have started to rotate into more attractive tower models that mirror AMT, AMT is better positioned financially to continue robust tower build-outs and acquisitions relative to their peers.
3. Strength of TowerCo Model / 5G Profitability due to DAS Network: AMT has consistently relied upon its Macro Tower model in suburban and rural areas where Macro Towers are far more feasible. This has provided increased operating leverage and ROIC relative to competitors and has differentiated its overall tower portfolio. Furthermore, while competitors have dedicated capital to small cell build-outs, AMT has developed DAS systems that operate with similar unit economics as Macro Towers. This provides AMT with a differentiated portfolio that allows them to take advantage of significant switching costs and network effects.

Key Risks and Considerations

1. Losing REIT Status: AMT's REIT status allows them to avoid double-taxation on dividend payments to investors. While not a high probability risk, the loss of REIT status would require a restructuring of the business and change the way that the business operates and returns capital to investors.
2. Concentrated Revenue Base: AMT is heavily exposed to AMT, T-Mobile, and Verizon, with approximately 51% of total revenue coming from these three carriers. This gives those three companies more bargaining power to push down pricing on leases and provide concessions in terms of costs. However, in the areas in which AMT operates, they generally do not have a large amount of competition and thus have even more bargaining power than the TelCos.
3. Shift to 5G: As mentioned previously, the shift to 5G will generally necessitate a change in technology. This shift could result in a proliferation of small cell networks to accommodate the millimeter-wave spectrum used in 5G. However, small cells are designed more for urban environments and are not feasible in the areas that AMT generally operates (suburbs, rural).
4. Macro Risks: Given that AMT is focusing on international expansion, there are risks associated with operating in emerging economies generally. Much of this risk is related to the possibility of corruption, adherence to the rule of law, and general cultural concerns with foreign investment in local areas. There is also the potential of a scarcity of capital in less-evolved economies to support the capital-intensive investments required in building out wireless infrastructure.

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Decision: NO PURCHASE

Communications Investment Committee Representative: Will Reid

The Communications Sector pitched American Tower (NYSE: AMT) on Wednesday, May 18 in General Meeting as a buy. The Investment Committee (ICOMM) decided not to buy the company. Our reasons are as follows:

FIRST:

While we believe that AMT will be able to continue its high profitability and have potential growth opportunities, the growth opportunities pointed out by the sector such as the international expansion and the buildout surrounding 5G are well understood and fully appreciated by the broader market. The claim that most investors are focused on small cells in the face of the 5G buildout might be true, but that is not sufficient evidence for a significant mispricing. Combined with the high visibility of pricing on their contracts and the low margin of safety as modeled by the sector, we were not convinced that now is the time to buy.

SECOND:

We are not convinced that the international opportunities presented by the sector are as attractive as claimed on a few fronts. First, as mentioned above, these are well-known opportunities and will only become more competitive with time. Second, there is little to no evidence that pricing in these markets will approach that of more developed markets and allow AMT to expand their margins. Third, there is significant geopolitical risk in some of their expanding markets, specifically India, which could easily hamper growth and market share.

THIRD:

The assumptions made surrounding the cost of the Telxius acquisition and capex going forward were too generous. We believe there is no reason to assume that the cost of M&A and the construction of new towers will go down in the future, and allowing for this the margin of safety shrinks significantly.

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Company Name (NYSE: BFLY)

Technology Sector Leader: Charlie Donnelly

Company Overview

Butterfly Network (BFLY) is a medical technology company that produces handheld ultrasound machines for primary care physicians, nonprofit partners, and consumer markets. Butterfly's ultrasound devices connect directly to smartphones to allow users to scan, upload, and share ultrasound images quickly. Butterfly's technology allows healthcare providers to take fast ultrasounds in emergency settings, while traditional legacy ultrasound tech requires a team of highly trained radiologists to maintain and transport large ultrasound machines around a hospital. Butterfly Network sells via eCommerce, an enterprise salesforce, and partnerships with major organizations and nonprofits. Their enterprise customers include most of the top 100 U.S. healthcare systems, and eCommerce customers include primary care physicians, emergency doctors, and medical students. Customers purchase hardware at a relatively low price point, then pay subscription fees to access pro software and analytics. This business model allows Butterfly to capture strong recurring revenue for successive generations of healthcare technology.

Investment Thesis

The Technology Sector recommend a BUY in BFLY for the following reasons:

1. **Large (8bn) TAM with Strong Emerging Market Focus**: BFLY's low price point allows them to reach emerging market healthcare practices, where legacy technology is too costly and patients would have to travel hours to reach the nearest major hospital. These cheap handheld probes could expand the resources of doctors working outside hospitals and compete directly with expensive probes manufactured by Phillips and General Electric, which are typically 2–3x the price of Butterfly handhelds. Furthermore, legacy technology is highly impractical in emerging markets where a single machine requires an extensive surrounding HIPAA compliant system.
2. **Addresses unmet need for more efficient care through Aggregation**: Legacy technology is capital intensive and time consuming to maintain; hospital staff must manage a fleet of large ultrasound carts, purchase additional analytics software, and choose from a series of imaging probes. Butterfly devices aggregate many of these features: the device has one probe with several imaging features, and users can instantly upload scans to a HIPAA compliant cloud for sharing within one hospital. By aggregating sharing, analytics, and imaging, Butterfly probes are more practical for emergency settings where time is crucial for diagnosis and treatment. These features also strongly differentiate Butterfly from existing legacy technology, which allows Butterfly to engage in the competitive ultrasound industry without displacing major players like General Electric, who focus more on disaggregated legacy technology.
3. **Dynamic Sales, Execution, and Growth Strategy**: Butterfly is a relatively new company with a strong management team and sales strategy in place. CEO Jonathan Rothberg has 30+ years of experience with founding and scaling medical technology companies, most of which have matured successfully and ultimately been acquired. Rothberg and other Butterfly Leaders have developed many major clinical partnerships, one example being Sientra. Sientra manufactures implants for plastic surgery, and has recently integrated Butterfly devices into their medical educational platform. Partnerships like this one will allow Butterfly to introduce their product to new practitioners quickly, and also pilot their new products (like veterinary imaging) with existing partners.

Key Risks and Considerations

1. SPAC Dilution and Valuation: Butterfly went public through SPAC, and shareholder value was destroyed in the transaction. Building public warrants into our valuation implied a far lower value. It is possible that going public via SPAC offered Butterfly a higher valuation, and may dilute the value of the company in future.
2. Highly Competitive Landscape: While we believe Butterfly has carved out a niche in low-cost handheld ultrasounds, major players like General Electric and Phillips are well poised to produce their own low-cost models and compete with Butterfly. It's possible that major hospitals would prefer to buy from a trusted brand, and Butterfly may need to prove itself to major healthcare partners before making a sale.

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3. Uncertainty around Revenue and Growth: Butterfly has grown its revenues by 68% in the last year—from $27.6 million in 2019 to $46.3 million in 2020. While we expect Butterfly to continue to grow, management provides limited financial data and revenue breakdowns, which makes it difficult to estimate how much revenue will come from hardware and subscription. Since Butterfly is a relatively new company (founded in 2011 and went public in 2020), more detailed revenue breakdowns would be helpful to estimate growth.

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Decision: No Buy

Technology Investment Committee Representative: Emily Ballinger

The Technology Sector pitched Butterfly Networks (NYSE: BFLY) on Wednesday, ? in General Meeting as a buy. The Investment Committee (ICOMM) decided not to buy BFLY. Our reasons are as follows:

FIRST: Competitive Landscape and long-term technological advantage: BFLY currently has a market leading technology in terms of price and range of features however the long-term durability of such an advantage is unclear. Competitors in producing smaller handheld ultrasound models such as General Electric and Phillips have similar but less advanced and more expensive models despite the firm's large scale and engineering know how. Furthermore, if BFLY's own projections are to be believed there is an 8bn and growing TAM for ultrasound devices. Such a market is large enough that major players who have already entered the space will continue to innovate and compete for market share and may result in the introduction of a lower cost model or premium version with upscaled features. Because BFLY does not clearly aim for either end of the market this may result in being taking from below, and lessening market share in emerging markets, as well as from above. This raises question of if their technology is in and of itself a competitive advantage for the firm, the likely answer to which is no. It is difficult for systems like scan uploading or analytic algorithms to avoid copycats especially those that come from large credible players with a history in the space. A similar but slightly worse product can often mimic well enough to convince administrators or finance departments to make a purchase, even in markets we consider to be "mission critical" such as healthcare. Although it may take some time for BFLY's competitors to accomplish similar innovations the long sales cycles typical for medical device upgrades established this a salient risk that hurts long term profitability and competitive positioning for the firm.

SECOND: Unprofitability and growth uncertainty: There is little historical financial information for the firm making realistic estimation of its current margin difficult, and thus judgment regarding managements projections for its future margins more so. With our concerns regarding the firms public offering being a SPAC the issue compounds by incentivizing greater optimism in projections then the typically more heavily scrutinized IPO. As such we are cautious regarding the timeline and margins for profitability management provides. Well, we do not believe the company is likely to face issues as a going concern, with $88m of cash burn a year and $545m in cash, the longer the road to profitability the lower our expected IRR will be. Secondly many of the areas that BFLY sees its long term growth in are difficult operating environments, namely emerging markets where technology likely comes through NGO buyers and the at home market. These environments are still relatively unproven, and although we see a great deal of potential in these spaces the speed at which it materializes may be well beyond our holding period.

THIRD: SPAC Warrants and dilution: Due to the public offering of BFLY being structed as a SPAC the entity currently has a large amount (13.8 million) of public warrants alongside 6.9 million of private placement warrants. Further with a strike of $11.50 it is highly likely BFLY would see these warrants excised in the future resulting in the destruction of value for shareholders who bought in after the SPAC due to the large degree of dilution. The initial decision to go public via SPAC at this time raises further red flags as their success in the private markets prior and lack of obvious go public need suggests that the firm simply found more attractive pricing in the bubble filled SPAC market then it did in today's lush venture environment. SPACs further give a significant number of shares to the sponsors promote regardless of later performance destroying shareholder value in the process. As investors in public equity markets companies recently taken public via SPACs should be viewed with caution, and in this case alongside several other factors in BFLY's business model and market make us uncomfortable with the margin of safety left in our investment.

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Company Name (NYSE: GSL)

Industrials Sector Leader: Jesse Weinstein

Company Overview

Global Ship Lease leases their growing fleet of ~50 small-to-midsize containerships to a select number of well-established liner companies. They have a market cap of $500m with $282M LTM revenue and a 40% EBIT margin and are 23% owned by the PE firm Kelso & Co. Growth is largely dependent on the acquisition of additional containerships at competitive prices. They also benefit from increasing charter rates and spreading fixed costs across a larger fleet. GSL is uniquely positioned to capitalize on rising charter rates.

Investment Thesis

The Industrials Sector recommends a BUY in GSL at $14.99 per share for the following reasons:

1. Supportive Supply-Side Positioning in Target Segments: As global container shipping capacity has risen in recent years, it has done so almost exclusively in the largest ship size brackets, outside of the segment in which GSL competes. Currently, the orderbook-to-fleet ratio in GSL's target segment is 0.6%. Scrapping has outpaced ship delivery, creating a squeeze in the supply of small-to-midsize containerships. Nevertheless, in addition to increasing their charter rates over time, GSL has been able steadily to purchase vessels at discounts and expand their fleet while finding customers to sign three-year leases immediately. Their idle capacity has consistently stood around 1.1% or lower, even during periods of heavy ship acquisition.
2. Well-Positioned to Capture Rebounding Charter Market/Market Failure to Recognize Contract Structure: Reopening ports and rebounding consumer demand for shipped goods has dramatically increased shipping volumes. Simultaneous container shortages have led to increased shipping rates. In GSL's target segments, rates are up hundreds of percent from pandemic lows in 2Q2020, and greatly exceed their pre-pandemic levels. This year, 12 of GSL's current 43 ships will come open; of those, five have already secured contracts at greatly increased rates from their previous leases despite their increased age. Due to GSL's unique contracts being three-or-more years, current revenues are a function of many ships leased at years-old rates from 2018 or earlier. GSL will soon experience a not-yet-priced-in spike in revenues as they continue to negotiate new contracts and all-time high rates.
3. Strong Fundamentals/Undercoverage: The 3+2-year leasing model ensures sticky and stable revenues and partially shields GSL from the short-term fluctuations of the container shipping market. The few competitors who lease containerships specialize in larger vessels (10,000+ TEU) and have shorter contracts. Their unattractive business model and GSL's lack of truly comparable companies contributes to this undercoverage. GSL's deep and long-term relationships with several of the largest liner companies, such as Maersk and CMA CGM, have ensured both dependable charter rates as well as access to purchase opportunities for new vessels. GSL's revenue has continued to rise through COVID and they have recently acquired seven new ships through a deal with Maersk.

Key Risks and Considerations

1. Macroscopic Shipping Industry Risks: The shipping industry is linked to the overall supply chain and can be subject to fluctuations in commodity prices and demands. ESG initiatives may reshape the industry long-term, although GSL preforms relatively well in ESG. However, GSL's major clients are top global shipping liners; these companies are "too big to fail" and have received sizable loans from various world governments to guard against any risk of insolvency.
2. Value Destruction: GSL operates an asset-intensive business with steep depreciation and depends on growing through further acquisitions. Nonetheless, at $14.99 a share, strong margins and the dependable promise of locking in large rate increases for at least three years, GSL is undervalued.
3. Risk of Major Shareholders: Kelso & Co. recently reduced their control of GSL from 35% to 23%. They have held their position in GSL for over a decade.

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Decision: BUY

Industrials Investment Committee Representative: Darius Hong

The Industrials Sector pitched Global Ship Lease Inc. (NYSE: GSL) on Wednesday, May 12th, 2021 in General Meeting as a buy. The Investment Committee (ICOMM) decided not to purchase GSL. Our reasons are as follows:

FIRST: We agree that the concentration of GSL's fleet on small-to-midsize containerships allows it to operate in an attractive space, as approximately 70% of global container volume is transported on intermediate and intra-regional trade routes. However, it does not appear that GSL possesses a durable competitive advantage within that space, and their customers have been heavily investing in their own directly substitutable midsize fleets, casting doubt on their reliance on GSL. For instance, CMA CGM, GSL's single largest customer, recently placed an order for 22 vessels (sized within GSL's "niche" load capacity) from Chinese shipyard CSSC Group, to be delivered in 2023 and 2024.

SECOND: The financial success of GSL is particularly sensitive to the global macroeconomic environment. Over the past few years, trade disputes and excessive supply have caused container shipping companies to struggle to survive. The recent spike in shipping rates has been a saving grace to many shipping companies, including GSL. However, we believe that the current container shipping rates are unsustainable, and it is likely that we'll see a reversal in the spike in North American goods consumption which is the main cause of the shipping rate boom. Many retailers and importers are struggling with shipping costs, which will eventually cause prices for goods to increase, decreasing consumption. Further, we believe the leverage of GSL and its customers leaves the overall industry highly exposed to this macroeconomic uncertainty. This is especially true when considering the large, levered investments that GSL and its customers have recently made into growing fleet sizes, despite several of them (including CMA CGM) having been on the verge of bankruptcy in early 2020.

We believe that if an Asian commodities super cycle were to catalyze the midsize container shipping industry, GSL could be an interesting short-term play. However, the absence of durable competitive advantages and the capital-intensive and value-destructive nature of this business implies significant long-term downside risk.

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Trupanion, Inc. (NYSE: TRUP)

Financials Sector Leader: Victor Liu

Company Overview

Trupanion, Inc. (NYSE: TRUP) is a pet insurance provider that offers and administers pet insurance for cats and dogs, with operations in over 120 territory partners in the United States, Canada, Australia, and Puerto Rico. TRUP's services cover medical expenses for new/unexpected injuries and illnesses, and the business primarily derives revenues from a subscription-based model, which accounted for ~77% of total revenues in 2020. Moreover, monthly subscription services are priced specifically for each pet's unique medical needs to help pet owners budget for unforeseen expenses.

Investment Thesis

The Financials Sector recommends a BUY of TRUP for the following reasons:

1. Solid Market Positioning in an Oligopolistic Industry: With over 20 years-worth of insurance subscription analytics collected, TRUP has accumulated a wealth of data that it can leverage to attract more customers, and subsequently, gather even more data. Using this information, TRUP constantly updates their predicted costs every year, which lowers their offered prices for pet owners to drive further customer acquisition. TRUP also operates a vertically integrated business by keeping underwriting, sales, actuarial, and policyholder services in-house, which effectively erases ~20% of traditional pet insurance models' operating expenses. This, coupled with the high barriers to entry into the pet insurance industry due to the expansive, long-term data needed to profitably calculate insurance plans, creates ample opportunities for TRUP to scale growth.
2. Differentiated Product Offering: Compared to other large pet insurance providers like Embrace and Nationwide, TRUP differentiates itself by offering higher reimbursement rates at ~90%, providing uncapped coverage, and expediting the claims process. Together, these aspects of TRUP's service allow it to stand out amongst other insurance providers by demonstrating to customers that they can extract a higher value from the premiums they pay. TRUP also offers TRUP Express, a direct pay software that can pay a pet owner's invoice to veterinarians at time of checkout, which is expected to pay over 90% of veterinary invoices within five minutes by 2025 using automated systems. TRUP Express ultimately helps owners avoid paying bills out of pocket, streamlines the billing process for clinics, and collects additional proprietary data for TRUP to continually improve pricing accuracy.
3. Analytical and Technical Advantages in an Underserved Market: By leveraging its expansive database of pet insurance product data, TRUP is able to granularly set parameters on factors such as breed, age, regions, postal codes, and preexisting conditions, which subsequently enable a higher degree of price discrimination. This also allows TRUP to be the only insurer that offers comprehensive, lifelong coverage for preexisting conditions. Furthermore, industry dynamics bolster TRUP's ability to actualize growth in a highly untapped market that is dominated by just a few competitors, which saw it increase the total number of subscriptions by ~17% from FY 19 to FY 20. Given that only around 1-2% of dogs and cats in North America are currently covered by insurance compared to the 25% figure in Europe, TRUP also has many opportunities to access currently underserved regions.

Key Risks and Considerations

1. Growing Competition: While the pet insurance industry is currently dominated by only a handful of competitors, there are some emerging players in the market such as Zoetis (NYSE: ZTS) and Petplan. There is also the possibility of some traditional accident and health insurance companies attempting to enter the industry as well.
2. Decelerating Growth from the End of COVID: With heightened pet adoption rates during COVID, TRUP witnessed a significant increase in the number of subscriptions added over the last year. Moreover, there was a decrease in the number of insurance claims paid out because customers were less willing to get their pets checked up at veterinary clinics.

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Decision: NO PURCHASE

Financials Investment Committee Representative: Adam Keller

The Financials Sector pitched Trupanion Inc, (NASDAQ: TRUP) on Wednesday, April 28th, 2021 in General Meeting as a buy. The Investment Committee (ICOMM) decided not to buy TRUP. Our reasons are as follows:

FIRST: Competition – pet insurance is fairly undifferentiated and we cannot identify a strong competitive advantage that will allow Trupanion to earn high and sustainable returns on capital. Large global insurers (Allianz SE, Nationwide, Metlife) and other standalone competitors (Zoetis, Lemonade) are all fighting for market share. We expect that the US market will ultimately resemble the UK market as it matures. This will entail a fairly large number of insurance offerings, priced competitively. In our mind, data does not provide a particularly strong competitive advantage given that a) data have rapidly decreasing marginal benefits, and b) large, international pet insurers already have significant amounts of data and underwriting expertise. For Trupanion's valuation to be justifiable, we would need to expect the pet insurance market to be significantly less competitive than the human medical insurance market, an uncertain proposition at best.

FIRST: Growth prospects - we agree that the US pet insurance market is highly underpenetrated relative to mature Western and Northern European markets. However, at Trupanion's current price, we would require an astronomically high terminal growth rate in order to justify the current valuation. Trupanion CEO Darryl Rawlings estimates the firm's intrinsic value at about $2.4B, with the current market cap at around $3.3B. Rawlings uses a 5% terminal growth rate and a 10.8% cost of capital. Although veterinary medical costs are projected to increase at around 5-6% per year into the foreseeable future, we are uncomfortable projecting this type of growth rate into perpetuity, since that would imply that eventually more than 100% of consumers' income will go to pet related medical expenses. Additionally, high cost increases are passed onto consumers, inducing significant churn. We believe that Trupanion's total addressable market is smaller than the sector expects because there are few consumers with sufficiently high disposable incomes to afford such an (increasingly) expensive product.

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Discovery, Inc. (NasdaqGS: DISC.K)
The Special Situations Group

Company Overview
Discovery is a global media company that provides content across multiple distribution platforms, including linear platforms such as pay-television ("pay-TV"), free-to-air ("FTA") and broadcast television, authenticated GO applications, digital distribution arrangements, content licensing arrangements and direct-to-consumer ("DTC") subscription products. They serve original content to approximately 3.7 billion subscribers and viewers through their networks across over 220 countries and in 50 languages. Discovery has an extensive library of content and owns most rights to most of that content--giving them the ability to quickly launch brands and services into new markets and onto new platforms. Their content spans genres including survival, natural history, exploration, sports, general entertainment, home, food, travel, heroes, adventure, crime and investigation, health, and kids. Major TV brands include: Discovery Channel, HGTV, Food Network, TLC, Animal Planet, Investigation Discovery, Travel Channel, Science Channel, OWN (Oprah Winfrey), MotorTrend, Eurosport, DMAX, Discovery Kids, and TVN.

The Special Situation
As of 2021, Archegos had $10 billion in assets on record. However, because Archegos was able to borrow money from major investment banks (Goldman Sachs, Morgan Stanley, Credit Suisse, Nomura) their exposure to stocks was reported at nearly $50 billion via contracts-for-differences (CFDs). Archegos integrated massive leverage positions (5-6x) in companies such as Baidu, Discovery, and Viacom CBS. Back in March, when MoffettNathanson downgraded its rating for Viacom CBS, it subsequently triggered a significant price fall to Archegos's position. This in turn caused a tide of margin calls from Archegos's lenders, which unfortunately Archegos was not able to meet. Consequentially, many major investment banks were forced to mass liquidate all of Hwang's positions—including Discovery. Massive block trades by banks ensued which shattered the market, with early movers such as Goldman Sachs conducting block trades valued over $10 billion in a single day. Discovery shares fell ~47% within a week due to the forced liquidation.

Investment Thesis

1. The Archegos Liquidation. The Archegos Liquidation was a major non-fundamental reason for the price decline and potential undervaluation. The near 50% decline in share price from the massive sell off of Discovery shares were a result of the massive block trades coming from the Archegos liquidation. Nothing about Discovery's core business during this period, and the true fair value of Discovery certainly did not drop by 50% overnight. Moreover, following the Archegos liquidation, Discovery was trading at EV/FCF multiples that implied a WACC-Terminal Growth Rate spread of ~13.5%. Ballparking a cost of capital of anywhere between 7-10%, Discovery was now undervalued so long as we could reasonably demonstrate that its long-term growth potential was not excessively negative.

2. Core Popularity of Owned Content. To be fair, Discovery has faced a slight decline in viewership over recent years as it transitions from a cable world to a streaming world. However, a brief look at Discovery's history reveals that Discovery as a corporation has consolidated a major portion of niche non-fiction & reality TV genres which are each followed by niche loyal viewer bases coming from a collection of unique demographics. As such, Discovery's enormous portfolio of owned content (60,000 hours with an estimated future pipeline of 8,000 new hours produced annually) represents a major portion of the world's popular non-fiction & reality television content. Furthermore, as evidence of Discovery's content popularity, in 2019 HGTV, TLC, Discovery Channel, Investigation Discovery, and Food Network alone collectively boasted over 5,555 mm prime time views—already outpacing the likes of Netflix, Hulu, and Amazon Prime. Thus, as Discovery continues to roll out its streaming platform Discovery+ its core popularity should ensure a smooth transition of viewers from cable to streaming in the long run. Moreover, Discovery's ownership over its content grants it significant optionality in ways to monetize viewership as evidenced by the Discovery+ ad-lite monthly ARPU of over $10.

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3. <u>Cash Cow Benefits.</u> DISC has been and will continue to be a cash cow in the short run. DISC has averaged a ~40% FCFF margin in the past 5 years. Moreover, DISC content has a favorable cost structure due to the low cost and capital requirements for producing reality TV shows. For example, the entirety of Discovery Channel had an annual budget of only $200mm. Compare that to Disney, which casually spends a budget of $225mm on a single show (*WandaVision*). While Discovery's competitors are spending billions on scripted programming, Discovery can reinvest its tremendous free cash flows into building out its streaming business. Thus, Discovery's near-term profitability will help act as a cushion for safety to ensure a successful transition in a cable cutting era.

4. <u>Consolidation as Downside Protection.</u> The streaming industry is expected to consolidate rapidly in the future. This is simply a byproduct of having too many streaming platforms for viewers to choose from. Discovery is in a good position to merge or acquire due to its cheap pricing and dominant ownership of niche non-fiction and reality TV content. The resulting streaming giant should boast significant economic profitability. Thus, consolidation pressure could serve as a catalyst for downside protection for Discovery.

A Note On Share Class

There is no economic difference between the A and C shares. The only difference is that A-Class shares have 1 vote per share and C-Class shares have no voting rights. Further note that B-Class shares have 10 votes per share and constitute 28% of the voting interest in the company. There's a provision in the articles of incorporation requiring 80% support for a change of control (i.e., hostile takeover). In this sense, the votes from the B-Class shares alone are sufficient to block anything, meaning that voting rights aren't particularly valuable, and a 22% control premium isn't warranted. Historically, the control premium between A-Class and C-Class shares were between 5-7%, and the recent divergence may have been due to banks selling more C-Class shares. In any case, for TBC's interests, buying C-Class shares are offer a greater margin of safety from a fundamental perspective.

Valuation

Due to the Archegos liquidation, the current market price for Discovery provides ample margin of safety. This becomes evident through a sensitivity analysis on Discovery's operations. Given that Discovery+ currently earns an advertising ARPU of over $5, there is a hypothetical world in which Discovery can maintain current viewership levels by making its streaming platform free, monetizing ads, and still have an intrinsic value greater than the current market price. However, we expect reality to be significantly better as Discovery+ currently already earns an average $7 ARPU. See Exhibit 1 for a sensitivity table on ARPU and viewer growth.

Exhibit 1: Viewer Growth & Monthly ARPU Sensitivity Analysis

		Monthly ARPU						
		4.00	4.50	5.00	5.50	6.00	6.50	7.00
Viewer Growth Rate	-2.0%	29.08	35.26	41.43	47.61	53.78	59.96	66.14
	-1.5%	30.12	36.43	42.73	49.04	55.35	61.65	67.96
	-1.0%	31.18	37.62	44.06	50.50	56.94	63.37	69.81
	-0.5%	32.26	38.83	45.40	51.98	58.55	65.12	71.70
	0.0%	33.35	40.06	46.77	53.48	60.19	66.90	73.61
	0.5%	34.46	41.31	48.16	55.01	61.86	68.71	75.56
	1.0%	35.60	42.59	49.58	56.57	63.56	70.55	77.54
	1.5%	36.75	43.88	51.02	58.15	65.29	72.42	79.56

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Decision: BUY

SSG Investment Committee Representative: Will Noddings

The Special Situations Sector pitched Discovery (NYSE: DISC) on April 7th, 2020 as a buy. The Investment Committee decided to purchase DISC. Our reasons are as follows:

FIRST: We believe Discovery's streaming service represents an extremely attractive business model, and their initial subscriber growth (11 million subscribers in under a month) demonstrates successful execution when benchmarked against other similar streaming services like Peacock.

SECOND: We also believe that there is a product market fit for Discovery's reality-TV content among middle-aged Americans, and Discovery's brand name, reality TV expertise, and backlog of content represents a significant competitive advantage over other original content creators and distributors.

THIRD: The recent Archegos liquidation has also created a significant margin of safety for Discovery. Low single digit growth rates are more than enough to justify its current valuation and the possibility of future ARPU increases represent enormous upside potential. However, due to uncertainty over the pace of Discovery's streaming growth and the effect of non-fundamental factors on near-term share price, we are choosing to take on a relatively small position sizing of 4%.

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Cognyte Software Ltd. (NasdaqGS: CGNT)
The Special Situations Group

Company Overview

Cognyte Software Ltd. provides security analytics software to governments and enterprises worldwide. The company's open software fuses, analyzes, and visualizes disparate data sets for security organizations. It offers investigative analytics, operational intelligence analytics, and threat intelligence analytics solutions. The company's end-users for its solutions include data analysts, investigation managers, security operating centers operators, and field unit teams. It also provides customer support, professional, and integration services. The company serves national, regional, and local government agencies; and enterprise customers consist of commercial and physical security customers. The company was incorporated in 2020 and is headquartered in Herzliya, Israel.

The Special Situation

Cognyte used to be a part of Verint. Verint operated two lines of businesses: Customer Engagement and Cyber Intelligence. The Customer Engagement segment helped other businesses with workforce engagement, self-service, experience management, and compliance. The Cyber Intelligence segment was a provider of data mining and analytics software that helps governments and corporations gain and analyze intelligence to help identify, neutralize, and prevent terrorism, crime, and cyber-attacks.

On December 4, 2019, Verint announced plans to spin off its Cyber Intelligence segment into Cognyte Software. After thorough planning and preparation, Cognyte finally spun off on February 2, 2021. The result of the spinoff separated Verint's two legacy lines of businesses into two independent companies: Verint Systems (Customer Engagement Segment) and Cognyte Software (Cyber Intelligence). Shareholders of Verint received one share of Cognyte stock for each share of legacy Verint stock owned. The official reasons for the spinoff where as follows:

- Allow more efficient allocation of capital tailored to the unique characteristics of each business.
- Maintain a capital structure optimized to the needs and unique requirements of each business.
- Allow enhanced strategic and management focus with dedicated management teams focused on their core business's distinct operational and regulatory requirements.
- Provide more specific alignment of incentives and performance indicators to more closely align employee incentive compensation opportunities with stand-alone business performance.

Investment Thesis

1. <u>Effects of the Spinoff</u>. The spinoff unlocked value by allowing management to better pursue enterprise selling strategies, improve brand name by becoming a pure play security analytics business, and allow for better capital allocation. Moreover, Cognyte's size relative to its parent company caused some degree of forced selling by institutional shareholders following the spinoff. Notably, passive index funds such as Vanguard's US Total Stock Market ETF, Vanguard Small-Cap ETF, Vanguard Extended Market ETF, and iShares Russell 2000 ETF sold a combined 10.3mm shares (15.6% of shares outstanding). This forced selling was a non-fundamental reason for CGNT's ~35% price decline and is a potential reason for its mispricing and undervaluation.

2. <u>Economies of Scope</u>. Unlike other security analytics firms, Cognyte's 400 government clients worldwide provide it with a vast access to data that can potentially be applied to enterprise clients seeking solutions. More generally, Cognyte's expertise and experience in the counterterrorism field gives it an operational advantage in enterprise security. The same techniques Cognyte uses to prevent terrorism can just as easily and effectively be applied to preventing corporate espionage, business continuity, security, and cybersecurity. Moreover, Cognyte's brand reputation as a trustworthy solution to counterterrorism across 100 different countries, including the United States and Israel, gives it an overwhelming selling advantage for its future expansion into the enterprise security software market. We expect significant forward client and price growth on the enterprise security front—at very low marginal costs.

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3. Untapped Pricing Power Potential. After interviewing a senior military SOF official working in cyber-enabled counterterrorism, we confirmed that Cognyte's customers have ludicrously high switching costs due to their reliance on real-time analytics and the dependency created through training services. Furthermore, due to data-sharing network effects within established data-sharing circles, the acquisition of new clients increases the analytical scope and power of Cognyte's predictive and investigative abilities. Thus, Cognyte's business strategy of starting small when selling to new customers takes advantage of both the switching costs and network effects to effectively extract the customer's willingness to pay in the long run. Finally, note that Cognyte is currently only charging ~$900,000 for the average government client and ~$150,000 for the average enterprise client. This is a trivial fraction in comparison to the expected costs of terrorism and data breaches. As such, given the extremely high willingness to pay for counterterrorism and enterprise security—in combination with the high degree of stickiness intrinsic to Cognyte's platform—we expect significant cross selling and price increases in the future.

Valuation

With very limited information, it's difficult to put a precise price target on CGNT. Instead, we propose two alternative approaches. First, we can use near-term comparable companies to ballpark fair value based on what we expect Cognyte's fundamentals to look like in the next several years. Cognyte currently boasts a 70% gross margin and a 7% ROIC. We expect Cognyte to easily maintain a gross margin of above 70%, an ROIC of above 7-10%, and a compounding growth rate of between 5-8% in the near term. Comparable companies with similar current metrics trade at a median of 5x Revenue with a standard deviation of 1.5x Revenue. This implies a fair value range of anywhere between $27 - $50 per share. Secondly, we can use a sensitivity analysis to ballpark a fair value range based on our expectations for Cognyte's unit economics. We expect unit sales growth of anywhere between 2.5% - 10%, implying a fair value range between $36 - $50 per share. But note that there is ample margin of safety should unit sales growth be slower than expected. Please see exhibit 1 for a sensitivity table on unit sales growth.

Exhibit 1: Enterprise and Government Sales Sensitivity Analysis

		Sales per Government Growth Rate						
		-5.0%	-2.5%	0.0%	2.5%	5.0%	7.5%	10.0%
Sales per Enterprise Growth Rate	-5.0%	25.88	28.29	30.95	33.89	37.13	40.68	44.57
	-2.5%	26.58	28.99	31.65	34.59	37.82	41.37	45.26
	0.0%	27.34	29.75	32.42	35.36	38.59	42.14	46.03
	2.5%	28.19	30.60	33.26	36.20	39.44	42.99	46.88
	5.0%	29.12	31.53	34.20	37.14	40.37	43.92	47.81
	7.5%	30.15	32.56	35.22	38.16	41.39	44.94	48.84
	10.0%	31.27	33.68	36.34	39.28	42.52	46.07	49.96
	12.5%	32.50	34.91	37.57	40.51	43.74	47.29	51.19

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Decision: BUY

Investment Committee Chair: Austin Wang

The Special Situations Sector pitched Cognyte (NYSE: CGNT) on May 27th, 2020 as a buy. The Investment Committee decided to purchase CGNT. Our reasons are as follows:

FIRST: We believe Cognyte has found a unique niche large pure-play in the cyber intelligence space. Particularly, Cognyte's niche experience in counterterrorism efforts is unmatched by competitors like Palantir and IBM's security division and has provided them with access to significant data resources. As demand for counterterrorism analytics grow, we believe Cognyte will be the preferred partner of most government departments.

SECOND: We believe that we may have an edge over the market in understanding the significance of Cognyte's switching costs. Based on the sector's primary research, we are convinced that government training programs for Cognyte's software and reliance on continuous analytics make it nearly impossible for government departments to switch cyber intelligence software. Furthermore, we also believe Cognyte has significant room to grow prices and upsell additional solutions as data-breaches and cyber crime become more common.

THIRD: While it is unclear whether forced selling still has a significant impact on the company's current stock price, we do believe the market may not fully understand Cognyte's unique competitive advantages due to the lack of company-specific information post-spinoff.

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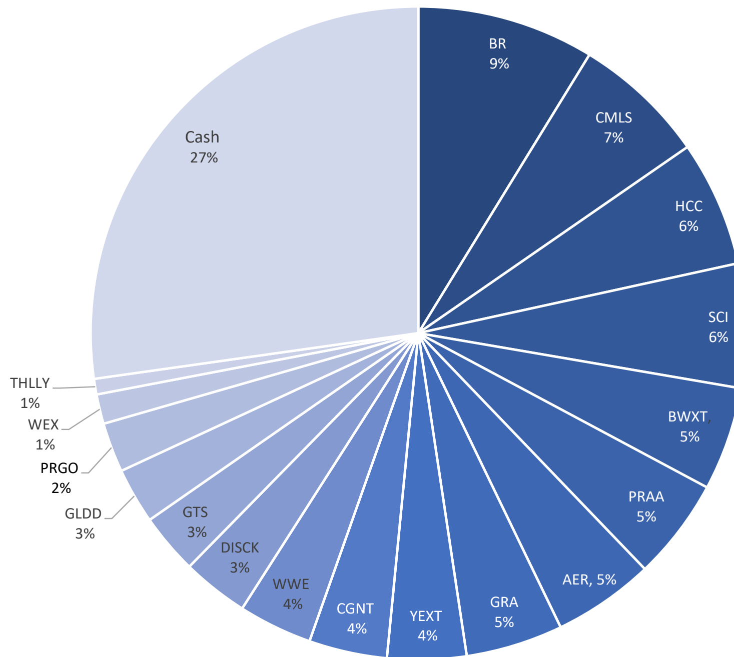
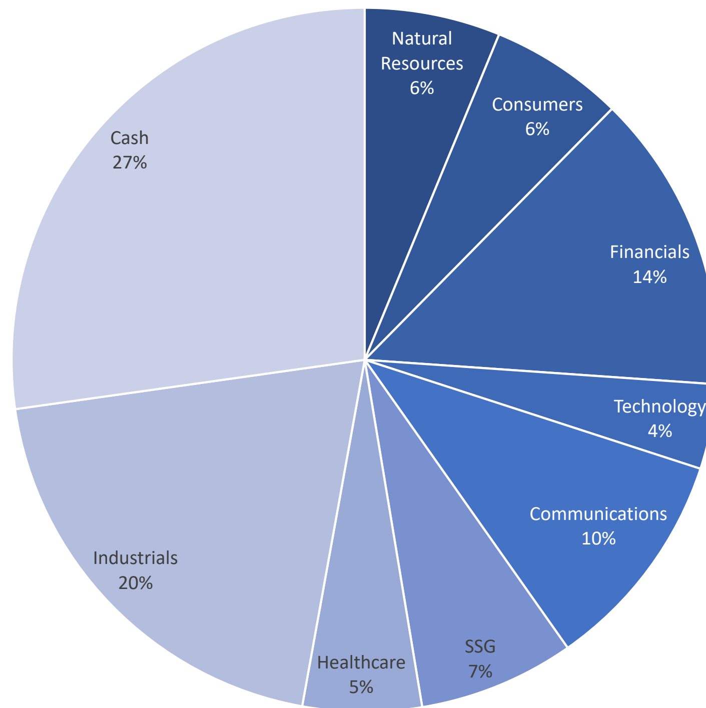
Portfolio Weightings





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