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Rowan Street Capital

Interview Two

ALEX KOPELEVICH

Rowan Street Capital

Mr. Kopelevich brings over 18 years of professional investment experience. Prior to finding Rowan Street, Alex was a Portfolio Manager at a privately held investment advisor, where he was responsible for managing in excess of $300 million in client assets. Previously, he spent eight years as a Portfolio Manager and Equity Analyst at U.S. Trust Bank of America Private Wealth Management where he co-managed multi-asset class portfolios for high net worth clients with assets in excess of $650 million. He started his career as a Portfolio Analyst at Bank of New York Mellon.

Mr. Kopelevich received his B.S. degree in Finance from University of Southern California (Marshall School of Business). He holds the CFA designation and is a member of the CFA Society of San Francisco.

You've previously described Rowan Street Capital as a "go-anywhere" fund. What do you mean by that?

Rowan Street Capital is not confined by any boundaries that are typical for a lot of funds (e.g. Market capitalization: Large-cap, Mid-cap, Small-cap; Geographical: Domestic, International Developed, International Emerging).
We focus on finding companies with exceptional economics that are run by honest and capable management teams no matter their size or geographical location. What gets us really excited is when we are offered a price for these type of businesses that allows for double-digit CAGR compounding over the next 5-10 years.

Are there any areas of the market you won't consider?

Yes, we will not consider businesses that we do not understand. The concept of the Circle of Competence has been used over the years by Warren Buffett as a way to focus investors on only operating in areas they know best. We don't have to be an expert in every company or every industry. In fact, we don't believe that the size of your circle of competence is very important, although we have expanded our circle quite a bit over the years just by being curious and doing a lot of reading.

What is most important is knowing the boundaries of your circle. For example, we had learned over the years that biotech and most pharma businesses are not our "cup of tea" and we do not have any particular insight into what their economics will look like 3-5 years from now. So we tend to avoid those. There is a great quote by Tom Watson Sr, the founder of IBM that I have posted at my desk: "I'm no genius. I'm smart in spots—but I stay around those spots."

You say you're looking for "The best opportunities for long term compounding." What sort of qualities a business must have in order to fit this bracket?

I recently had a trip to France and visited the Le-Mont-Saint-Michel, which is one of the coolest landmarks I've ever seen. It's an island-fortress and mainland commune in Normandy, located just a few hundred meters from land and is completely surrounded by water at high tide. Due to its defensible position, the island remained unconquered during the Hundred Year War.

> *"We are looking for a unique edge/ advantage that is defensible against the competition, as well as a talented management team that is fully committed to expanding that advantage or "moat" over time."*

These are the type of characteristics that we look for in a business. We are looking for a unique edge/advantage that is defensible against the competition, as well as a talented management team that is fully committed to expanding that advantage or "moat" over time. For us to invest, a company does not necessarily have to possess a solid moat right off the bat, but we have to have a degree of confidence that the moat is likely to grow over time.

What is the process you go through to evaluate management and their capital allocation decisions?

There is no formula for evaluating management and it's more of an art rather than science. Although we typically don't speak with management directly, we get to know them through a lot of reading and studying the company's history.

Usually, we like to start by reading the last 10 years of annual shareholder letters from the CEO. It's a useful exercise for us to get a feel for what management was "selling" investors 5-10 years ago and compare that to what they actually delivered. Although the bigger part of analyzing management is qualitative in nature, we combine that with quantitative analysis of the company's financials for the past 10-15 years. Numbers never lie and we uncover a lot of questions for management and potential red flags by studying them.

We also believe that if you really want to understand somebody's true motivations, you have to study their incentives. Studying the proxy statements comes very handy in that regard. We learn the real truth, and a lot of times it is similar to reading a horror story. We often uncover some information that really turns us off from management and the investment idea.

This is a topic that you can go on forever about, but at the end of the day we look for management that has a lot of skin in the game - managers that think and act like owners of the business. We prefer management that has spent a lot of its time and energy building the company - it's their baby. We want management that is entirely focused on widening the moat of their business and on delivering the best possible returns on capital invested over time. We tend to avoid situations where management is focused on building an empire at any cost, whose incentives are entirely based on revenue and earnings per share growth.

What is the preferable time frame for holding a position and what is your turnover?

We always buy into a position with a mindset of a 100% owner of the business. Thus, our time horizon is at least 3-5 years, but we aim to find opportunities that we can hold for a decade or longer. Once you find a great business, a perfect time to sell it is almost never. Having said that, we have a very strict selling discipline that we have developed over the years.

"Our turnover is usually very low by industry standards. Since we typically hold 10 positions on average, we only need about 2-3 new ideas per year. Some years, when there is a significant dislocation in the market, we will have more ideas, just like we had in 2018. And some years we will have zero, and we are okay with that."

Our turnover is usually very low by industry standards. Since we typically hold 10 positions on average, we only need about 2-3 new ideas per year. Some years, when there is a significant dislocation in the market, we will have more ideas, just like we had in 2018. And some years we will have zero, and we are okay with that.

But over time, we expect our portfolio to turnover no more than 20-30% per year.

In your previous letters you've discussed a particular investment in PRA Group, Inc. which you recently sold as part of your "Buy-hold but diligently verify" investment process. How did you first come across this opportunity?

We have a list of our favourite fund managers and we look through their 13F filings every quarter in search of new ideas. We found PRA Group in one of those 13Fs back in 2015, but we only started buying the stock more than a year later as it took us quite a while to get comfortable with the company.

What made you decide to buy, and what price/valuation made it look attractive for you?

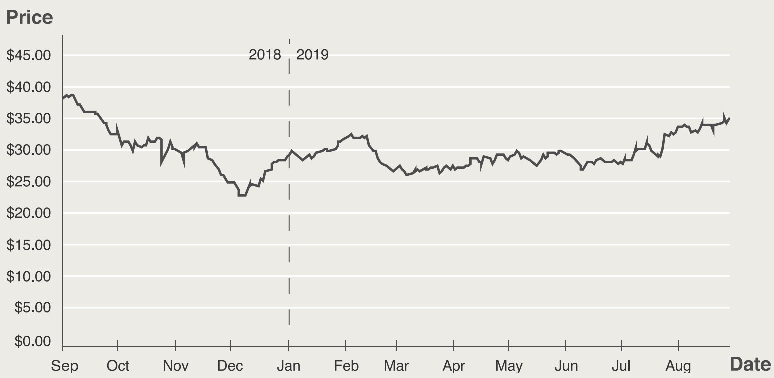
PRA Group (PRAA) was formed as Portfolio Recovery Associates, LLC on March 20, 1996. Co-founders Fredrickson and Stevenson created the company to address the lack of professional businesses in the debt recovery market. Their goal was to build an ethical company focused on treating customers with respect and fairness, interacting with clients and banks with the highest degree of operating expertise, compliance and reliability, and creating meaningful and rewarding careers for employees.

The company went public on November 8, 2002, as Portfolio Recovery Associates, Inc. and changed its name to PRA Group in October 2014. Over the past 20 years, PRA has grown to become one of the largest debt buyers in the world, with 3,800 employees in 10 countries throughout the Americas and Europe. In 2015, the company recorded cash collections of $1.54 billion, total revenues of $942 million and net income of $168 million, with $5.1 billion in future estimated remaining collections.

What attracted us to PRA Group are significant barriers to entry in the debt collections industry as well as PRA Group's unique competitive strengths that were unmatched by their peers. Our research uncovered that nearly all of the competitors PRA Group faced in 1996, when they first started, were gone. The same can be said for those they faced in 2001, 2006, and even 2011. Onetime market leaders were all out of debt buying business. Meanwhile PRA Group was able to navigate well past these misfortunes while generating an average 20% return on equity capital.

Stock Information September 13, 2019 I **PRA**

Data Source: Morningstar



Market Cap.	**Average Vol. *(3m)***
$1.6bn	225,029
P/E *(forward)*	**P/B**
14.3	1.4
EV/EBITDA	**ROIC *(ttm)***
19	5%
Divident Yield	**Debt to Equity *(net)***
N/A	250.00%

Moreover, they had collected a collections data set that is unmatched in the industry. The company is still run by its original founders that are the most experienced, consistent, and excellent operators in the industry. PRA Group is very well capitalized, owned more than $5 billion of future estimated remaining collections, and had access to significant and attractively priced financing that extends their investment capacity well beyond their substantial free cash flow.

In terms of multiples, historically the stock has traded 13x forward earnings but was trading at 7.4x 2016 Estimated earnings at the time of our initial purchase. Longer term earnings were estimated to grow by 14-15% per year, and the stock was only trading at 6.7x 2017 estimates. In 2016, revenues have grown at 22% annual rate for the past 10 years, operating Income has grown at 21%, Net Income has grown at 20% and EPS has grown at 20% as well. During the financial crisis of 2008/09, EPS had declined in both years, but only by 3% while revenue growth had always been positive. We thought the risk/reward was on our side at the time.

What was your initial estimate of valuation?

We were assuming that net income could grow at least 10% annual over the next five years. Applying a 10-12x multiple would result in a forward company valuation of $3.2 - 3.9 billion. PRA Group's market cap was only $1.25 billion at the time, which offered us a 20-26% annualized return potential. If we made a mistake in our estimates and earnings growth failed to materialize, we still had a pretty good margin of safety with the price we were paying at the time.

"After owning the stock for about two years, we still believed that the company had significant opportunities for growth once the credit cycle turned. However, after our analysis of cash collections in Europe, we got a sense their European portfolio purchase economics is not very good and nowhere close to the U.S. core economics."

Management's poor capital allocations finally pushed you to sell. Which part of their actions made you unhappy?

After owning the stock for about two years, we still believed that the company had significant opportunities for growth once the credit cycle turned. However, after our analysis of cash collections in Europe, we got a sense their European portfolio purchase economics is not very good and nowhere close to the U.S. core economics.

Management spent $1.3 billion to acquire Aktiv (Norway-based company specializing in acquisition and servicing of non-performing consumer loans throughout Europe) back in 2014, including assuming over $400 million of debt.

Four years after the acquisition, our view was that this has been a poor allocation of capital and the company would have been much better off focusing on US business. The numbers don't lie! Looking at cash collections of Europe Core, from $800 million purchase in 2014 they only collected $1,022 million or 128% of the original purchase price. That is four years later, which is a very poor return (vs 167% in U.S. core for the same vintage year).

2015 looked even worse, out of $422 million spent they collected only 65% of that three years later vs 136% collection rate in U.S for the same vintage year.

For 2016, it looked equally bad where they spent $350 million on Europe core purchase and collected only 45% of money spent (vs. 111% collection rate in U.S.).

We envisioned that it would have been much better for shareholders to invest all that capital in U.S. core, pay back their debt, buy back shares and pay dividends. The returns on the stock since 2014 speak for themselves! You can blame it on the credit cycle and on the regulatory environment, but we believed that a big part of the poor stock returns had to do with poor allocation of capital on the Aktiv acquisition.

Our decision to sell our position in PRA Group came in March 2018. I always thought that you don't really know the business until you own it. So it took us about three years of owning the stock in PRA Group to realize that it doesn't have as good economics as we initially thought it had.

In every business analysis, you always find several metrics that are fundamental to judging business performance over time. For PRA Group, the most useful to me was looking at the cash collection chart by vintage year, looking at the ratio of cash collected vs cash paid out on the purchasing in the portfolio. At first, maybe in 2017, we started noticing the returns of the European business are not even close to being attractive - it had been five years since the Aktiv acquisition, so we figured it was sufficient time to show their true colors.

When we first purchased the stock, we believed that it was the credit cycle that was solely responsible for poor returns at the time as we were coming off some very attractive vintage years of the Great Recession. But it became evident to us that their acquisition was a very poor allocation of capital and has driven the returns to highly unattractive rates, and we would be very surprised if the returns on invested capital ever got to double digits again. Our conclusion was that this business does NOT meet our retirements for returns on capital and we are very unlikely to make double digit returns on the stock over the long run if the underlying business is not producing double digit ROIC.

Another of Rowan Street Capital's former investments that seems to be a great example of your "Buy-hold but diligently verify" investment process in action is Teva (TEVA). What was behind your initial attraction to this business?

Teva was founded in 1901 and boomed under the leadership of Eli Hurvitz, CEO (1977-2002), chairman until 2010. During his tenure, the company employed aggressive tactics to obliterate drug patents, launching copies faster than its peers and producing them in high quantities.

In 1996, the company introduced its major proprietary drug, Copaxone. Hurvitz spent his formative years in the kibbutz, he began washing test tubes for the company in his early 20s.

In Israel, he is a business icon, a local equivalent of Steve Jobs. When Hurvitz died in 2011, the prime minister called him “One of the greatest industrialists the state of Israel has ever known.”

Teva was on our watchlist for a long time and we believed the company possessed strong economics. In 2016, the stock experienced a huge decline and was trading at extremely low levels or so we thought at the time - $32 billion in market cap (today’s market cap is $8.5 billion!). We estimated that by December 2016, about $28 billion in market cap value had been erased since the beginning of 2016.

“A lot of times the pendulum spends in the neutral position (fair value). Ideally, our job as value investors is to pick up a stock in a quality business when the pendulum swings to the point of max pessimism.”

What was interesting is that only in early August 2016, Teva acquired Allergan’s generics business Actavis Generics for $33.43 billion in cash and about 100 million Teva shares. The deal itself has been hailed as “The biggest M&A deal in Israeli history,” and its announcement led to Teva’s shares making their biggest-ever jump (16%) and reaching their highest-ever price ($72), giving the company its highest-ever valuation of $61 billion.

This is a great example of how quickly Wall Street sentiment can change! When investing in stocks, we always visualize a pendulum that swings from the point of maximum optimism (euphoria) to the point of maximum pessimism (just like Teva’s stock did following their Actavis acquisition). A lot of times the pendulum spends in the neutral position (fair value). Ideally, our job as value investors is to pick up a stock in a quality business when the pendulum swings to the point of max pessimism. Since it’s impossible to perfectly time your entry point, we are happy to pick up our positions in the range of anywhere from Neutral position to the point of maximum pessimism (you never know when that point comes until after the fact).

In the second half of 2016, the overall pharmaceutical industry started facing drug pricing pressures as the entire industry was under the DOJ’s radar in matters related to price collusion. On top of that, Teva Pharmaceutical was facing investigations under the FCPA (Foreign Corrupt Practices Act of 1977) related to its operations in Mexico, Russia, and Ukraine from 2007 to 2013. At the end of the third quarter of 2016, the company set aside reserves of about $520.0 million to settle these matters, based on its discussions with the DOJ (United States Department of Justice) and the SEC (Securities and Exchange Commission).

The generic drug market was also facing slowing growth as drug launch opportunities declined and pricing pressure remained stagnant. Concerns over expiration of patents covering 20mg/mL version of Copaxon were also pressuring Teva’s stock. Lastly, on March 3, 2016, Teva Pharmaceutical completed its acquisition of Representaciones e Investigaciones Médicas, S.A. de C.V. (or Rimsa), a Mexican pharmaceutical company, for a total consideration of about $2.3 billion. However, in September 2016, Teva filed a lawsuit against Rimsa. Teva alleged that Rimsa’s sellers had indulged in fraud and a breach of contract related to representations and warranties in the purchase agreement. Teva claims that Rimsa was involved in manipulating information related to its drug development and manufacturing processes. This information wasn’t disclosed to Teva in the due diligence process, and Teva claims it was presented with false records. All of these concerns caused Teva’s price to tank.

What attracted us to the stock were it’s very cheap valuations. At the time we were paying an Enterprise value of about $56 billion for the biggest generic manufacturer in the world that had the potential of generating $6 billion in Free Cash flow. That was an almost 11% yield on that enterprise value. Our original rationale was that the Free Cash yield was most likely to grow over the next five years, which made it a very attractive proposition with low probability of losing money in the long run. The free cash flow yield at the time of our purchase on just market cap was 18.6% (compared to the S&P FCF yield of 4.2%) On top of that, the dividend yield was ~4.88%. We believed that at the price of $35 per share, a lot more pessimism had been priced in than there needed to be, and the odds have turned heavily in our favour when we looked out 3-5 years.

And what were the red flags that pushed you to sell?

One of the investors whose track record we really admire is Allan Mecham. In one of his letters to investors, he wrote: "I think the most important three words in investing may be: I don't know. Having strong viewpoints on a lot of securities, and acting on them, is a sure-fire way to poor returns in my opinion. In my view, it's easier to adopt this "I don't know" ethos by focusing on the business first and valuation second, as opposed to the other way around. I've found that when valuation is the overriding driver of interest, I'm prone to get involved in challenging businesses or complicated ideas and liable to confuse a statistically cheap price with a margin of safety."

> *"We all make mistakes as investors and we learn and grow from them and fine tune our investment approach. The key is to admit to yourself that you have made a mistake as soon as possible. Shortly after our initial investment into Teva stock and diving in deeper into the company fundamentals, we realized we got involved in a challenging situation."*

We all make mistakes as investors and we learn and grow from them and fine tune our investment approach. The key is to admit to yourself that you have made a mistake as soon as possible. Shortly after our initial investment into Teva stock and diving in deeper into the company fundamentals, we realized we got involved in a challenging situation. Just like Allan Mecham's words of wisdom, the overriding driver of interest for us was the statistically cheap valuation and the possibility of a quick rebound in the sentiment. In the case of Teva, we had put valuations first and business second, and experience has taught us that these kinds of "opportunities" almost never work out well over time.

We sold our entire position of Teva on February 7, 2017. What prompted us to sell immediately was the resignation announcement of Erez Vigodman, who was the CEO at the time and part of our investment thesis. We spend a great deal of time researching and thinking about company culture and its DNA that makes it tick. Our research uncovered significant cultural issues and board of directors conflicts during the time period when both the Chairman of the board and the CEO were foreigners. Teva's DNA is entirely Israeli and having outsiders run a company that was built by Israelis did not work out well. When Erez Goodman - an Israeli native CEO with great track record was hired for the job, it seemed like the board was finally taking steps in the right direction to fix the cultural issues of the company. Erez had a solid vision of how to position the future of the company for the Copaxon patent expirations - world's leading Multiple Sclerosis treatment, with annual sales over $4 billion in 2015, and contributing over one-third of Teva's consolidated operating profits. Erez also architected the acquisition of the Allegan's generic business that sent the stock soaring to $72. Erez resigned after being three years on the job and it was a clear signal for us that his plans were not working out. We ended up taking a small loss of 8% on our position and time showed that it was a very good decision. Had we held our shares until today we would have lost ~80% on our original cost basis.

Another stock you like right now is Under Armour (UA). Can you tell us why you believe Wall Street is overlooking the opportunity here?

Under Armour was founded by an exceptional entrepreneur, Kevin Plank, in 1995 with one simple insight: The cotton undershirts football players wore under their pads slowed them down when they became soaked with sweat. After prototyping a moisture-wicking, form fitting alternative--made of fabric for women's undergarments--and testing it on ex-teammates, Plank set up shop in his grandmother's basement and, just before he went broke, scored his first big sale to Georgia Tech. The company went on to create a whole new market for performance apparel, IPO'd in 2005, and now sponsors some of the world's greatest athletes, including Tom Brady, Jordan Spieth, Stephen Curry, Lindsey Vonn, and celebrities like Dwayne Johnson (The Rock).

"We believe that Under Armour is a "pitch right in our sweet spot." It's a great athletic brand that was built by a very talented entrepreneur, Kevin Plank, who is still the CEO and a major shareholder."

When Under Armour went public in 2005, its sales were $281 million. By 2010, sales grew to over $1 billion despite the 2008/09 crisis. By 2016, their revenues grew to $4.8 billion, posting 26% annual sales growth over a 10 year period (Nike grew at 8% and Adidas grew at 5% over the same time period). The company snapped its streak of 20 straight quarters of 20%+ sales growth, and over that time period investors couldn't get enough of the stock. Investors' optimism peaked in 2015, as they were willing to pay 60-80x earnings for the stock that was supposed to grow at 20+% forever. Well, things don't grow forever without limits and even the best companies experience challenges and struggles from time to time. In the fourth quarter of 2016, their growth sputtered as the North American retail environment had become challenged with many sporting goods stores bankruptcies (e.g. Sports Authority) and Under Armour was much more leveraged to the North American market than their competitors. The stock closed 2016 at $28, dropping from a peak of $54 per share in 2015, as expectations came down significantly. Then, in January of 2017, the stock plunged nearly 25% as the company delivered a trifecta of bad news: (1) reported sales and earnings that missed forecasts (2) said revenues for 2017 would be lower than what Wall Street expected (3) CFO was stepping down for "personal reasons". And in March of 2017, we started slowly accumulating shares of Under Armour as the stock dropped to $17 per share (for class C).

We believe that Under Armour is a "pitch right in our sweet spot." It's a great athletic brand that was built by a very talented entrepreneur, Kevin Plank, who is still the CEO and a major shareholder. Even though Under Armour is undergoing some temporary growing pains and a shift in the retail landscape in North America, we believe they will adapt, evolve and emerge a much stronger company that has the potential to grow into a $10+ billion business.

After reporting its Q3 2017 earnings, Under Armour's stock plunged 21% in one day as reported results fuelled fears that Under Armour's best years are behind it. Quarterly revenue was down 5% as North America challenges impacted results (North America revenue down 12%). The company updated its 2017 full year outlook and then expected revenues to be up in low-single-digits and took down their margin and earnings expectations. Despite North America struggles, their international business was still growing 35% with Asia Pacific growing 52%. Since international sales are still only 22% of overall, they are not big enough to offset the North America weakness in a meaningful way (Yet!). As is almost always the case, Wall Street analysts and "investors" cannot see past the next couple of quarters, driving valuations of Under Armour to completely unreasonable levels, in our view. Paralyzed by fear, Under Armour was valued at just over

$5 billion at the end of 2017 and nobody wanted it, in contrast to its peak valuation of $22 billion in 2015, when investors couldn't get enough of the stock and analysts couldn't praise the company enough.

How does this fit your "Best opportunities for long term compounding" framework?

Based on our deep research of the company, we had built a conviction in Under Armour's positive long term prospects. Thus, we took advantage of extreme fear and rapidly declining valuations for Under Armour in 2017 to build a large position in the company. We had been accumulating shares since March of 2017 with average cost basis of approximately $15 per share. We viewed this decline in market price as temporary and believed current valuations are extremely attractive for a long term investor. If we were a private equity fund and came to Kevin Plank at the end of 2017, offering to buy his whole business for only $5 billion, he would have laughed in our faces. He knows that the long term value of his company is multiples of that.

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The beauty of the public markets is that, from time to time, Mr. Market does not mind selling us his share of good businesses at completely foolish prices. Our job, as stewards of our investors' capital as well as our own, is to take advantage of him (Mr. Market) and not to be influenced by his "Incurable emotional problems."

We believe that any good businessman should be willing to take a short term impact to performance in order to gain real value over the long run, and would gladly jump at the opportunity to purchase a high-quality business for $5 billion, when there is a high probability of this business being valued at $15-20 billion in a few years. Yet, most participants in the marketplace do not behave like businessmen. Why? It is simply human nature. It is extremely difficult psychologically to go against the crowd – to buy when everyone else is selling, to buy when things look the darkest, to buy when so many experts are telling you that this particular company is risky right now.

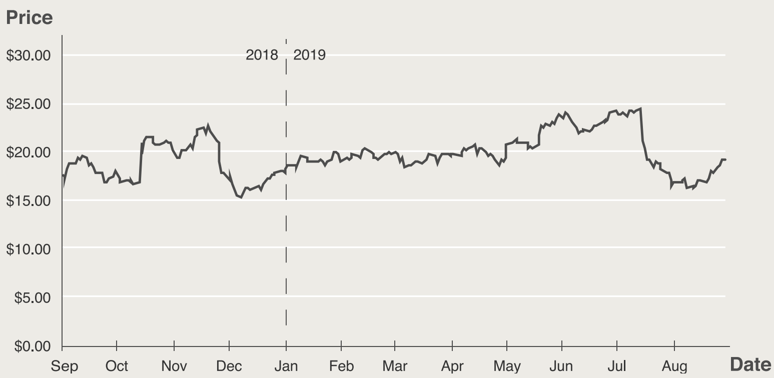
But, this is exactly what produces outsized investment results over the long run. Being able to take advantage of these kind of opportunities when they arise and to take the long term view, to manage money prudently for our investors with the lack of concern for "conventional wisdom" is the primary reason why we started Rowan Street.

You first started buying the stock during March 2017. Since then the shares went up around 50%. What's changed since Q1 2017?

I think it's useful here to put the Under Armour story in context and the chapters where they have been and where they are today. Chapter one was a basement startup. As Kevin Plank describes it: "It was a scrappy, hard-fought fight" that established their DNA and laid the foundation. Chapter two was about expanding into women's and International, while driving the product innovation engine, drilling consumers and taking it to the limit of what was possible as a private company. Then Under Armour went public in 2005 and entered Chapter three - a period anchored in the idea of getting big fast and rapidly expanding their business to gain scale. Under Armour hit $1 billion in revenues in 2010, which kicked off a 6.5 year run of 20%+ quarterly growth getting them to nearly $5 billion by the end of 2016. All this growth didn't come at no cost and in 2017 Under Armour found itself dealing with issues of that growth as operations have become increasingly more complex.

Stock Information September 13, 2019 I **UA**

Data Source: Morningstar



Market Cap.	Average Vol. *(3m)*
$8.6bn	2.1m
P/E *(forward)*	**P/B**
42	4.2
EV/EBITDA	**ROIC *(ttm)***
25.9	2.80%
Divident Yield	**Debt to Equity *(net)***
N/A	64.00%

Kevin Plank realized that in Chapter four of their story, Under Armour would need to become a truly operationally excellent business. Thus, in the summer of 2017, Kevin Plank hired Patrick Frisk as President and COO, and we believe Mr. Frisk is the right man to help Kevin take Under Armour into their next chapter. Mr. Frisk, who is a 30-year retail veteran, came in and focused on processes, workflow, product development, timelines and tightened them up. He was finding synergies across categories and cost savings across the company. Patrick was also responsible for a significant management turnover within the company, which were the tough decisions that had to be made as part of his restructuring plan.

We believe Under Armour has turned the corner into 2019, and a lot of hard work is really starting to pay-off. They have stabilized their largest region - North America. They have started to really get into a healthier marketplace for the Under Armour brand where inventories are actually much healthier and come from a position of strength if you compare them even back to as far as 2016. So, it's a long play for us on Under Armour. The company's management is feeling more and more confident that a lot of the things we have been doing are really working. But it will be ongoing work, as 2019 is still in the last phase of the "Protect This House" chapter.

How would you compare current valuation to that of March 2017?

In March 2017, we believed that Under Armour could get back to low-teens top-line growth by 2019. We estimated that Under Armour could grow mid-teens starting with 2019, thus reaching $10 billion in sales by 2021-2022. We reasoned if they could gradually improve their operating margins back to 11% (still way below Nike's of 13%), they can surpass $1 billion in operating income by 2021-2022, which would imply 20% operating income CAGR. Reduction in corporate tax rates would boost future Net Income even further.

> *"Their international business is still growing mid-teens, their e-commerce is growing low-to-mid-teens, and they are going to go from 1,100 doors to 2,600 doors around the world over the next five years. Combine that with gross margin and operating margin improvements, and Under Armour could still reach our original target of $30-35 by 2023."*

Originally, we modelled that Under Armour may earn $1.25 - 1.40 in 2021-2022, which would likely value the stock at $30-35. From our average cost basis of $15, this presented an opportunity to double our money within five years. We believed the price we paid in 2017 still presented sufficient margin of safety if our growth expectation didn't work out.

Our original expectations for top line growth have not worked out yet as North America continues to be a drag on the overall growth. Under Armour had an analyst day in December 2018 when they updated their long term guidance. Their guidance now implies top line CAGR of only high single digits by 2023. However, we still believe that Under Armour management is low-balling to set themselves up for an opportunity to easily exceed expectations over the next few years. Their international business is still growing mid-teens, their e-commerce is growing low-to-mid-teens, and they are going to go from 1,100 doors to 2,600 doors around the world over the next five years. Combine that with gross margin and operating margin improvements, and Under Armour could still reach our original target of $30-35 by 2023.

What would be considered a 'sell' signal as part of your "Buy-hold but diligently verify" framework?

So the sell decision is almost always much harder than the buying decision. However, we have a strict selling discipline and will sell the stock if one of the following occurs: (1) stock price becomes egregiously overvalued and discounts future expectations that are completely unreasonable and have low odds of occurring (2) when we observe deteriorating fundamentals in the business and there is evidence that the superior economics that the company once enjoyed are no longer there (3) when we have better ideas, which could be a better business with much more upside potential over the long run and/or businesses that we understand better and have more conviction on (4) lastly, we are not afraid to admit that we made a mistake, cut our losses and move on as we did with our Teva position.

Rowan Street Capital

You've said you're looking for the "Best opportunities for long term compounding." Why do you think Box falls into this bucket?

Box is a very recent addition or what we call an "emerging position" for us. To take a step back, in one of our recent investor letters, we drew an analogy of our portfolio construction to putting together a 10-player All Star team. I grew up playing ice-hockey competitively and often use sports analogies.

We like to think of Rowan Street portfolio as a sports team made up of 10 best players we can draft, and we are lucky to have a huge universe of talent to pick from. We spend a lot of time and energy studying our "players" and understanding their game. We not only look for All-stars, but also the ones with the highest potential to become All-stars down the road. Often times, these All-stars come with a hefty price tag since we are not the only ones that recognize how good they are, so we wait patiently for unique opportunities to acquire them for our Rowan team when they are available at reasonable prices (usually when they are injured or temporarily struggling in their current season).

We believe this 10-player mindset that we use in managing our portfolio forces us to be extremely disciplined and picky. If we find a new potential player that we really like, somebody from our current team (who we already know very well) has to be kicked out. It's never an easy decision to get rid of someone that has been with you for years, and this forces us to build a strong conviction in the potential of a new incoming player before we are able to make the replacement.

Sometimes, you like a few players enough to let them on your team, but you don't know them or their game well enough to give them a lot of "ice-time". So they become your temporary "benchwarmers" or what we call "emerging positions". You try them out, keep learning about them and how they complement your team, and if it all falls into place, they eventually become fully-fledged players on the Rowan team. If they don't turn out to have the potential that we thought they had, we will let them go.

So, with that, Box falls into an "emerging position" category. Currently, it's only a "benchwarmer" (small weighting) looking to get more ice-time (capital) if our confidence in their game grows over time.

> *"There are significant switching costs in this business. As enterprises sign up and expand their use cases and their workflow gets imbedded into Box platform, they are not very likely to leave as it would be extremely disruptive to their business and operations."*

We like the cloud content management space and we believe that Box has a very solid value proposition. Enterprises are choosing Box as a strategic technology partner and its Cloud Content Management platform to power their digital transformation. Content is at the heart of how we work, and it is only becoming more critical as powerful new technologies like AI, machine learning, and workflow create opportunities to make the business processes around content more intelligent and automated. 60% of Box's revenue comes from customers with more than 2,000 employees. There are significant switching costs in this business. As enterprises sign up and expand their use cases and their workflow gets imbedded into Box platform, they are not very likely to leave as it would be extremely disruptive to their business and operations. So we think this business has a lot of potential, but it's still too early to tell whether it's going to become an "all-star" on our team.

How does Box compare to peers like Dropbox? What's different about Box's offering that makes the business stand out?

Box is fundamentally different from Dropbox with different mix and make-up of their revenue stream. Dropbox is much more of a consumer-driven company with an additional small business revenue stream on top of that. Only 30% of Dropbox revenue comes from business product compared to Box, which is entirely enterprise-driven (mostly focused on mid-market to large enterprises, even though they serve companies of all size). So being fundamentally focused on a different part of the market, what they build is different, how they sell is different, what they power for customers ends up being very different.

As far as Dropbox go-to-market strategy, they have 90% of business coming thru self-service and about 10% where sales reps are involved. In contrast, the types of deals, use cases and customers of BOX require a higher-touch model and a sales force involvement.

What about larger competitors like Amazon and Google?

Microsoft's SharePoint and Google Drive are the main competitors.

For large companies in regulated industries such as health care or defense compliance is of utmost importance. Large companies need to control who can access files, and with whom the files can be shared both externally and internally. There needs to be a log of all activity surrounding the file. Who opened it, when and where did they log in from, etc.?

Box focuses on solving these problems for large enterprises. They provide the most advanced set of security controls and intelligent threat detection capabilities for content management. These capabilities help prevent accidental data leakage, detect potential access misuse and identify external threats. For example, with their new product Box Shield, banks can more easily prevent accidental sharing of documents in an M&A process; media companies can better ensure content doesn't leak; and government agencies can quickly decipher regular versus anomalous activities affecting sensitive information.

"We believe that Box offers services to enterprises that are becoming increasingly mission-critical to their customers' internal and external business operations, as well as their ability to comply with legal requirements, regulations, and standards. Currently, 69% of Fortune 500 companies are already Box's customers."

While Google Drive may work for a small business, the compliance needs of an enterprise quickly strain the functionality of Google Drive. Do you want your health records stored on a free Dropbox account your doctor got by sharing the email address of five friends? If you run a defense contractor with 150,000 employees, do you want them using a hodge-podge of Dropbox, Google Drive, and OneDrive? Large companies need more robust data storage solutions. They need the ability to share content internally and externally but also to have controls and records of how that sharing occurred. They need the ability to lock files.

Why do you think the competitive advantage will endure?

Enterprises need a central hub for their content, connecting best of breed applications while meeting security and compliance demands for multiple industries and geographies. With Box's solution selling strategy more deeply embedded into their business, Box is in a stronger position than ever before to deliver more value to customers. Enterprises are choosing Box as a strategic technology partner and the Cloud Content Management platform to power their digital transformation. Content is at the heart of how we work, and it is only becoming more critical as powerful new technologies like AI, machine learning, and workflow create opportunities to make the business processes around content more intelligent and automated.

People need more flexibility and choice in how they work and enterprises need a single source of truth for content across their end user applications and backend systems, which can only be delivered by an open platform like Box. From Box's conversations with their largest customers, it's clear that they have a wealth of manual business processes prime for automation, but have struggled to enable this, given the lack of flexibility from legacy ECM systems.

We believe that Box offers services to enterprises that are becoming increasingly mission-critical to their customers' internal and external business operations, as well as their ability to comply with legal requirements, regulations, and standards. Currently, 69% of Fortune 500 companies are already Box's customers.

There are significant switching costs in this business; as enterprises sign up and expand their use cases and their workflow gets imbedded into the Box platform, they are not very likely to leave as it would be extremely disruptive to their business and operations. So, our take is that Box will continue building out their moat as time goes on, and we will continue following this story and building out our conviction. Time will tell.

The business is currently generating loss. Does it have enough capital to profit and what is its cash position?

In terms of balance sheet, Box is in good shape. They have $200+ million in cash and very little debt. The business also generated a very healthy $60+ million in cash flow from operations. In terms of profitability, the business generates very healthy gross margins of 70%+. As for most SaaS platforms, their biggest expense is currently Sales & Marketing, which runs around 50% of sales on a GAAP basis. It did improve pretty dramatically since their IPO in 2015, when it was 80% of sales. Over time, as their existing customer base grows (current paying users at 12.5 million) and a relatively higher percentage of their revenue will be attributable to renewals versus new or expanding Box deployments, they expect that sales and marketing expenses will continue to decrease as a percentage of revenue. They have an inherent business model leverage.

R&D is the second biggest P&L expense, which runs a bit below 30% of sales. As they continue to grow their paying users as well as their revenue base, R&D expense as a % of sales should come down over time. Thus, just like most platform businesses, scale instead of immediate profitability is of utmost importance. As scale grows, it accelerates the flywheel effects and more and more revenue dollars can be reinvested into R&D in order to deepen the company moat. Amazon still spends 30%+ of sales on R&D.

How has management created value here? How can you be confident they will continue to do so?

If we take a look at the current stock price, it is sitting pretty much at the same level of its IPO in 2015. Hence, no return for shareholders that bought at the IPO. The stock has been pretty volatile and has closed as low as $9.90 and as high as $28.12.

In terms of value creation by management, I believe they have made a lot of progress since the IPO. They have doubled their sales from $300 million in 2015 to $608 million in 2018 and are expected to generate $690 million this year. Paying users have increased from five million to 12.5 million. And paying organizations have increased from 57,000 to more than 92,000, which fit quite nicely to their "Land-and-expand" strategy.

Stock Idea One

BOX, INC. I Rowan Street

Stock Information September 13, 2019 I **BOX**

Data Source: Morningstar

Market Cap.	**Average Vol. *(3m)***
$2.6bn	2.4m
P/E *(forward)*	**P/B**
N/A	118.8
EV/EBITDA	**ROIC *(ttm)***
N/A	N/A
Divident Yield	**Debt to Equity *(net)***
N/A	0%

> *"Paying users have increased from five million to 12.5 million. And paying organizations have increased from 57,000 to more than 92,000, which fit quite nicely to their "Land-and-expand" strategy."*

The company just recently introduced a couple of ground-breaking products (Box Relay and Box Shield), which have been very well-received by customers. Their continued innovation-led Forrester in June to name Box as the most visionary leader in its new wave for cloud content platforms. Out of 13 vendors, including Microsoft, Box received the highest overall score for their strategy as determined by their clear, compelling, incredible three-year vision, their ease of use and their strong security, governance and compliance capabilities. These are all great signs that management is putting those R&D dollars to good use.

What about capital allocation?

So far, Box has about $1.1 billion in accumulated losses on its balance sheet (negative retained earnings). Just like most platform businesses, management has been supporting its operations through raising private capital and through its 2015 IPO where they raised $185 million. The business has started to generate positive cash flow from operations. Over the past two fiscal years, they have generated close to $120 million in cash. Their capex requirements are relatively minimal, running at only $15 million over the past three years. To reiterate on my answer in previous questions, their biggest use of revenue dollars is going toward their sales efforts. Box does employ an expensive, top-down sales efforts with salespeople targeting CIOs and CTOs of large enterprises.

While selling into large organizations comes with a longer sales cycle, we believe the enterprise segment that Box focuses on is generally comprised of stickier customers and higher lifetime value than individual or SMB businesses that Dropbox usually goes after. Although not without bumps on the road, we believe this is the right long term strategy as Box is trying to become a cloud enterprise content management (ECM) provider of choice. They are putting their dollars behind scaling their platform as fast as they can, so they can enjoy the flywheel effects of their business down the line. Their low customer churn rates and high retention rates of 108% are very promising.

The company isn't profitable yet, so what is your approach to valuation in this case?

In my opinion, this is an extremely interesting topic when you consider the nature of the typical brick and mortar business that grew up in the Industrial Age versus the nature of a platform company that is growing up in the digital age of today.

Let's take Starbucks as an example. It was founded in the 70s and it went public in 1992 with 140 stores and a revenue of $74 million. Today it has 28,218 worldwide with almost $25 billion in annual revenues. The way you achieved growth and created more value for the shareholders in that business is by investing more and more capital into opening new stores, hiring more people to service those stores, and replicating the business model that was already working very well at new geographic locations. You invested into branding and into consistent customer experience, and with that you grew average traffic to stores as well as the average spend. As you got to scale, you also had the benefits of leveraging your operating expenses. So essentially, each store could be profitable within three years on a stand-alone basis and could produce cash flow that could be used to open new stores (you invested in growth though capital expenditures). That was the model.

Now, with all these platform companies in the digital age, the way you grow your business and scale it has changed; the time-frame that you can get to scale has also shortened dramatically. Once you have a certain technology and a product-market fit, your job is to get to scale as fast as possible. Thus, the investor focus has shifted dramatically to user growth and revenue growth. As you sign up new users and revenue dollars start flowing in, your investment in growth happens almost entirely through your P&L. You are trying to grow users, thus you have a number of years of elevated Sales & Marketing expenses. In the early 2000s, when Netflix was still in the midst of its battle with Blockbuster, it was spending around 70% of its gross profits on Marketing.

Another large investment is R&D, where Amazon, for example, has been spending about 30% of its sales on R&D over the past 20 years. That is how you essentially widen you moat as a platform company.

> *"To be very conservative, if Box can improve their sales effectiveness even by a small margin and achieve $1 billion in sales within the next 4-5 years and start leveraging their Sales & Marketing expense (as existing customer base grows and a relatively higher percentage of revenue is attributable to renewals versus new or expanding Box deployments), we believe they can turn to profit and improve their cash flow."*

So to get back to valuing Box, the approach is a lot more of an art rather than science where you can apply any kind of formula or construct a model with any kind of precision. I think the main thing is to be right on the long term prospects of the company. The main questions to answer before approaching valuation are: Do I think this business will experience a wide user adoption over the next 5-10 years?; Do I think that they can get to scale in their platform where they start experiencing the powerful flywheel effects of their business model, which will make it difficult for newcomers to compete with them? And of course, do I think that the management has got the right focus, the right motivations and are they creating the right environment for their employees in order to maximize their chances of succeeding?

It takes time and quite a bit of effort in order to begin to answer those questions, but once you start developing a conviction, then you can start making sense of the future growth expectations of the company. For example, Box had only about 5 million paying users in 2015. Today they have 12.5 million (2.5x in just four years). Now, the rate of growth has slowed down pretty dramatically.

In the last two quarters it was only 16% year-on-year.

The company has also backed off its original forecast of achieving $1 billion in revenue by FY2022 as recent sales efforts have not met expectations. Because of this deceleration, which we view as temporary, Box is currently trading at only 2.7x Enterprise value to 2019 Revenue. In comparison to most SaaS companies that currently trade at 25-30x revenues, the market has painted a very pessimistic picture of the company.

To be very conservative, if Box can improve their sales effectiveness even by a small margin and achieve $1 billion in sales within the next 4-5 years and start leveraging their Sales & Marketing expense (as existing customer base grows and a relatively higher percentage of revenue is attributable to renewals versus new or expanding Box deployments), we believe they can turn to profit and improve their cash flow. This scenario should boost sentiment and drive a much higher EV/Revenue multiples over time.

We are willing to be patient here as long as we still have conviction in the business and in its management. And we were always a believer that you don't really know a company until you own it!

What's your price target and time frame?

It's very difficult to assign any kind of precise price targets to a business that is still in its initial growth stages. We always approach valuation with a mindset that we would rather be approximately right than precisely wrong (wisdom borrowed from Warren Buffett). We believe that Box revenue growth rates can still get back close to 18-20%. Even without much of a boost in multiple (to be very conservative), we think Box can get close to $3.5 billion valuation by 2022. That would give us at least a 15% annual compounded rate of return from today's level. That meets our long term target of double-digit annual rates of return.

"We think Box can get close to $3.5 billion valuation by 2022. That would give us at least a 15% annual compounded rate of return from today's level. That meets our long term target of double-digit annual rates of return."

The stock is currently down around a third year-to-date so it seems that the market disagrees with your thesis. Why, in your opinion, is the market so negative?

Thankfully, we only started buying the stock recently and have watched most of the decline this year from the sidelines. Since it's an emerging position for us, we are looking to add to our position as/if our conviction builds over time. And if we like the company, we are only happy to pick up more stock down the line at lower prices. As far as to why the market has become so negative on the stock, I have explained it in question 8.

What markers down the road will justify your view of the business?

I would like to see Box pick up the pace of their deals, especially the deals over $500,000+ and over $1,000,000+, as these have slipped over the past few quarters. Their $100,000+ deals have worked well and showed good reading in the latest quarter.

Along with the number of deals, I'm looking for a pickup in the paying user adoption of their platform. In the first half of 2019, they have only added 500,000 paying users in comparison to 1.2 million in the first half of 2018. They have just hired a new Chief Revenue Officer, Mark Wayland, who is a 10 year veteran from Salesforce.com. They are revamping their sales efforts in order to focus on helping their customers leverage Box as a complete platform for secure content management, workflow, and collaboration. Management states that when customers use their full suite of cloud content management solutions, they see dramatically higher average contract value and better retention leading to greater lifetime value. I will be paying close attention to how their sales productivity improves over the next several quarters.

As part of your "Buy-hold but diligently verify" investment process, what could drive you to sell? Which markers are you looking for?

I'm looking for my companies to continue investing into widening their moat over time. Obviously, for Box, if I find evidence that the expected wide user adoption of their platform is not materializing and that their value proposition to their enterprise customers is becoming inferior to that of Microsoft SharePoint or Google Drive or any other competitors, then I would be inclined to sell my position.

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