ValueInvestor INSIGHT

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Investor Insight: Travis Cocke

Voss Capital's Travis Cocke and Jon Hook explain why transitioning businesses can be fertile ground for ideas, how they get comfortable with extreme negative market sentiment, the big mistake they made when the pandemic hit, and why they see mispriced upside in Nintendo, Avid Technology, Extreme Networks, Louisiana-Pacific and Rimini Street.

INVESTOR INSIGHT

Travis Cocke
Voss Capital

Investment Focus: Seeks companies whose share valuations indicate that an ongoing transition for the better is unappreciated or misunderstood by the market.

While crowd-following tends not to be in any value investor's playbook, Voss Capital's Travis Cocke would seem to have a particular aversion. "We generally want expectations for our companies to be so bad that reality has a low hurdle to clear to create the types of surprises that move stock prices," he says.

Low expectations have translated into excellent returns for his long/short Voss Value Fund, which since inception in October 2011 has earned a net annualized 15.6%, vs. 11.6% for the Russell 2000 Index. Focusing on businesses that are going through significant transitions, he and colleague Jon Hook are finding opportunity today in such areas as videogames, digital media production, networking systems, software support and wood products.

All smart investors are looking to take advantage of market mispricing. Can you generalize about where over time you've learned to look for that?

Travis Cocke: We believe it's ultimately surprises relative to expectations that cause the greatest moves in market prices, so we look for that potential on the long side in a few ways. One would be clear evidence of extreme negative sentiment, which can manifest itself in things like a significant valuation de-rating versus peers, high short interest, or if analysts all have a hold or sell rating on a stock. Sometimes this results from investors focusing on one negative, like a legal or regulatory issue, which drags the valuation down more than we think is justified by the bottom-up developments in the business. Whatever the cause, low expectations can increase the probability of positive surprise.

We also really hone in on business transitions, especially ones that result in short-term optical headwinds but will ultimately change the profile of the company if management executes. The trendy example would be a shift by a software company from a perpetual license/maintenance model to a subscription-as-a-service model, where you lose upfront licensing revenue but are building a large, sustainable revenue stream at high margins. Another good example would be a company with multiple segments that have different economics and growth trajectories, where we see the mix changing for the better but the market appears not to understand what's going on or just isn't paying attention.

We're agnostic when it comes to market cap, but our sweet spot has been in the $500 million to $1 billion range. The companies are liquid enough for us to reasonably buy or sell, but they're also typically underfollowed, which makes it more likely for the existing narrative on the stock to be wrong and for us to be able to define an alternative narrative the market is missing.

Jon Hook: One thing I'd elaborate on is that we're OK with extreme sentiments as long as we can understand both sides of the investment thesis and can see how the narrative can shift over time. Our largest position at one point this year was Benefytt Technologies – formerly known as Health Insurance Innovations – which operates a technology platform for buying health insurance and which we believe at the time was the most shorted stock as a percentage of its float in the entire world.

We understood the negative bias, which centered around past regulatory problems in one of its business lines, but our due diligence found a big disconnect between the negative market perception and the reality that the company had made major improvements in its compliance and was shifting focus toward selling Medicare-related policies where it had had no compliance issues and had hit the ground running in the 2019 open-enrollment period. The company had also said it was exploring strategic alternatives to enhance shareholder value, but the market didn't believe any sort of transaction was likely.

Our contrarian position was vindicated over the summer when Benefytt was taken private by a top-tier private equity firm,

Madison Dearborn, at a 60% premium over its average share price in the month before the deal was announced. They paid roughly 9.7x EV/EBITDA – when we first started looking at the stock in mid-2019 it traded at less than 5x EBITDA and at roughly 20% of the valuation of the nearest competitor, eHealth (EHTH).

To highlight how you come across some of your more obscure names, how and why did you first get interested in Canadian media-production company Thunderbird Entertainment [Toronto: TBRD]?

TC: Their investor relations firm e-mailed me a number of bullet points on the company in July and asked if I wanted to see its investor presentation. I looked it over quickly and a number of things jumped out that seemed potentially interesting. The stock traded at 3.5x EV/EBITDA even though revenues were growing at a more than 30% annual rate. The balance sheet had net cash. The core business of producing TV series like *The Man in the High Castle* for Amazon was booming as the race to create content to stream was intensifying. There was also a business-transition angle. The company was moving from mostly producing shows on a fee-for-service basis to both partnering more fully with others on the development and creation of shows, and on creating, developing and actively monetizing its own intellectual property.

As we started to dig in, we had multiple calls with various levels of the management team, and each time found they had thoughtful and detailed answers to every question and were never evasive. We were just very impressed with the management quality relative to the size of the market cap, which at the time was C$65 million.

This is one where there wasn't some extreme negative sentiment on the company, but we thought it was very much under the radar and that with the discovery of the story and time for it to play out it could be a big winner. The shares [at a recent C$2.55] have doubled since we first started looking at it, but we still think there's a lot of upside left.

In general, once you've identified a potential idea where does your research focus?

TC: We spend a lot of time talking to industry experts to understand a company's competitive position and the industry dynamics. We also actively seek out other informed investors who hold varying fundamental views on the company to gauge what is well known and already likely priced into the stock. We're trying to understand what the current narrative on the company is that's holding back the valuation, and then determine if we can construct an alternate, credible narrative that can replace the current one and could potentially cause the stock to at least double over the next three years.

ON EXTREME SENTIMENT:

We're OK with extreme sentiment as long as we understand both sides and can see how the narrative can shift.

JH: Usually there are one or two or three things that really define the "story" of a particular stock and the multiples it currently gets. Maybe the narrative is "nice technology, but too levered" or "the company is losing market share in its core business," or "nice company, but terrible management so the potential won't be achieved." Most of the time the narratives make sense and are borne out by the evidence as we look into it.

But in what become core positions for us, our research leads us to either completely disagree with the existing narrative, or believe a new narrative has a good chance to displace it. For instance, if the narrative is nice technology, but too much debt, what happens to that view if revenue growth reaccelerates and the resulting free cash flow is directed to paying down debt? If the narrative is the company's core business is suffering, what happens if another segment of the business that's even better grows rapidly and accounts for a much larger share of the overall business? If the narrative is management isn't good enough, what happens if new management comes in and starts to capitalize on

Travis Cocke

Starting the Clock

It was clear fairly early on that Travis Cocke was going to start his own investment firm. He "caught the investment bug" in high school, he says, and before heading off to study finance at Texas A&M had already been asked by parents of his friends to start a partnership to invest for them. While in college he had internships with the Teacher Retirement System of Texas pension fund and with Leon Cooperman's Omega Advisors.

Soon after graduating from college in 2009, another friend's father asked Cocke to manage investments for a small family office, and less than a year later he parlayed that into starting his own firm, now called Voss Capital, at the ripe old age of 24. Why start so early? "It was a function of a few things," he says. "One, coming out of school in the aftermath of the financial crisis wasn't the best timing for getting hired by a top-tier firm. Two, I was always entrepreneurial and valued the personal freedom I had working for myself. Finally, if you're young and headstrong, you think to yourself, 'I talk to these guys who are considered the best investors in the world and they put their pants on one leg at a time and aren't doing anything I couldn't do.' I needed a track record to attract capital, so why not start the clock?"

the available potential? If we believe the company can look very different in 12 to 24 months and that the narrative will change for the positive as a result, that's interesting for us.

You've in recent years taken a more activist approach with certain of your holdings. Explain the rationale behind that.

TC: From the beginning I'd say we've always thought like activists – doing detailed segment analysis, thinking about the portfolio of businesses, putting a priority on capital allocation, thinking about how to improve the capital structure. As our assets have grown and we've gotten more experienced with board-level discussions, we've done more. We don't want to be activists for activism's sake, running the same playbook over and over. It's simply one tool in the toolbox that can help generate returns for our investors.

JH: With our core names we typically like to have developed sort of a nuclear option, where if the new narrative isn't developing as expected we have a Plan B. Perhaps the company has followed the strategy we would employ, but still isn't getting credit from the public markets. In that case we might determine the company simply shouldn't be public and would be better off working toward a sale. Benefytt Technologies and Rosetta Stone would be recent examples of that.

Or perhaps the company for whatever reason isn't following the trajectory we believe will build the most value. In this case we have no qualms engaging with management and the board – and eventually the market if necessary – to try to get the company back on course. Par Technology [PAR] would be a good recent example of that. We thought its strategy was unfocused and weighed down by legacy businesses and legacy costs that were keeping it from capitalizing on an excellent developing business selling cloud-based software systems to quick-service restaurant chains. Ultimately we concluded management needed to change for the company's potential to be realized and we engaged with the board to help make that happen, including having a hand in bringing on a board member, Savneet Singh, who then took over as CEO near the end of 2018.

We wrote about Par [*VII,* June 26, 2019] when the shares were at just under $28. The stock's now at around $55 – do you still see upside from here?

JH: We think the best is yet to come and that the sell side still hasn't grasped the upside potential here. Par can demonstrate that customers using its Brink cloud-based point-of-sale systems and software are selling more and improving cost efficiency relative to its customers who are using its legacy systems. That type of thing gets people's attention and the company is seeing demand for Brink systems pulled forward, which should result sooner rather than later in the type of inflection quarter that will get the Street's attention. We also think Savneet Singh is a gifted capital allocator, and after a recent capital raise is likely to put that to good use in scaling the company.

How many positions do you tend to hold at a time?

TC: We usually hold about 35 long positions, concentrated at the top, with the five biggest at around 40% of the portfolio and the top 10 around 60%. We want our top ideas to move the needle, but also try to size positions so that we don't believe we'll lose more than 2% of total fund net asset value on any one position if our draconian bear case for it plays out. That's happened over the past 10 years, but we've kept it rare.

We are regularly rebalancing, scaling into and out of positions based on how the risk/reward ratio between our base case and bear case value targets moves relative to other stocks in the portfolio, or to new ones we might buy. Another thing to mention is that we keep a number of small "farm team" positions in the portfolio that we continue to research and monitor while waiting for them to get cheaper, to get closer to a catalyst, or that we'll sell if we change our minds as we get further along in the due-diligence process.

ON MARKET MYOPIA:

There's an obsession with macro events. It's more likely people are ignoring what's going on beneath the surface.

Are you generally finding plenty worth looking at in today's rather unusual market environment?

TC: This has changed somewhat in the past two weeks, but our portfolio companies overall are as cheap as they've been since inception, while at the same time they have as much or more growth potential than ever. We're finding a lot of good long ideas.

Why would that be? There's a very high level of business disruption and uncertainty caused by the pandemic, which is creating a lot of winners and losers and the market can find it difficult to accurately reflect rapid changes in fundamentals. There's also a myopic obsession with a few macro events. What's going on with lockdowns? What's going on with the stimulus? Who's going to win the presidential election? What's the latest vaccine news? That may make it more likely people are ignoring changes going on beneath the surface at companies. We think it's a great time to be looking at those.

Nintendo [NTDOY] would seem to be quite a bit bigger and higher-profile than most of your holdings. What do you think the market is missing in it?

JH: Yes, everyone knows Nintendo as a Japanese videogame developer and console manufacturer. What we don't think is fully understood is the extent of its business model shift underway and the latent power it has to unlock the value of its owned intellectual property.

We see three fundamental changes happening. One, they are decreasing the cyclicality of the hardware business by taking a more iterative approach to product development. The latest console, the Switch, was released in March 2017 and sold nearly 35 million units in its first two years on the market. In the fall of 2019 the company rolled out the Switch Lite, a handheld-only version that is priced at a discount to the original. The goal is to keep building over a longer time period the installed base of users, selling them high-margin games, downloadable content and subscriptions, and avoiding the more boom/bust pattern of brand-new gaming consoles every five years or so where you start over from scratch. The cumulative Switch installed base is now over 68 million, and we think is on the way to over 100 million. The next hardware iteration, rumored to be the Switch Pro, is expected to be released next year.

The second important shift underway is toward higher-margin digital and subscription revenue, which Nintendo up until fairly recently has been slower to embrace. The company's software revenue comes from five sources: physical video games, downloadable versions of games that are also offered physically, download-only games, add-on downloadable content like maps, outfits and new characters for given games, and Nintendo Switch Online subscriptions. The last four categories make up the digital portion of software revenue, which is growing rapidly, up 100% over the last twelve months to around $2.9 billion.

The company doesn't break out margins for the digital segment, but you can see the impact on overall margins as digital becomes an increasingly large contributor of total revenue. Gross margins have risen steadily to 53% in the trailing year and to 58%year-to-date in 2020. Similarly, overall trailing operating margins have expanded to 34% and were 36% in the most recent quarter. Software overall makes up just under 50% of the company's overall revenue, and driven by digital will continue to grow at a faster rate than hardware.

Finally, the third big change we also see is Nintendo capitalizing on its world-class intellectual-property library, which it's at the early stages of starting to monetize. The library includes the rights to such properties as the Mario universe, Star Fox, Zelda, Donkey Kong, the newer Animal Crossing and, through a large ownership stake, Pokémon. Among the licensing initiatives underway is the development of a Super Nintendo World theme park in partnership with Universal and a Mario movie being produced with Illumination, which is behind the *Despicable Me* and *Minions* franchises. In a world where entertainment content is in increasingly high demand, especially when it can build on an already massive brand franchise, we think the growth runway in this area for Nintendo is very long.

How are you valuing all that differently than the market, which currently puts a $70 price on the U.S. ADR?

JH: We have a detailed sum-of-the-parts analysis that values the Digital, Hardware, Physical Game Sales, and Mobile and IP parts of the business separately, based on our next-twelve-month estimates of sales,

INVESTMENT SNAPSHOT

Nintendo
(OTC: NTDOY)

Business: Global development, manufacture and sale of gaming consoles and the games played on them, including franchises such as Mario, Pokémon, Zelda and Animal Crossing.

Share Information (@11/27/20):

Price	**70.00**
52-Week Range	35.82 – 73.75
Dividend Yield	1.4%
Market Cap	$66.65 billion

Financials (TTM):

Revenue	¥1.63 trillion
Operating Profit Margin	33.6%
Net Profit Margin	25.1%

Valuation Metrics
(@11/27/20):

	NTDOY	S&P 500
P/E (TTM)	16.9	41.3
Forward P/E (Est.)	18.9	25.9

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Nomura Asset Mgmt	3.1%
Vanguard Group	2.3%
Capital Research & Mgmt	1.8%
Daiwa Asset Mgmt	1.4%
Nikko Asset Mgmt	1.3%

Short Interest (as of 11/15/20):

Shares Short/Float	n/a

THE BOTTOM LINE

The market doesn't appear to be correctly handicapping the under-the-surface changes going on in the company's business model and in its hardware and intellectual-property strategies, says Jon Hook. Based on his sum-of-the-parts analysis of its Digital, Hardware, Physical Game Sales and Mobile and IP segments, he values the shares today at $112.

Sources: Company reports, other publicly available information

earnings before interest and taxes [EBIT] and what we believe is the appropriate EBIT multiple.

Breaking that down further, we value the Digital segment – which we expect to grow at a 45% annual rate with 45% operating margins – at 22x EBIT. We at this point assume no growth for Hardware, believe it earns a 22% margin and we value it at 7x EBIT. Physical game sales grow 20%, with 35% margins and deserve a 12x multiple. Finally, we think Mobile and IP grows 35%, with 90% margins, and deserves a 20x EBIT multiple. Add it all up and we value these four pieces of the business at $93 per share. Adding in net cash and other investments, we arrive at a total equity value of $112 per share.

If you back out the cash and investments on the balance sheet, at today's price we're paying around 7x our estimate of operating income over the next 12 months. That's way too low considering the company's growth, profitability and the increasingly recurring nature of its revenue. This is also just our base case – if things like Mobile and IP take off over the next couple of years, the upside potential will likely be considerably higher.

Explain how you see the narrative changing for digital-media company Avid Technology [AVID].

JH: This is one of two dominant players – the other being Adobe – making software-based tools for digital media production. It's the clear leader in sound editing with its Pro Tools line, but also sells video-editing software, media-storage products, and has developed a range of collaborative editing tools as part of its Avid Everywhere platform. The products are particularly well established in higher-end applications like big-budget Hollywood movies and major television shows, where the overall demand outlook is quite positive going forward.

We were able to come to a pretty clear understanding of the negative narrative here. There has been significant investor fatigue with the company's long transition from a hardware and perpetual-license software model to becoming more focused on recurring subscriptions. There's a perception in the market that Adobe is rapidly taking market share. There's concern that the balance sheet is overly levered. Top management, which has since been replaced, had a reputation for overpromising and underdelivering, making poor acquisitions and burning significant cash. Layering on damage from Covid, with all media production basically stopping for a time, and we felt we understood pretty well the negativity toward the stock.

When we looked under the hood, we came to some different conclusions. First of all, we believe new management under CEO Jeff Rosica is highly knowledgeable of the entertainment industry, pragmatic, and has laid out a sound operating plan with clear and consistent target metrics. Second, we believe the business-model transition is finally taking hold, with recurring revenue – for both hardware and software maintenance – now at 70% of the total and with gross margins up to the mid-60s, from the mid-50s a few years ago. Third, while our conversations with channel partners and industry experts did speak to some market share loss to Adobe, we were still able to identify clear compet-

INVESTMENT SNAPSHOT

Avid Technology
(Nasdaq: AVID)

Business: Development and sale of hardware and software used primarily in the creation of digital media, with a focus on sound and video editing for movie and TV-show production.

Share Information (@11/27/20):

Price	**12.34**
52-Week Range	4.67 – 12.48
Dividend Yield	0.0%
Market Cap	$545.5 million

Financials (TTM):

Revenue	$372.5 million
Operating Profit Margin	10.1%
Net Profit Margin	5.2%

Valuation Metrics
(@11/27/20):

	AVID	S&P 500
P/E (TTM)	27.9	41.3
Forward P/E (Est.)	12.7	25.9

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Impactive Capital	15.7%
Vanguard Group	5.1%
BlackRock	4.3%
Goldman Sachs Asset Mgmt	4.3%
Royce & Associates	3.9%

Short Interest (as of 11/15/20):

Shares Short/Float	4.9%

AVID PRICE HISTORY

THE BOTTOM LINE

The negative investor narrative around the company is increasingly out of date as it's business-model transition takes hold and new management better positions it to take advantage of a thriving end market, says Jon Hook. Applying a market multiple to his run-rate estimate of annual free cash flow, the shares within 18 months would trade at $25.

Sources: Company reports, other publicly available information

itive differentiators for Avid and thought minor share losses in some niche markets were being overly magnified by the buy-side. Customers can and do work with product offerings from both companies, and they recently announced a joint effort to make each other's products work more easily together so customers have even more flexibility on that front.

Avid's hardware business in particular took a hit from the pandemic, but we expect that to come back fully and we've also seen some parts of the business pick up speed through the pandemic. For example, they have a clear advantage in collaborative editing tools – allowing multiple editors to work remotely on a project at once – which has been in very high demand of late.

Finally, we've come to see the leverage situation as quite manageable. They currently have about $160 million in net debt, so are a bit over 2x levered against the consensus estimate of $72 million in EBITDA over the next twelve months. Free cash flow went positive in the most recent quarter, to the tune of $15 million, and as that continues to grow the CFO has made clear that the #1 priority is to pay down debt.

The shares have shown some life of late – how inexpensive do you consider them at today's $12.30 price?

JH: Up until very recently the stock was trading at pretty distressed technology multiples: 2x total gross profit, around 2x subscription maintenance revenue, and at around 7-8x estimated free cash flow.

We think over the next 18 months the company can be generating cash flow at an $80 to $100 million annual rate. If they pay down debt and continue to increase recurring, less-cyclical revenue, we think the stock deserves at least a market multiple on free cash flow. That would result in a share price of around $25.

Another way to look at it is to take the recurring revenue base from software only – which is growing 12-15% annually – and put a 5x multiple on that. That alone comes to $19 per share in value. That ignores the hardware and hardware maintenance pieces of the business, which are lumpier but still generate about 40% of total revenue.

Sticking with relatively beaten up technology companies, describe why you're high on the prospects for networking company Extreme Networks [EXTR].

JH: Extreme specializes in configuring large setups for complex wireless network environments, including hospitals, universities, stadiums, convention centers and subway systems. It sells both network infrastructure equipment as well as software for network management, analytics and security.

Many elements of the story here are similar to what I described for Avid. The transition underway toward recurring software and services revenues has been slow to develop and investors have lost patience. There have been concerns about leverage, particularly after the pandemic first hit. Extreme competes with very big players like Cisco, Juniper Networks and Hewlett Packard Enterprise, which have more complete networking portfolios. Management has made several acquisi-

INVESTMENT SNAPSHOT

Extreme Networks
(Nasdaq: EXTR)

Business: Production and sale of wired and wireless network infrastructure equipment and software used for enterprise network management, analytics, security and access control.

Share Information (@11/27/20):

Price	**5.76**
52-Week Range	1.43 – 8.00
Dividend Yield	0.0%
Market Cap	$708.6 million

Financials (TTM):

Revenue	$928.3 million
Operating Profit Margin	(-3.1%)
Net Profit Margin	(-10.5%)

Valuation Metrics
(@11/27/20):

	EXTR	S&P 500
P/E (TTM)	n/a	41.3
Forward P/E (Est.)	11.0	25.9

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
BlackRock	12.5%
Vanguard Group	6.5%
Paradigm Capital Mgmt	5.9%
D.E. Shaw	3.8%
Renaissance Technologies	3.6%

Short Interest (as of 11/15/20):

Shares Short/Float	5.2%

EXTR PRICE HISTORY

THE BOTTOM LINE

Jon Hook believes the company has the capability to take market share from much bigger competitors as technology networks become increasingly cloud managed. Even without such gains, he values its ongoing business at around $8.50 per share. Each additional 1% in market share, he says, could translate into an additional $1 billion in market cap.

Sources: Company reports, other publicly available information

tions over the past five years, without a lot to show for it.

We think those narratives can flip over the next 12 to 24 months, in large part due to the potential we see for the company to take share in wireless networking through its cloud-based offerings. The big transition going on in the networking industry is that all the devices constituting a network – including switches, routers and access points – are starting to be cloud controlled and managed. From our research, Extreme's technology for that – mostly coming from its latest acquisition of a company called Aerohive – is matched among competitors only by Juniper. Given the size of the addressable market, they don't need to win every cloud-networking deal for it to have a significant impact on the business. Management says each 1% market-share gain in the entire wireless networking space would add $200 million in annual revenue and $100 million in incremental EBIT.

They're starting to log a number of impressive competitive wins. They recently signed with Major League Baseball to provide wireless connectivity and software services at all big-league stadiums, displacing Cisco. They recently landed a big new contract with Amazon for its warehouses. They've also won major business with telecom operators who are trying to coordinate their 5G rollouts with Wi-Fi connectivity.

The cloud business is the most exciting, but we believe the rest of the business is well positioned and evolving in a positive way. Software subscriptions generate roughly $60 million in annual revenue, but that business is poised to grow at 30-40% per year, with 85% gross margins. There's a recurring hardware-maintenance revenue stream that makes up 30% of total revenue, generates 60-70% gross margins, and isn't cannibalized by the software-subscription business. Even equipment revenue, which still makes up 60% of the total, earns gross margins above 50%.

Extreme's shares were at $15 less than three years ago. How are you looking at valuation at today's price of $5.75?

JH: We think with its run-rate revenue base – assuming hardware sales come back more or less to pre-Covid levels – the company is capable of generating $80 to $100 million in free cash flow over the next 12 months. The CFO has made it clear that most of that will be used to pay down debt. If all that comes to pass – moderate deleveraging, accelerating sales growth and higher visibility of revenue – we'd expect the stock to earn at least a 12x multiple of cash flow, which would translate into a price of around $8.50.

ON SHORTING:

Passive flows make it harder to realize mean reversion in over-hyped, overvalued, cash-incinerating companies.

What we're in this for, though, is the potential of incremental market-share gains. Say they can add 1% in market share and that translates into an additional $100 million in free cash flow. What is that worth? Even at 10x that would be another $1 billion in market cap for a company whose market cap today is just over $700 million. By then you should have a full narrative shift and the upside just from re-rating would probably be quite a bit higher.

Do you have a Plan B in this case?

TC: Given our strong belief in the company's technology, its great relationships with resellers, and its 60,000-strong customer base, we think it's highly likely there would be a number of potential strategic acquirers who could cut costs out and make a very accretive acquisition. A strategic buyer could offer $10 per share for Extreme, take out 30% of the operating cost base, and we believe would end up paying only 5x pro-forma EBIT. If the company doesn't execute, we and probably a number of other investors would likely push for a sale.

Turning to something quite different, what sparked your interest in wood-products company Louisiana-Pacific [LPX].

TC: We've been very bullish on housing in the U.S.. If you look at rolling, cumulative 10-year housing starts relative to population growth and household formation, housing starts are at their lowest level in history by far. Believing that corrects over time, we ran a regression to see which stocks were most positively correlated to rising U.S. housing starts, and Louisiana-Pacific was at the top of the list after actual homebuilders. Even with the sharp increase in housing demand from the pandemic, we think the duration of the upcycle is underestimated and housing and mortgage-related investments as a result are a large theme in our portfolio.

As we dug in, we found that the company is also going through a transformation that we don't think the market is fully recognizing. It's known primarily as a leading player in the market for oriented strand board [OSB], a common building material considered an economical and sturdy plywood substitute. As with most price-taking commodities, the OSB market is notorious for its booms and busts tied to housing starts and home remodeling activity, with lumpy supply responses reacting to market prices on a lagged basis. It's not a terrible business because the supply side is very concentrated and L-P has done a good job coming out with more value-added and specialty OSB products, but it's not the type of business the market tends to value very highly.

The more interesting product line is siding, which now accounts for around 40% of annual sales. The company's siding business consistently takes market share in home construction, is rolling out higher-margin pre-finished products, and has been able to put through price increases independent of underlying commodity-price levels. It wasn't the case in the latest quarter due to record-high oriented strand board prices, but siding appears to have sustainably overtaken OSB as the larger profit contributor for L-P. So in addition to the tailwind for both businesses from

rising housing starts, we think the shares can also benefit from re-rating as siding becomes a bigger part of the business.

The stock is at a 10-year high, so the market appears to have taken some notice. How are you looking at upside from the current $33.80 price?

TC: The shares trade at about 6.3x forward EV/EBITDA, which is below the 7x 10-year median multiple for OSB pure-play Norbord [OSB] and way below the 18x EV/EBITDA multiple today for the best siding comp, James Hardie Industries [JHX]. Hardie, by the way, is growing at a slower rate than L-P's siding segment and earns a lower EBITDA margin.

Doing a simple sum of the parts, even if we use a 14x multiple for the siding business and keep a 7x multiple on the OSB business, we arrive at a fair value for the shares that is more than 50% above today's price. If we subtract unallocated corporate overhead but add in reasonable values for the company's engineered wood-products business, its South American segments and its prefabricated house-frame business, our estimate of value is closer to $57 per share.

INVESTMENT SNAPSHOT

Louisiana-Pacific
(NYSE: LPX)

Business: Development, manufacture and sale of wood products – focused on oriented strand board and siding – used primarily in North American new-home construction.

Share Information (@11/27/20):

Price	**33.84**
52-Week Range	12.97 – 35.92
Dividend Yield	1.7%
Market Cap	$3.70 billion

Financials (TTM):

Revenue	$2.46 billion
Operating Profit Margin	14.8%
Net Profit Margin	7.8%

Valuation Metrics
(@11/27/20):

	LPX	S&P 500
P/E (TTM)	20.0	41.3
Forward P/E (Est.)	10.7	25.9

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
BlackRock	10.2%
Vanguard Group	9.9%
Wellington Mgmt	6.2%
Macquarie Investment Mgmt	3.5%
State Street	3.1%

Short Interest (as of 11/15/20):

Shares Short/Float	1.9%

THE BOTTOM LINE

The company is well positioned to benefit from a long-duration U.S. home-construction upcycle as well as from an ongoing business-mix shift toward siding, says Travis Cocke. Valuing its various businesses separately and then subtracting unallocated corporate overhead, he values the stock at around $57, a nearly 70% premium to today's price.

Sources: Company reports, other publicly available information

Coming back to the world of software, describe your investment case for services company Rimini Street [RMNI].

JH: The business model is straightforward. Big enterprise software companies like Oracle and SAP traditionally sell upfront licenses for their products and then make their real money in providing ongoing maintenance and service. Rimini basically says we can handle that ongoing maintenance with highly qualified engineers and highly responsive customer service, and we'll do it for half of what Oracle or SAP currently charge you. Annual run-rate revenues today are around $330 million and have grown at a compound 30% per year since the company was founded in 2005.

There are a few elements to the negative narrative here. First, they have a complex and expensive capital structure, including outstanding convertible preferred equity that eats up $16 million per year in cash flow for dividends. There are also millions of warrants outstanding that could dilute shareholders at some point, although most of those have a strike price of $11.50, well above the current stock price.

A second more recent overhang is that the company did a poorly timed equity offering right after a mildly disappointing second-quarter earnings report this year, which immediately made people expect more negative news coming in the third quarter. That turned out not to be the case, but the timing of the offering and the lack of a clear explanation for it I think has made investors a bit leery.

Third, the company has an ongoing case against it by Oracle, which claims Rimini is infringing on its copyrights by providing support services on its products. There have been a number of court cases already which have established that it's legal for Rimini to provide these types of outsourced services, but there are still technical issues around their established processes and procedures that are a source of ongoing dispute between the two companies. The current lawsuit is going to trial with a date set for mid-2022.

Taking those overhangs one at a time, we're confident the company will be able

to refinance the expensive preferred shares and materially lower its cost of capital. That's not likely to happen before mid-2021, but it's clearly a management priority and if the current financing environment holds, it shouldn't be an issue. As for the capital raise, management has explained they wanted to err on the side of caution because of the pandemic, and results have already shown it wasn't indicative of future poor performance.

With respect to the trial, we don't at all consider it an existential threat for Rimini. At worst, the jury might decide that some of the company's processes put in place after the last trial didn't go far enough to avoid copyright issues, and it will have to pay some fines and recast some technical aspects of its process. Based on past history, that could result in fines as high as $40-50 million, but we think the actual number will be much less than that. Our base case is they owe $10-15 million in fines and nothing materially changes in their process. The market appears to be pricing in much worse and is just overly focused on this legal overhang.

We've talked a lot about software companies shifting their businesses away from licensing plus maintenance toward recurring subscription services. As that continues, wouldn't that have a negative impact on Rimini?

TC: You're right that the company ultimately depends on customers sticking with on-premise enterprise software solutions rather than moving to cloud-based options from companies like Salesforce. But we don't consider that a particularly pressing issue. The shift to the cloud in the areas Rimini focuses on is likely to be a very long, drawn-out affair. Companies have a considerable amount of time and money invested in their existing customized systems and are in no rush to rip them out and go with something new. Gartner actually forecasts that the "third-party software support" market, of which Rimini has about 85% market share, is going to grow 30% per year through 2023, to $1.05 billion.

New business has actually been quite strong. In the most recent quarter, recurring revenue grew 19%, billings grew over 30%, EBITDA was up 40%, and they added 206 net new customers, which is 70 more than they've ever added in any previous quarter. While some enterprises have likely delayed maintenance spending due to the pandemic, we also think the difficult environment has everyone trying to figure out how to cut costs, and Rimini offers that.

What do you think the shares, now at $4.15, are more reasonably worth?

JH: We're talking about a software services company, at scale, with 60-65% gross margins, generating solid free cash flow, with growth inflecting upward – and the stock trades at 1x our estimate of 2021 recurring revenue. A normal company with those characteristics and without the legal overhang would reasonably trade at 6-10x recurring revenue. Even factoring in the legal overhang, we think 3x recurring revenue would be the bottom-of-the-barrel base case. Our bull-case target a few years out we'll keep to ourselves – I'm almost embarrassed to say.

INVESTMENT SNAPSHOT

Rimini Street
(Nasdaq: RMNI)

Business: Provider of enterprise software support and services, typically offering a lower priced, third-party option for customers with installed Oracle and SAP enterprise platforms.

Share Information (@11/27/20):

Price	**4.15**
52-Week Range	2.22 – 5.97
Dividend Yield	0.0%
Market Cap	$316.6 million

Financials (TTM):

Revenue	$315.1 million
Operating Profit Margin	8.6%
Net Profit Margin	2.9%

Valuation Metrics
(@11/27/20):

	RMNI	S&P 500
P/E (TTM)	n/a	41.3
Forward P/E (Est.)	18.9	25.9

Largest Institutional Owners
(@9/30/20 or latest filing):

Company	% Owned
Voss Capital	2.7%
Cannell Capital	2.6%
Nokomis Capital	2.5%
Vanguard Group	1.5%
BlackRock	1.2%

Short Interest (as of 11/15/20):

Shares Short/Float	1.3%

RMNI PRICE HISTORY

THE BOTTOM LINE

The company's business performance has been excellent, but the market has been more focused on capital-structure issues that Jon Hook believes are temporary and a legal overhang he considers eminently manageable. If he's right about the threats as well as the opportunities, he thinks the base-case share valuation would be 3x the current level.

Sources: Company reports, other publicly available information

Even in the ten years since you started Voss, passive and algorithmic investing has expanded dramatically. Has that changed the game for you at all?

TC: It absolutely has. One important way is that ETFs and passive flows make it harder to realize mean reversion in overhyped, overvalued and even cash-incinerating companies on the short side. The stocks keep going up because they're in the index and the index has to buy more as they go up.

This isn't a cash incinerator, but look at something like WD-40 [WDFC]. This is a simple consumer-products company with a limited product line that generates GDP-level growth – revenues since 2011 have grown at a 2.2% annual rate – but the stock trades at 50x forward earnings and 35x EV/EBITDA. The 20-year median P/E is 20x and the 20-year median EV/EBITDA is 12x. The stock has consistently been acquired by passive investment funds that continue to buy at any valuation.

I also think quant-driven trading that is style or factor driven can help create additional long opportunities because those strategies ignore firms that might not screen well. A company with negative revenue growth due to divesting a less profitable or slower growing segment will screen poorly now, but could look much better when it laps that divestiture a year from now. Passive flows also tend to avoid more illiquid stocks, so that's where a lot of the better opportunities are now. If you're right about the fundamentals, a company can grow and evolve and the liquidity becomes less of an issue.

You were hard on yourself for what you considered mistakes made as the pandemic crisis was hitting the market so hard earlier this year. Talk about that.

TC: Basically I spent too much time in front of the computer and over traded. All the ups and downs led to too much meddling and flip-flopping with the portfolio, when what I should have done was ignore the short-term fluctuations, focus on re-underwriting our really core ideas, and rely on what we believe are rigorous, fundamentally derived and deeply researched long-term price targets. It was a good lesson to relearn. VII

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