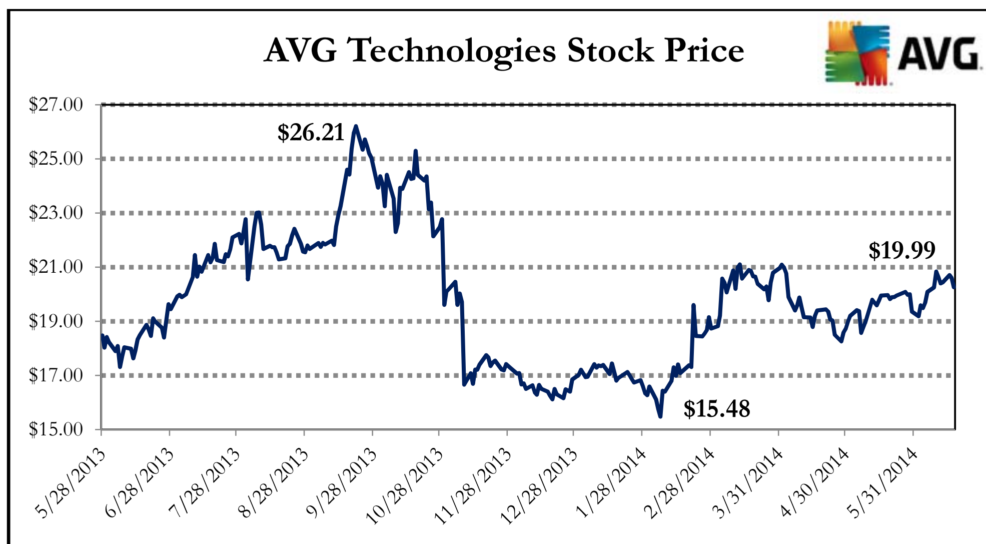
VOSS CAPITAL

2365 Rice Blvd, Suite #217 | Houston, TX | 77005

713.328.1126 | www.vosscap.com

> **"Your mission, should you choose to accept it**: Buy an above avg business with below avg valuation to generate above avg alpha
> **The market cap**: Greater than $500 million
> **The place**: Anywhere outside the United States"
>
> — *paraphrase of* ***Sum Zero*** *Team*

Imagine yourself high on a suburban hilltop, perhaps where you grew up, perhaps a small town where your grandmother lives. You're in the midst of a terrible wintry thunderstorm. It's cold outside and the entire city you look down upon seems inhospitable. Tattered buildings line the traffic-clogged streets engulfed in mist, everything is cast in a dull gray light and you think about how miserable everyone looks. Then… suddenly the clouds part and the sun comes out of hiding, embracing everything in its golden warmth and casting the scene in a different light. The whole town is transformed in an instant. The windows on the buildings sparkle, dust has been washed off the streets and they look clean. A river in the distance turns a beautiful aqua as it reflects the glinting sunlight. As you move closer and approach some individuals that appeared gloomy from a distance you realize they are beaming. There was in fact *zero* transformation. Nothing *actually* changed, you simply got up close and now see everything in an entirely new light. The market may see our idea in a negative light now, but every critical fundamental piece is in place for it to become a market darling: an asset light business model with strong free cash flow conversion and recurring revenue, complemented with some operational call options. Value…growth…free cash flow…these are not mutually exclusive components of an investment, not an ideal one at least, rather they are functions of each other—value is a function of growth—listing these traits as part of our idea is quite redundant, akin to saying "biotech bubble." In the case of our best international stock idea, *nothing needs to change* in order to earn an adequate return. If something does indeed change for the better, well then that's just icing on an already sweet cake. Now, let us mosey on out of the flowery abstract metaphors and delve into the enticing specificity of the sweetness that is AVG.



AVG Technologies NV (**AVG**) is a leader in antivirus and security software headquartered in the Netherlands (valuation, however, has been relegated to the market's *Netherworld* for now) with just over 51% of its revenues coming from outside the US and a market cap edging past $1 billion. AVG is a classic free cash flow compounding story, generating over $125 million a year (relative to a ~$1 billion enterprise value), resulting in squeaky clean balance sheet and highly visible, highly profitable, recurring revenue. Add to that two clear growth drivers currently coming to life, at least one lottery ticket, a stale short case with one of the highest short interests (and lowest valuations) in the Russell 2000 Index, and you have a stock that has a clear path to $30 (~50% upside), with much more upside possible as catalysts play out in 2015.

Summary of Key Points of Investment Thesis:

- ✓ **Cheap, Profitable Growth**: What matters for us is not if a company grows earnings, but rather *how* a company grows its earnings. AVG has a superior business model that can profitably grow revenue and earnings without concurrent growth in assets, providing for immensely attractive ROIC profile and ever growing incremental margins. The company's subscription business, representing 75-80% of the company's revenues in 2014, grew 27% Y/Y in 2013, with management forecasting 15-20% growth in 2014 and hitting 19% in Q1 2014. This 19% growth coincided with an all-time high 90% gross margin and 37% operating margin for the company. For this titillating margin and growth profile you have to splurge and pay a whopping 7x EBITDA, 9x FCF, and 3.5x Subscription Revenues, multiples more in line with declining/collapsing tech businesses.
- ✓ **Forest for the trees syndrome**: Sentiment on the stock has been decimated due to problems with its smaller, less profitable, and more volatile "secure search" Platform business. After speaking with several analysts and savvy buy-siders, we believe this continues to be at the core of most short cases, and sell side analysts seem to have a singular focus to the issue. Despite its positive cash flow, to appease said naysayers and some of the more ungenerous souls out there, we value this piece of the business at a conservative $0 and still get a total valuation 40-50% higher.
- ✓ **Misunderstood in relation to PC Cycle**: The consensus mythology of thematic shorts and those who summarily disregard the name is that AVG is difficult to embrace due to its ties to the PC. While acknowledging that PCs need to exist for AVG to be successful, we believe AVG has cleverly given itself *counter-cyclical* PC properties by taking advantage of the elongated PC purchasing cycle. We also note that, for AVG, the PC installed base is far more important than PC shipments and that the total installed base continues to grow as people hold onto their PCs longer.
- ✓ **Deleverage Story**: The company has gone from over $200 million in debt in 2012 to less than $5 million and sits on a comfortable pile of growing net cash. Given the strong balance sheet the company now possesses, we believe there is plenty of capital flexibility for management to work with, including large buybacks if the stock stays this cheap, or…
- ✓ **Tuck In Acquisitions Acting as Growth Drivers**: The company's acquisition strategy of buying good technology that they can plug into their gigantic user base (187 million active users and growing) has already seen one grand slam: PCTuneup, purchased for ~$40 million in 2011, grew from about $10 million in revenues at acquisition to $50 million in high margin revenue (we estimate 40% EBIT margin) in 2013. Other successful acquisitions include Level Platforms, purchased for $20 million in July, 2013 (just starting to spread its wings, see SMB section), and DroidSecurity for $5-10 million, the Android app that now has over 100 million downloads (see Mobile Lottery ticket below). These cheap acquisitions are reflective of their successful freemium model, one reason the company is running at well over 100% ROIC, and a reason we believe the company can sustain 10%+ revenue growth for at least the next few years.
- ✓ **Underappreciated Tax Story**: The company has explicitly stated that, due to tax advantages in the Netherlands, they expect their long term, normalized cash tax rate to be at or under 12.5%, yet bearish analysts we talked to still have the cash tax rate rising to (and remaining at) 30% over the next 5 years in their models. We believe this, along with relatively high amortization of intangible assets, will make Free Cash Flow outpace GAAP Net Income for the foreseeable future.
- ✓ **The Mobile Lottery Ticket**: The company has over 100 million downloads of its mobile anti-virus product from the Google Play market and over 80 million active users (130% y/y growth in the last quarter), far and away the highest number of downloads for any anti-virus company, and off of only 8 million at the beginning of 2012 (that's 10x growth in two years). Management is putting the pieces in place to generate "meaningful" revenue off these users in 2015, something we view as a free call option for the stock. Even small penetration off their mobile base will make our current projections look very conservative.
- ✓ **The AVG Zen Platform:** CEO Gary Kovacs (formerly CEO of Mozilla) arrived in mid-2013, and his primary output since joining AVG has been to take AVG's strength (its huge user base) and put it on cross-selling steroids. The AVG Zen platform takes all of AVG's products, across devices (mobile and PC), and acts as a user management console/interface. For a family with 10-15 devices, we believe this provides legitimate utility. For AVG it adds numerous chances to engage in cross-selling, while also building a platform that could become a security app store (e.g. management has discussed allowing other companies to plug in their apps as available on the Zen platform, with a revenue share). We are bullish on AVG Zen and believe it will act as the glue to catalyze the growth drivers described above.

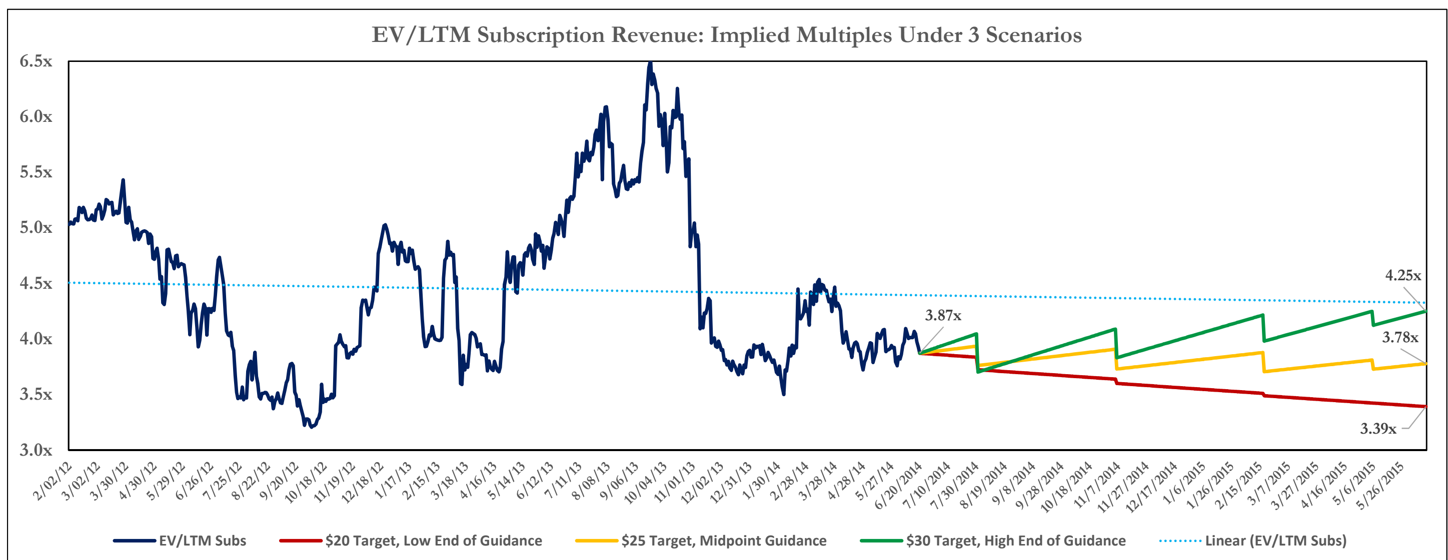
Valuation Summary

Ambiguous Upside, Limited Downside: After running the stock through a number of scenarios, we find it very difficult to value AVG much below $18, even under rather draconian assumptions, giving us a mere 10% downside in a particularly punitive bear case. On the other hand, we find the path to $25 (25%+ upside) very straightforward by the end of the year, $30 (50% upside) in the next 12 months is eminently achievable, and a double is realistic if certain catalysts play out.

Below is a summary table of our Bear, Base, and Bull cases using three different valuation methods: Multiples, Relative Valuation, and DCF, which we give equal weights in arriving at our final target.

AVG 12 Month Price Targets				
Method	**Bear**	**Base**	**Bull**	**Comment on Base Case**
Multiple	$20.00	$25.00	$30.00	Assumes static EV/Subscription Multiple
Relative Valuation	$18.10	$33.00	$40.45	Assumes 35% discount to peer group
DCF	$18.16	$34.12	$46.45	Assumes slowing growth, steady margins
Platform to $0 DCF		$29.73		Assumes Platform has 0 revenues in 2016
Average	**$18.75**	**$30.46**	**$38.97**	
Downside/Upside	-5.8%	53.1%	95.8%	
Current Price	$19.90			

The easiest way to visualize the limited downside and straightforward upside is shown in the chart below. AVG has historically traded in a range between 3.25x and 6.5x trailing subscription revenues. Subscription revenues are high visibility revenues that management has always forecast conservatively (and beaten), with 50%+ already on the balance sheet when the year begins and a predictable renewal percentage making up the vast majority of management's guidance. With subscription revenue set to grow at least 15% this year (guidance is between 15-20%), the multiple will compress over the next twelve months as LTM Subscription revenues rise and cash builds (Enterprise Value declines) if the stock stays where it is. If the stock stays where it is today for the next twelve months, management hits the low end of their subscription guidance (already hit high end in Q1), and FCF *declines by 25%* (well below forecasts), the multiple will naturally move to 3.19x (red line below), which would be an all-time low, but gives the stock zero downside. At $18 (10% downside), the stock would be under 3x subscription revenues, something we believe is an absolute floor (discussed in much greater detail later). Note that this method implicitly models the company's Platform revenues (non-subscription) at close to $0 value.



Company Background and History

AVG was founded in 1991 in the Czech Republic and is a leading software security provider with particular strengths in consumer and small business antivirus software. The company ended Q1 in March with ***187 million active users***, with 81 million currently un-monetized mobile users and 106 million active PC users. AVG is a bit different from the traditional antivirus stalwarts McAfee (owned by Intel) and Norton (owned by Symantec) in that they neither partner with big box PC manufacturers nor have their software pre-installed on the computer. Instead, they employ a freemium model, whereby basic features are provided for free via internet download (including basic anti-virus and malware protection) and then users can add additional protection through an annual subscription service. Of the 106 million active PC users, roughly 16 million are paying users.

We believe management has a strong backbone at both the CEO and CFO level. The CEO, Gary Kovacs, took over in March of 2013 after a longer term stint with web browsing company Mozilla Corporation, which had a 500 million user base when he departed. Kovacs has a long history in the technology field with high level management jobs at SAP and IBM. The CFO, John Little, has been with AVG since 2008, and acts as a longer term glue to the management team.

AVG Products

AVG reports in two distinct operating segments: Subscription and Platform.

The Subscription business (~75% of revenues and growing) includes their flagship antivirus product, of which there are several pricing tiers. Price-sensitive users can get the core antivirus and spyware/malware protection for free, forever. The basic $39.99/year package gives additional features such as their Online Shield (which scans all downloads) and Data Safe (which allows users to encrypt and password protect what they deem critical files). The "Premium" version goes to $69.99/year and adds features like Firewall and Anti-spam.

So readers may wonder, are the flagship products any good? There are numerous antivirus ranking websites out there, and we feel AVG holds up well. For instance, we looked at CNET.com's rankings of various freemium and paid antivirus options (CNET uses a 1-5 star system), and compiled the following table:

Antivirus Software	CNET Pro Rating
Avira Antivirus	5.0
AVG Antivirus	4.5
Avast	4.5
Bitdefender Antivirus Plus	4.5
ESET Antivirus	4.5
Norton Antivirus	4.0
McAfee Antivirus	3.0

AVG is also frequently cited as the best "free" antivirus software, without the reviewer actually getting into the paid version, making a comparison relatively difficult. For instance, PC Magazine named it the top 2014 free antivirus software while naming others as the best paid option.[1] Net-net, we think AVG is close to an "industry leading" antivirus software and do not fret too much over relative product quality. We believe the freemium model is more important and converts users over time that are generally loyal to AVG, something that is reflected in the consistent paying base.

Within the Subscription Revenues are two other important pieces of the business:

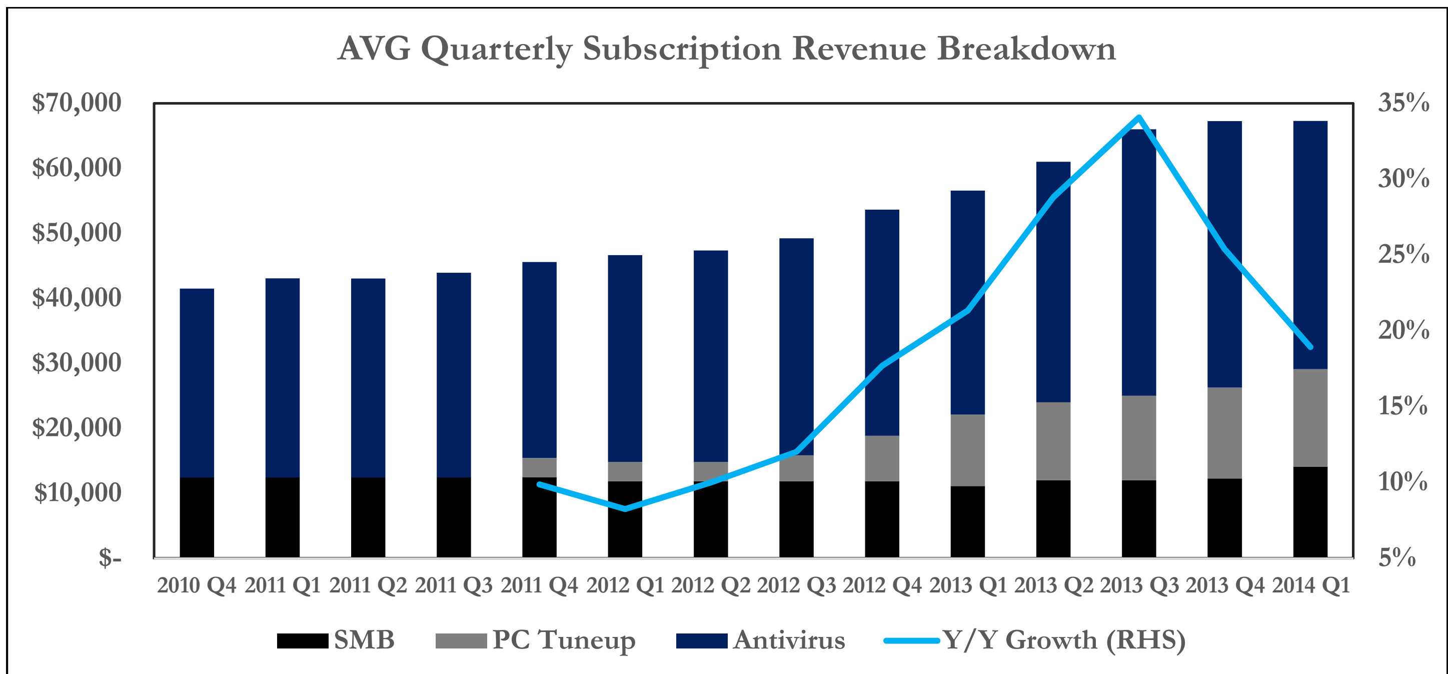
- **PC TuneUp**, which also has a freemium component, takes a PC and scans for inefficiencies in an effort to make the PC run more smoothly, extend the battery life through various power management techniques, and free up hard disk space. AVG recently revealed at its analyst day that PC TuneUp generated $50 million in revenue in 2013, making it a material standalone product (20% of subscription revenue). PC TuneUp is, in our estimation, quintessential validation of the freemium model: maintain a gigantic base of loyal users, and then roll out additional products over time that ~15% will pay for.
- **AVG Small/Medium Business (SMB)** has similar software offerings as the Antivirus products but adds several other features for either IT Administrators or Managed Service Providers (outsourced IT Administrators). These additional features include remote Mobile Device Management (remotely lock/wipe devices, add applications), Content Filtering (e.g. block Facebook), and a security management platform called AVG CloudCare. This segment also includes their Level Platforms acquisition from July 2013, for which they initially guided $15 million in revenue in 2014. The company has also recently partnered with major resellers like Ingram Micro to boost the scale and scope of sales. The company states they will "never" go

Enterprise (something we view positively given the need for a huge enterprise sales force: see Symantec for cautionary tale) and that the products are designed for companies with up to 100 employees.

As reference, we have listed below the core products and annual pricing structures:

Core PC Products	Platform	Price	Grouping	Covers
AVG AntiVirus Free 2014	Windows	$0	Core Consumer Antivirus	Antivirus, spyware/malware
AVG Antivirus 2014	Windows	$39.99	Core Consumer Antivirus	Antivirus, spyware/malware, Download protector, Data protector
AVG Internet Security	Windows	$54.99	Core Consumer Antivirus	Antivirus, spyware/malware, Download protector, Data protector, Firewall, Anti-Spam
AVG Premium Security	Windows	$69.99	Core Consumer Antivirus	Antivirus, spyware/malware, Download protector, Data protector, Firewall, Anti-Spam, Identity Alert, Quick Tune, Android Mobile
AVG PC Tuneup	Windows	$39.99	Other Consumer Sub	Faster Computer (Turbo), Less Crashing, Longer Battery life, More Disk Space
AVG Family Safety	Windows	$49.99	Other Consumer Sub	Anti-bullying, Safer Surfing, Inform Parents of Web Usage, Multiple Account Configuration
AVG File Server Edition	Windows	$39.99	SMB	Customer Support, Endpoint Management, Antivirus for Sharepoint
AVG Antivirus Business Edition	Windows	$89.99	SMB	Customer Support, Endpoint Management, Antivirus for Sharepoint, Endpoint Security
AVG Internet Security Business Edition	Windows	$125.99	SMB	Customer Support, Endpoint Management, Antivirus for Sharepoint, Endpoint Security, Email Security, Email/ Network Protection
AVG Secure Search (Free Edition)	Windows	$0	Platform	Provides safer searches by blocking unsafe websites; do not track features available
AVG Antivirus for Mac	Mac	$0	Free Mac	Same features as PC, but on Mac
AVG Cleaner for Mac	Mac	$0	Free Mac	Disk space clean up and duplicate file removal, for the Mac

While the company has been a bit coy in explicitly breaking out its Core Antivirus Consumer, PC TuneUp, and SMB products, we believe we have pieced together an estimate of quarterly Subscription Revenue distribution by product, shown below, based on various disclosures over the last three years:



Platform Product

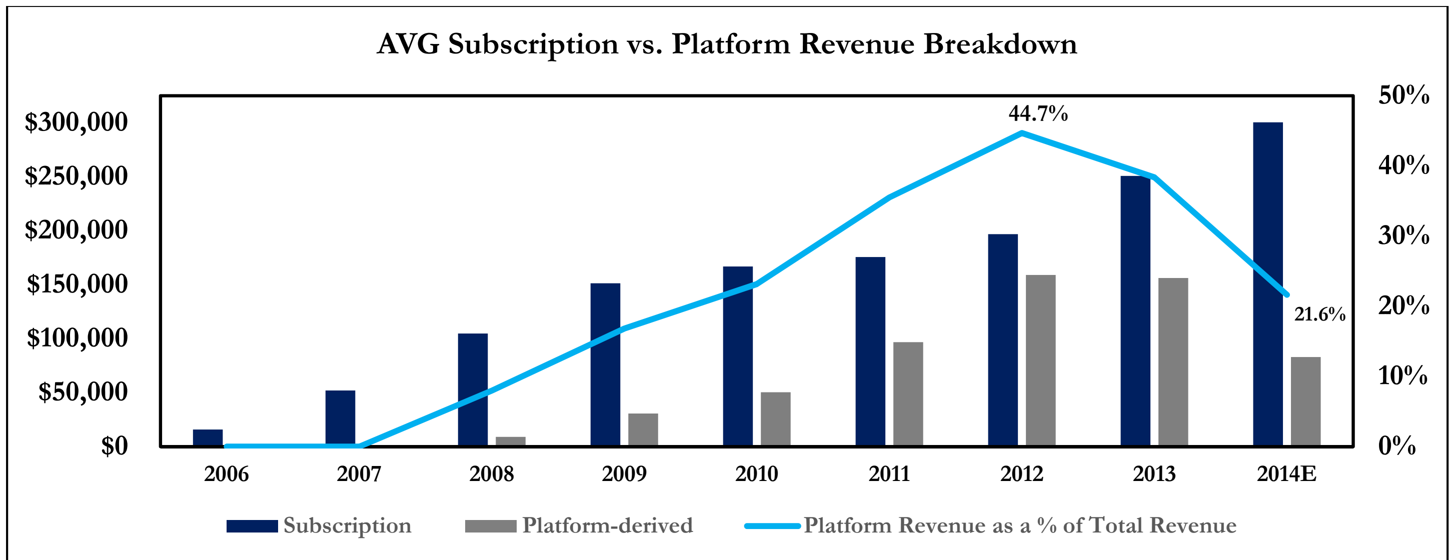
AVG's second reported segment, Platform revenue, is essentially an ad sharing relationship with Google and Yahoo. The product is called "Secure Search," and is a layer over search providers (also known as a toolbar). After installing the AVG Secure Search Toolbar, AVG effectively becomes your search engine (powered by either Google or Yahoo) and attempts to detect unsafe pages while also allowing "do not track" functionality for users who don't want certain websites tracking their actions. Below you'll see what your search webpage looks like after installing AVG Secure Search (in this case powered by Yahoo):

Once the user is searching on AVG Secure Search, any revenue generated on search ads is split between the search provider (e.g. Google/Yahoo) and AVG. The product can be installed in three ways:

1) Download Secure Search directly, independent of other AVG products
2) Download Secure Search as part of downloading AVG Antivirus or other AVG products
3) Download Secure Search through other 3rd party programs that partner with AVG, at which point the revenue gets split three ways (between Google/third party/AVG)

In a way, Secure Search is another product that takes advantage of AVG's user base, not unlike PC TuneUp. The big differences are the revenue is transactional in nature, not recurring/subscription, and the company is beholden to terms set by a few larger companies.

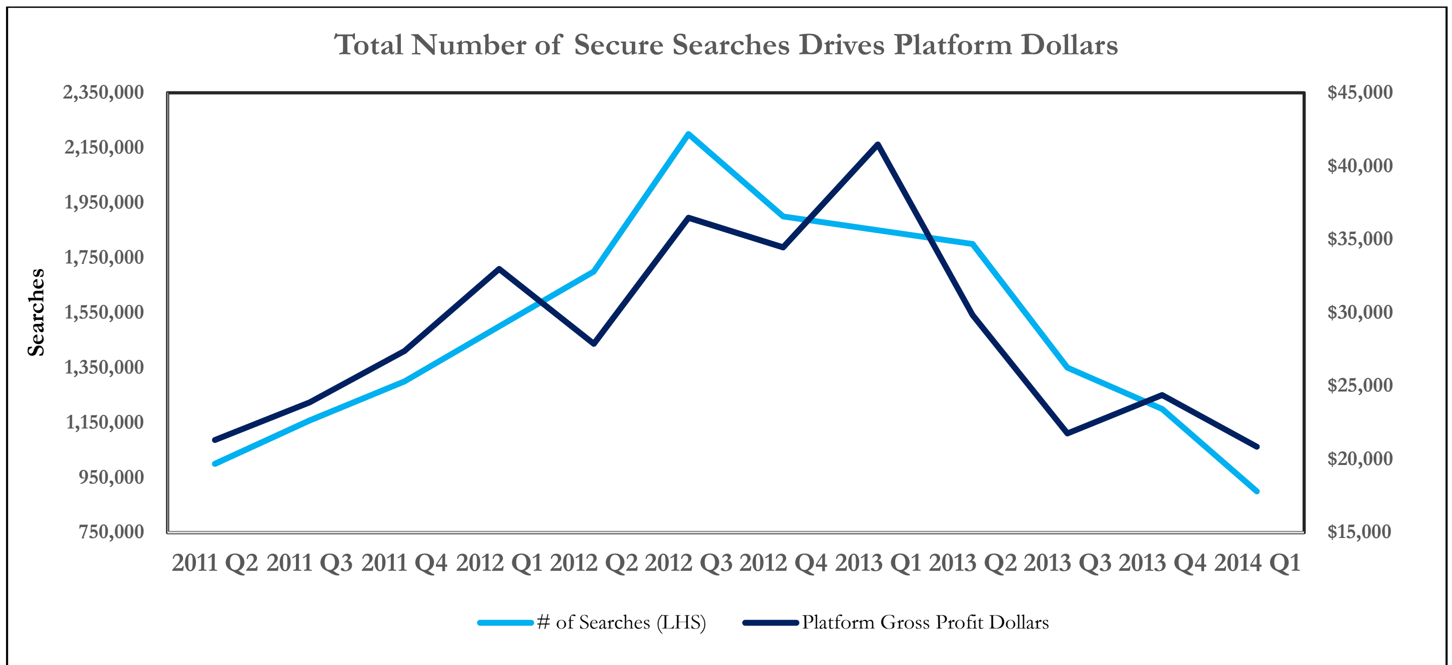
In 2011 and 2012 the Platform business was a major growth driver for AVG, peaking at 45% of total revenues. However, due to two key developments (discussed below), the Platform business has essentially been disrupted, with management guiding for a nearly 50% decline in revenue in 2014, and believing a "new base" will be established in Q4 of 2014, with growth resuming in Q1 2015.



What Happened to Platform?

The key development that probably made AVG management wish they never got into the Secured Search business is when Google announced, in January of 2013, that a user installing a toolbar (not just AVG, all toolbars) would have to *opt in* to have that toolbar take over as their default search provider. Previously, as shown below, when a user installed AVG Antivirus, they would click through the "AVG Secure Search" screen, and Secure Search would be checked to *install automatically*. Starting February, 2013, AVG was forced to leave that box unchecked, forcing the user to actively choose to have it installed and to have it be the default search provider.

This had predictable and unpredictable effects, both negative for AVG. The predictable effect was that user growth for Secured Search (and hence number of searches/clicks/ad dollars) stalled and began declining as users less frequently checked the check box and churn on toolbars is rather high (fewer new users and a steady churn rate). The chart below shows how Platform Gross Profit dollars are tied to the # of Searches done on the AVG Secure Search Platform:



The second effect, less immediately obvious, was that the economics AVG had with 3rd party toolbars became much worse, so much so that AVG chose to withdraw from the 3rd party business in Q3 of 2013 in a controlled and systematic manner:

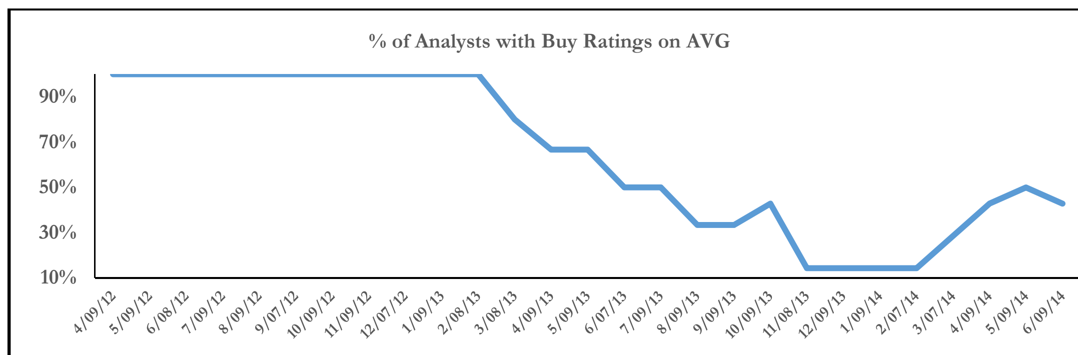
> *"The competitive headwinds were most apparent in third-party distribution, impacting both our ability to compete and gross margins in the search traffic we did acquire. As a result, we have decided to execute a controlled exit from the third-party distribution business over the coming quarters and focus on our more profitable organic search users."- CFO John Little, Q3 2013 Earnings Conference Call*

These two developments, the "opt in" issue and the withdrawal from 3rd party providers, will likely result in a ~50% decline in Platform revenue in 2014. We believe this has temporarily distorted the company's overall growth profile and set the stage for the miserable sentiment the company is currently going through. For perspective, in the recent quarter the company generated $9 million in third party revenue, so this is the revenue that is "going away" over the next couple of quarters.

Sentiment

We have several ways of gauging sentiment on a stock. On the sell side, we look at the number of buys/holds/sells and average target prices. On the buy side we examine short interest (both absolute and over time), or just look at the multiple the stock is getting relative to other technology peers. In AVG's case, it really doesn't matter: Its sentiment ranges from bad to dour across the board.

Sell side sentiment has deteriorated over time for AVG. When coverage first launched in February, 2012, all five analysts covering the name had Buys on it. As you can see, this bullishness has sharply dissipated over time.



AVG is now covered by seven analysts after Imperial Capital initiated a Neutral on the name on June 4th. There are 3 Buys and 4 Holds, per the table below, which on the surface does not seem terribly bearish (if not exactly bullish).

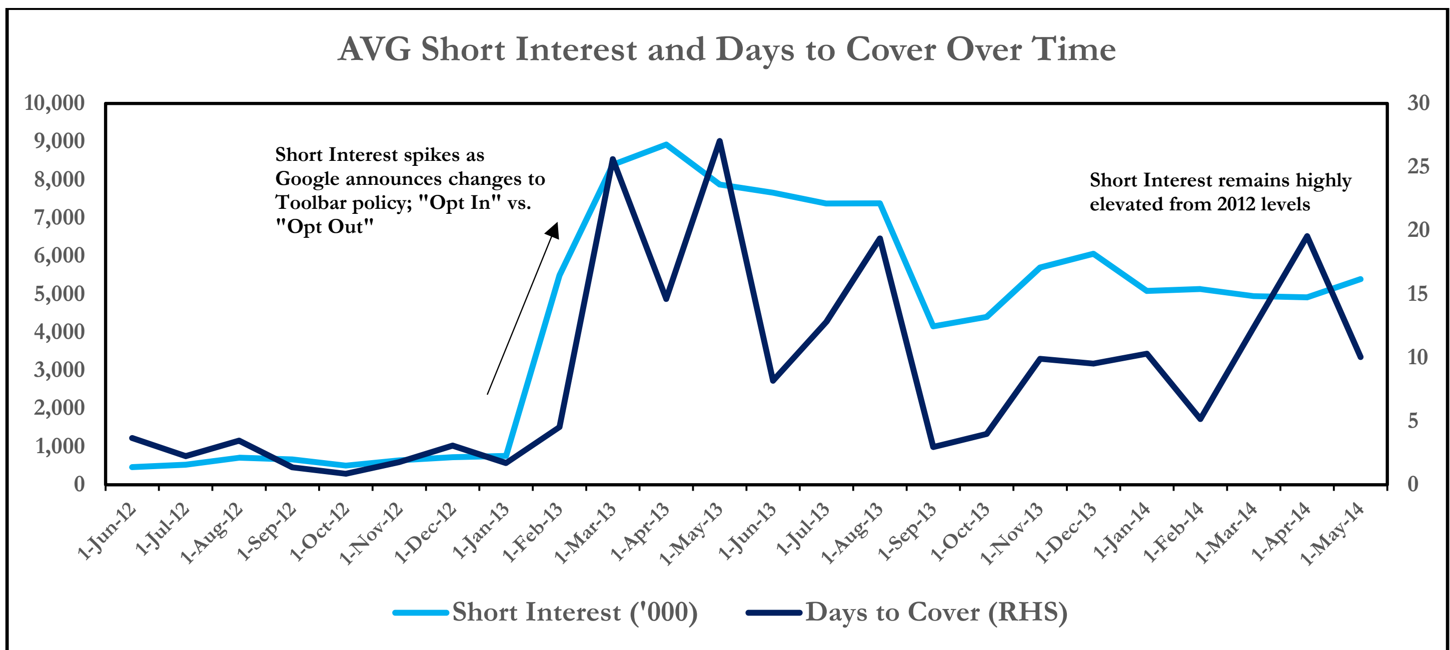
Broker	Recommendation	Price Target
Imperial Capital	Neutral	$21
Morgan Stanley	Neutral	$20
BWS Financial	Buy	$30
JMP Securities	Buy	$28
Nomura Securities	Buy	$25
Cowen and Company	Neutral	$22
Goldman Sachs	Neutral	$21

However, we would note that the buys come from the smallest shops (BWS, JMP, Nomura), while the more influential Holds come from the bulge-bracket banks (Morgan Stanley and Goldman Sachs, along with Cowen and Company, which specializes in technology stocks). Furthermore, until late March it was even more slanted, as both JMP and BWS upgraded the stock. Finally, it deserves mention that star software analyst John DiFucci left JP Morgan for Jefferies in May and took his Hold rating for AVG with him. We do not know if DiFucci will reinitiate on AVG, but we do believe his downgrade (after being one of AVG's biggest cheerleaders) in October of 2013 has led to lingering negative sentiment, as he is one of the few value leaning technology analysts out there and was probably the most high profile analyst covering the name.

Ultimately we believe a turn in sell side sentiment will catalyze the stock, and our deep dive on Goldman Sachs model and Morgan Stanley's valuation method (discussed later) will attempt to show just how easy it would be for them to get more positive on AVG.

Buy Side Sentiment

The Buy Side sentiment is arguably worse. AVG has maintained remarkably high short interest since problems began to surface with the Platform business. At 10 days to cover and over 5 million shares still shorted, the stock is still not all that far from its all-time high short interest when the Platform problems were rearing their ugly head.



Valuation

We looked at the entire universe of Global Technology stocks with market caps > $500 and FCF estimates. By this metric, AVG is the 9th cheapest (out of 288 stocks), per the table below. We will not go through each stock that is cheaper than AVG, but suffice to say that they

are a mix of Chinese/Russia ADRs, mobile gaming companies, companies with wild working capitals swings, and companies whose estimates are severely in doubt (e.g. Neustar).

Cheapest Global Technology Stocks by FCF Yield *MC>$500 million, in Information Technology Sector, has forward FCF estimates, 288 stocks in total universe*					
Symbol	Company Name	Market Cap (USD)	FCF Yield (LTM)	FCF Yield (NTM)	Sales Growth (FY2/FY1)
PWRD	Perfect World Co., Ltd. Sponsored ADR Class B	790.0	32.6%	31.9%	15%
KING	King Digital Entertainment Plc	5,470.4	13.9%	18.5%	17%
B53NQB	Mail.ru Group Ltd. Sponsored GDR RegS	2,899.1	16.8%	18.0%	19%
BFRB2W	IGG, Inc.	964.4	2.1%	14.2%	32%
NSR	NeuStar, Inc. Class A	1,454.1	12.6%	13.6%	1%
3659	NEXON Co., Ltd.	4,210.0	18.0%	13.6%	5%
NTES	NetEase, Inc. Sponsored ADR	9,860.1	12.5%	12.8%	17%
615159	MphasiS Limited	1,570.6	2.5%	12.7%	5%
AVG	**AVG Technologies NV**	**1,084.3**	**12.0%**	**12.7%**	**11%**
705822	OHB AG	552.2	-10.8%	12.4%	1%
B0V2C1	Bull SA	825.5	1.2%	11.8%	2%
2432	DeNA Co., Ltd.	1,900.6	18.3%	11.6%	6%

This is a teaser on valuation to give you a taste of how sour sentiment is. Valuation is discussed in more depth in the Price Targets section.

Given the universally low sentiment in the name, we feel it is prudent to go through what we believe the Bear Case is, and why we disagree with it. After speaking with other investors and analysts about AVG, we feel there are three key sticking points that come up frequently, in rough order of importance:

1) The Platform business is going to disappoint and may be worth nothing
2) AVG's subscription business is almost entirely tied to PCs and PCs are in secular decline
3) Microsoft, with its free Security Essentials product, is going to take market share from AVG

Bear Point #1: The Platform Business

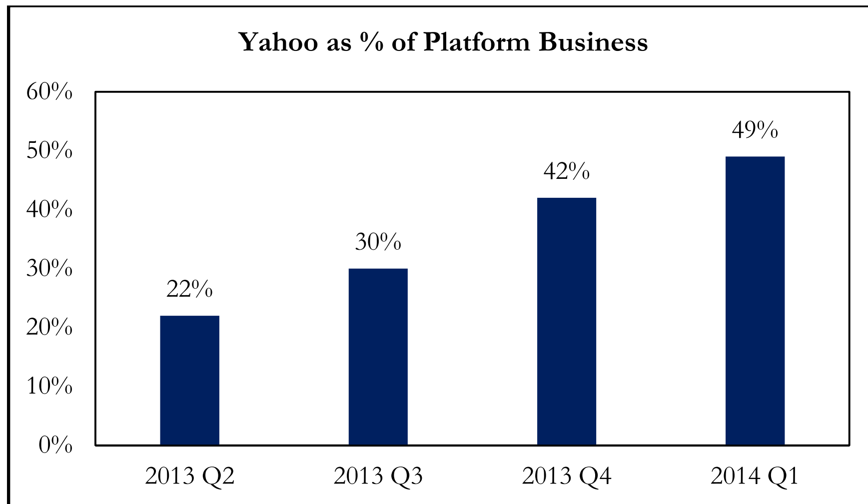
We believe a vast, vast majority of the negative sentiment in AVG resides in the Platform business, as discussed above. This is not only reflected in the timing of the short interest's rapid rise, but also in the almost bizarre singular focus from sell side analysts on this segment, causing the tail to wag the dog.

After AVG's most recent quarter, which we felt was undeniably excellent for a number of reasons, we woke up with breathless anticipation of glowing upgrades. Instead, we got the proverbial lump of coal (all quotes from notes issued on May 8th):

> *"Margins fuel EPS beat, but concerns on Platform keep us Neutral"- Goldman Sachs*
>
> *"Awaiting more visibility on the Long-Term growth drivers…at 9x EPS, the stock is not expensive, but we remain EW amid transitions in the business."- Morgan Stanley*
>
> *"2014 guidance was reiterated, but near-term Platform revs look to be weaker than expected. AVG is a very cheap stock but, in our view, these results aren't enough to drive meaningful upward momentum." – Cowen and Company*

While we wholeheartedly agree that Platform revenue is weak, and don't expect a sharp turnaround anytime soon, we would like to point out the growing disconnect between sentiment and reality:

1) **Google Dependence**: The Platform business is now far less dependent on Google, something the company began reporting in Q2 2013. Additionally, the company signed an agreement with Yandex, the Eastern European Google (most notably, dominant in Russia, as determined by Putin), and is actively looking to find other partners. We believe the shift in dollars to Yahoo is not by coincidence, as when we downloaded our own version of Secure Search we were given the Yahoo search engine by default. We think Yahoo is desperate enough to gain search share that they are far more accommodating in revenue sharing than Google will be, and that their percentage will continue to rise in the future. The balance here, though, is that Google tends to monetize every click far better than Yahoo does.



2) **Brand Equity**: Secure Search, aka Platform, is easily the shadiest part of AVG and threatened to damage its brand in its previous incarnation. The "Opt Out" was more or less a trick to get unsuspecting users to search using AVG Secured Search, and if you Google "uninstall AVG secure search" you will find plenty of rants about people feeling duped. Some of the 3rd party partners were even worse and likely bordered on illegal, as the CEO talked about at the Analyst Day:

   > *"We obviously discarded part of our business, which was part of the inorganic third-party toolbar. It was brand damaging. We had to get rid of it. It was turning into a business that was full of nefarious actors, and we did not want to be one. We did not want to stand in front of our customers and say, trust us, we are a security company. And oh, by the way, we're going to do things that you didn't ask us to do. So we took that out of the business."- CEO Gary Kovacs*

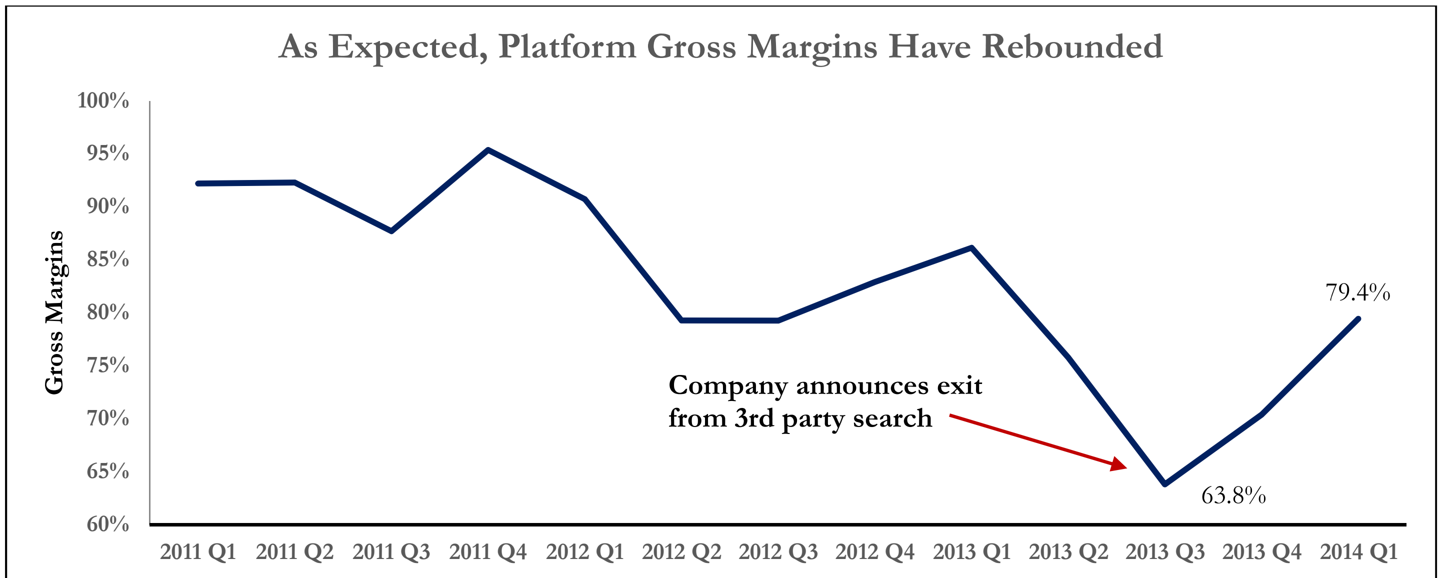
   Whether or not you believe the exit was done for ethical or economic reasons, we believe AVG's brand is safer now.

3) **Less Volatile, Low Visibility Revenue:** Subscription revenue is more predictable and far less volatile. With Subscription, a large percentage of AVG's quarter and even yearly revenue is already guaranteed in the form of deferred revenues (the company has received the cash or it is in Accounts Receivables), making it much easier for management and analysts to forecast their business and make it less likely the company will have any kind of nasty surprise. In fact, the company has always exceeded its Subscription forecasts. The Platform business does not have these qualities. It is a transactional business that is more susceptible to economic sensitivities and, given customer concentration, more susceptible to event risk. Mechanically we believe that a lower percentage of Platform revenue will in theory lower the company's Beta, resulting in a lower cost of equity.

4) **Better Engineer Utilization**: As Kovacs noted at their Analysts Day, getting out of the 3rd party business allowed them to divert engineering resources to products more core to AVG, like the AVG Zen Platform and other core security offerings. Again, we believe this is better for the company in the long term.

5) **Changes Already Helping Margins**: The "uneconomic" impacts on the Platform business were more than just rhetoric, they were blatantly obvious in the gross margins, shown here:

A business that had 90%+ gross margins in 2012 cratered to 65% gross margins in Q3 of 2013. The implemented changes moving away from 3rd party toolbars have already helped gross margins improve back to 80%, snuffing out any bear case claiming that Platform was actually detracting value from AVG's price. We are certain Platform is cash flow positive (when we asked the CFO about this, he said it was "impossible" Platform could be valued at less than zero given its margins) and, at worst, could be valued at $0 in a Sum of Total Parts analysis.



Summing Up on Platform: If one's portfolio companies must wear an albatross around their neck and cannot rid themselves of it, we can be thankful that we at least picked a 'cash generative albatross' in the case of AVG's Platform segment. Even with all these defenses, the entire Platform business could vanish tomorrow and the company would still be worth substantially more than it is today (see the Price Target section for this exercise). Much like the Peeps marshmallow bunnies from last Easter I ate recently, the short case is beyond stale, but unlike the Peeps, the short thesis does not get better as time marches on. The problems with Platform are completely known and understood by the market. The "stabilization" the sell side desperately craves is coming in the next four quarters, either by the Platform business becoming so small that it's immaterial to revenues, or (more likely) by Wall Street's perverse logic, lapping the collapse in revenue so that a "new base" forms and revenue growth once again permeates their olfactory systems.

Management has stated this new base will occur in two quarters from now, and that growth can commence again in Q1 2015. Growth or not, simply getting resolution and removing uncertainty around this business will provide fodder for improved sentiment, as the sell side will be forced to focus on something else (perhaps something like, say the Subscription business growing at 20%) and the short case will lose most of its teeth (faster than us from eating Peeps).

Bear Point #2: PC Market

The second biggest argument we hear from shorts (and, more commonly, those who just want to stay away from the name) is that AVG's Subscription business is completely tied to PCs. We will not dispute the notion that PCs and AVG go together like Kimye; if every PC vanished tomorrow AVG would have very little current business left. To us, though, this is akin to saying that if people stopped eating hamburgers McDonalds would have issues. PCs are not going away anytime soon, at least not close enough in the future that it matters to any relevant DCF analysis.

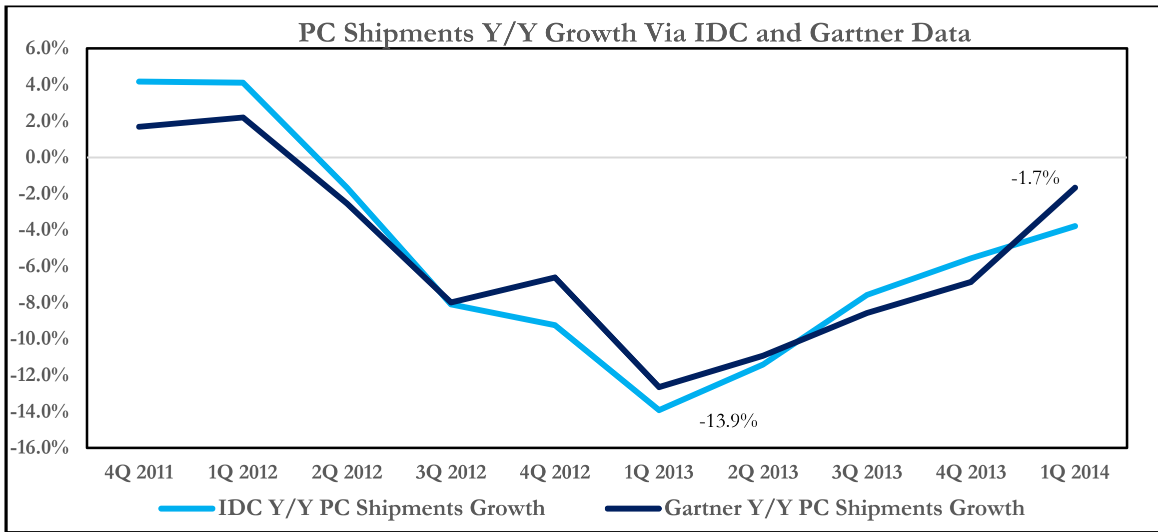
To the contrary, we believe that:

a) The Total PC Installed base is actually growing, which is more important to AVG and

b) Due to its business model and product mix, AVG is *benefitting* from fewer PC shipments.

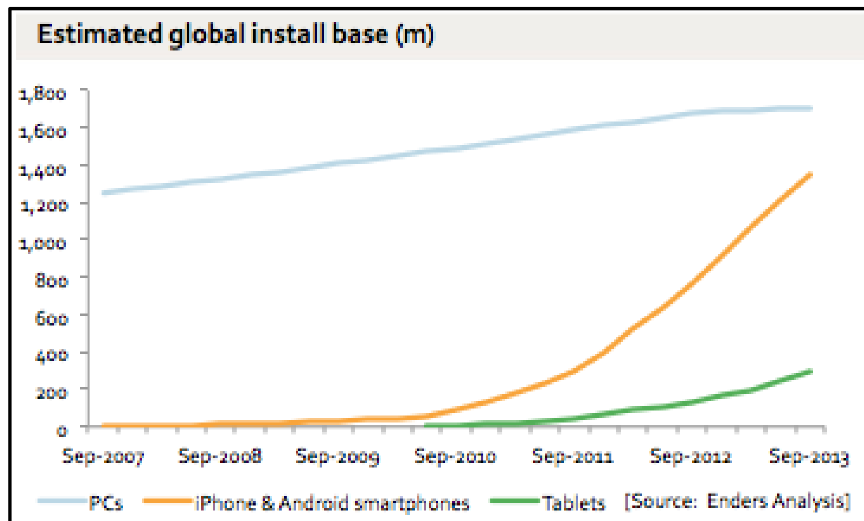
PC Shipments vs. PC Install Base

Both Gartner and IDC have reported their estimated PC shipments, per vendor, for many years now, and their estimates are close enough that we believe they are reasonably accurate. The chart below shows the Y/Y growth over the last few years in PC Shipments



We believe the sharp decline in 2013 is primarily attributable to the clunky and confusing release of Windows 8 by Mr. Softie, and the general rejection of the market to that platform. Thus, buying intentions were held off and you are just now starting to see some pent up demand for PCs returning (most likely in the form of Windows 7 PCs).

It is difficult to know for certain what the exact PC Install Base is, but most sources we researched believe that the PC Install Base is, at worst, flat, and more likely growing marginally, compared with the parabolic rise from smartphones and tablets, as shown below.

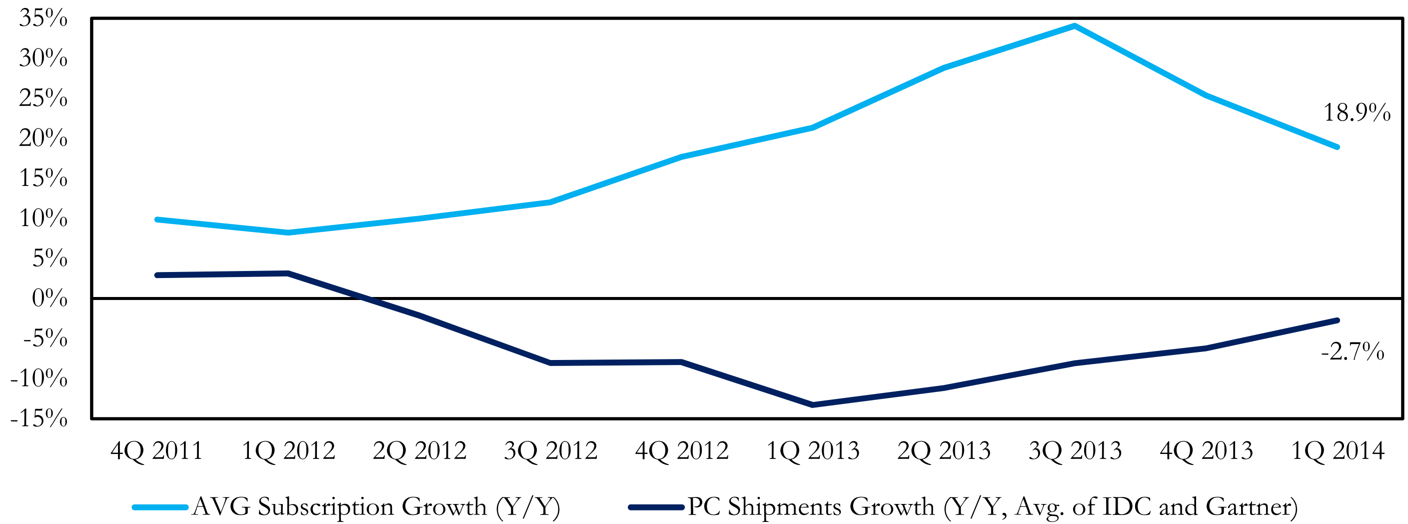


The simple explanation as to how PC shipments can be declining but the Install Base can be rising is that people are holding onto their PCs for longer (the cycle is elongating). The wallet share for "new tech" is going to phones and tablets, yet the utility of the PC means people are retaining their PCs, and holding onto them for longer. This makes intuitive sense to someone who uses all three (like the author).

Consider a couple points on how these dynamics (fewer shipments/elongated PC cycle) impact AVG:

1) **AVG's relationship with retail/OEM**: New PCs will almost never have AVG antivirus software on them. Instead, they will have some mix of Symantec/Kaspersky or whatever the Best Buy employee convinces the customer to go with (there is a free trial generally), or perhaps nothing. So, *at best a new PC purchase is a neutral event for AVG*, and at worst it's a lost customer from their previous PC who AVG will have to locate again and convert.
2) **PC TuneUp is counter cyclical**: We believe the massive success of PC TuneUp ($50 million in revenue in 2013, from almost nothing in 2011) is directly reflective of the elongated PC Cycle. PC TuneUp's primary purpose is, in fact, to keep an older PC running longer.

As a final piece of evidence, we would point to AVG's Subscription revenue Y/Y growth rate compared to PC Shipment's Y/Y growth (average of Gartner and IDC data). While we would not expect perfect correlation, the correlation is -.7, suggesting to us that AVG is at least resistant to weak PC sales.



Bear Point #3: Microsoft will Eat AVG (and others) Alive

Microsoft has a history in the antivirus market. In 2009, they released an optional, free download product called Microsoft Security Essentials, which ran on Windows XP, Windows Vista, and Windows 7. However, starting in 2012 with Windows 8, they announced a strategy change that probably created a heart attack across the antivirus provider community: a product called Windows Defender would be automatically installed and activated on all Windows 8 devices. Windows Defender is essentially Microsoft Security Essentials but slightly rebranded and repackaged for Windows 8. It includes basic components of antivirus like antispyware/malware, and some download protection.

The best source we can find on antivirus market share comes from OPSWAT, a company we believe is independent and unaffiliated with antivirus vendors and claims to provide "security software interoperability certification." Although the data is not perfect, we believe it is at least directionally accurate.

From the table below, you can see that Microsoft's share of the antivirus market surged from about 13% in the second half of 2012 to nearly double that, 26%, a year later (note there was not a Q1 2013 or Q4 2014 report). However, AVG hovered in a remarkably tight range, with share loss hitting Avira and other brands much more severely.

Antivirus Company	Q3 2012	Q4 2012	Q2 2013	Q3 2013	Q1 2014	Change
Microsoft	13.9%	16.8%	25.8%	25.4%	23.0%	9.1%
Avast	17.5%	17.5%	23.6%	23.6%	15.9%	-1.6%
AVG	**9.1%**	**8.8%**	**9.1%**	**8.3%**	**8.9%**	-0.2%
ESET	10.6%	10.8%	7.1%	7.2%	8.1%	-2.5%
Symantec	10.2%	10.5%	8.4%	7.6%	8.0%	-2.2%
Avira	12.1%	10.4%	6.6%	6.8%	5.6%	-6.5%
Kaspersky	6.2%	5.9%	5.8%	6.5%	5.5%	-0.7%
McAfee	4.5%	4.4%	3.1%	3.2%	3.5%	-1.0%
Other	15.9%	14.9%	10.5%	11.4%	17.3%	1.4%

Meanwhile, Microsoft appears to have peaked and has ticked down the last two quarters. Why?

Microsoft disclosed some telling tidbits in an interview in September of 2013. Holly Stewart, the senior program manager of the Microsoft Malware Protection, stated that Microsoft works closely with antivirus partners (like AVG) so that "they can do at least as well as we are. The natural progression is that we will always be on the bottom of these (antivirus) tests." She went on to state the Microsoft should be seen as a "baseline" and that other services are recommended for more complete protection. Several websites who had previously

supported using Microsoft Defender flipped support following this interview. For instance, howtogeek.com stated "Yes, it's a shame- MSE's lightweight and hassle-free nature make for a great interface and a faster computer. But the core of an antivirus is the detection engine, and Microsoft appears to be throwing in the towel here."[2]

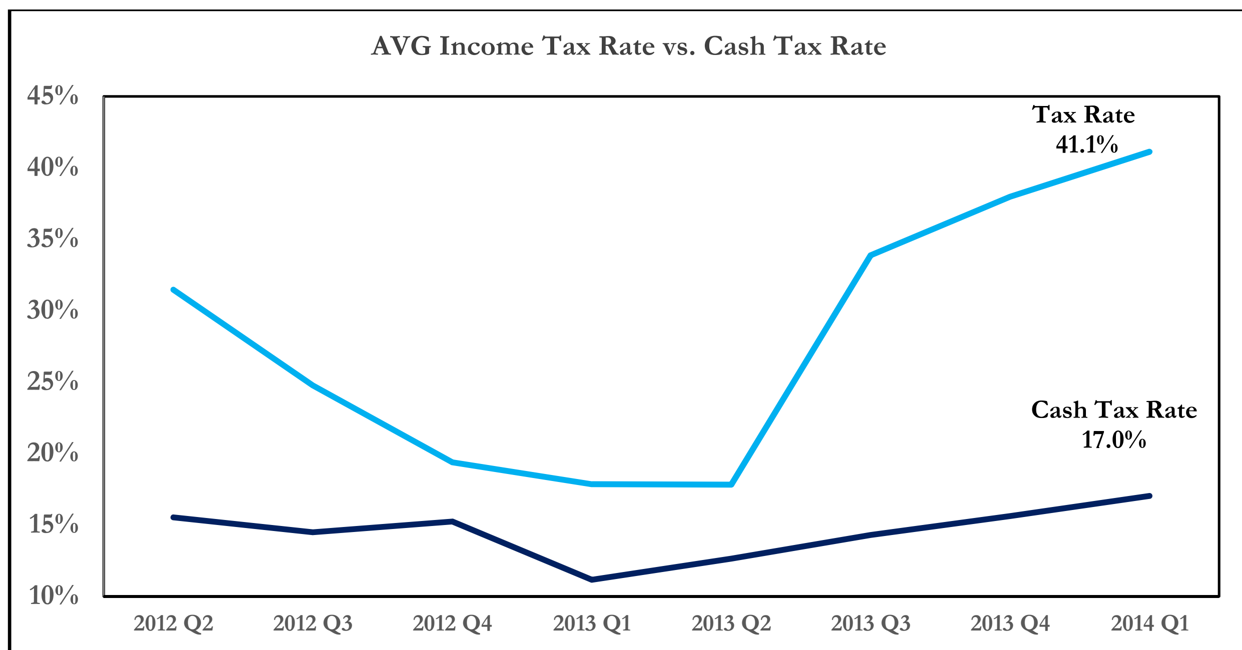
Net-net, while we continue to monitor market share, we believe this thesis has sailed. Microsoft is now losing market share, the company itself is saying its basic security product is not enough to protect your computer, and that they give all their information to their competitors. Meanwhile, the impact has only impacted AVG marginally (if at all), something we attribute to their successful freemium model.

Focusing on the Positive: Five Underappreciated Things We Love About AVG

We have spent an inordinate amount of time on the negativity surrounding AVG and nobody likes a Debbie downer, so before discussing price targets, let's look at *cinco positivo cosas* occurring within the company that we believe are not well known and will help catalyze the stock to the multiple it deserves.

Tax Story

The company has guided to a long term, "normalized" cash tax rate of 12.5% or less. Due to timing differences, the cash tax rate and effective tax rate have diverged significantly, understating true cash earnings power.



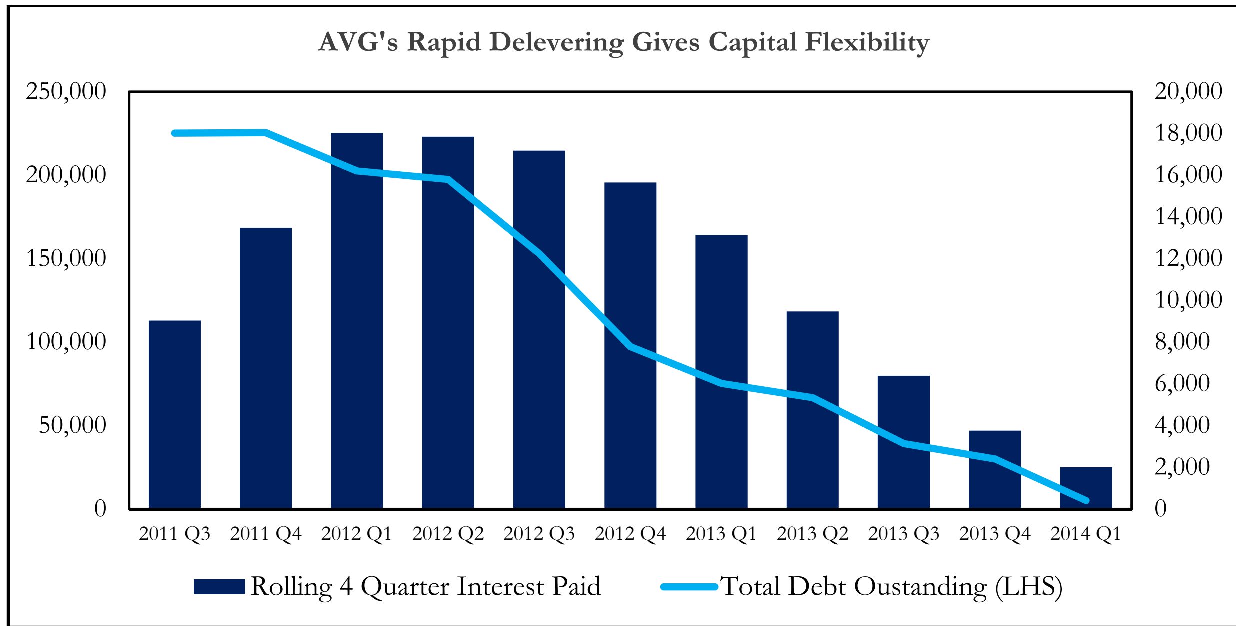
How is the company confident in this longer term, 12.5% cash tax picture? We refer you to an excerpt from their most recent K:

> *"The normalized tax rate of approximately 12.5% is based on an estimate of the Company's future cash tax rate as well as its recent cash and income statement tax charges… as of January, 2014, we relocated our Cypriot e-commerce entity to the Netherlands and obtained a special deduction which will result in an expected cash tax rate of 11.25% over the following ten years. As a result of these group tax restructurings our future effective tax rate will mainly be determined by the "innovation box" tax regime in the Netherlands and the effective corporate tax rate of AVG e-commerce distribution entity of 11.25% in the Netherlands."*

As we understand it, and corroborated with the CFO, a vast majority of their revenue is generated under the "AVG e-commerce distribution entity," which results in an effective cash tax rate of 11.25%. In addition, the Netherlands has an "innovation box" tax regime which allows some of their income to be taxed at 5%. This "innovation box" agreement has been ongoing for AVG and explains much of their historically low taxes, but is less certain to continue in the future. Thus, we are not assuming a lower tax rate than 12.5% although we believe it is quite possible. The CFO told us that he believed the 12.5% number is actually "conservative" but that 12.5% to 10% is not all that important to articulate, in his view. The upshot of all of this is the company will be paying a very low tax rate for quite some time, something that sell side analysts seem to have missed (see Goldman Sachs section below).

Deleverage Story

In Q3 of 2011, the company had over $225 million in debt outstanding, resulting in over $16 million a year in cash interest payments. In two short years, the company has paid down nearly the entire debt balance ($5 million remaining as of end of Q1 2014).



In addition to giving the company a $16 million a year levered FCF tailwind, this deleveraging gives management major capital flexibility as cash will quickly begin accumulating on the balance sheet. We expect a mix of buybacks, investment back into the business, and more "tuck in" acquisitions that the company has been so successful with. Speaking of…

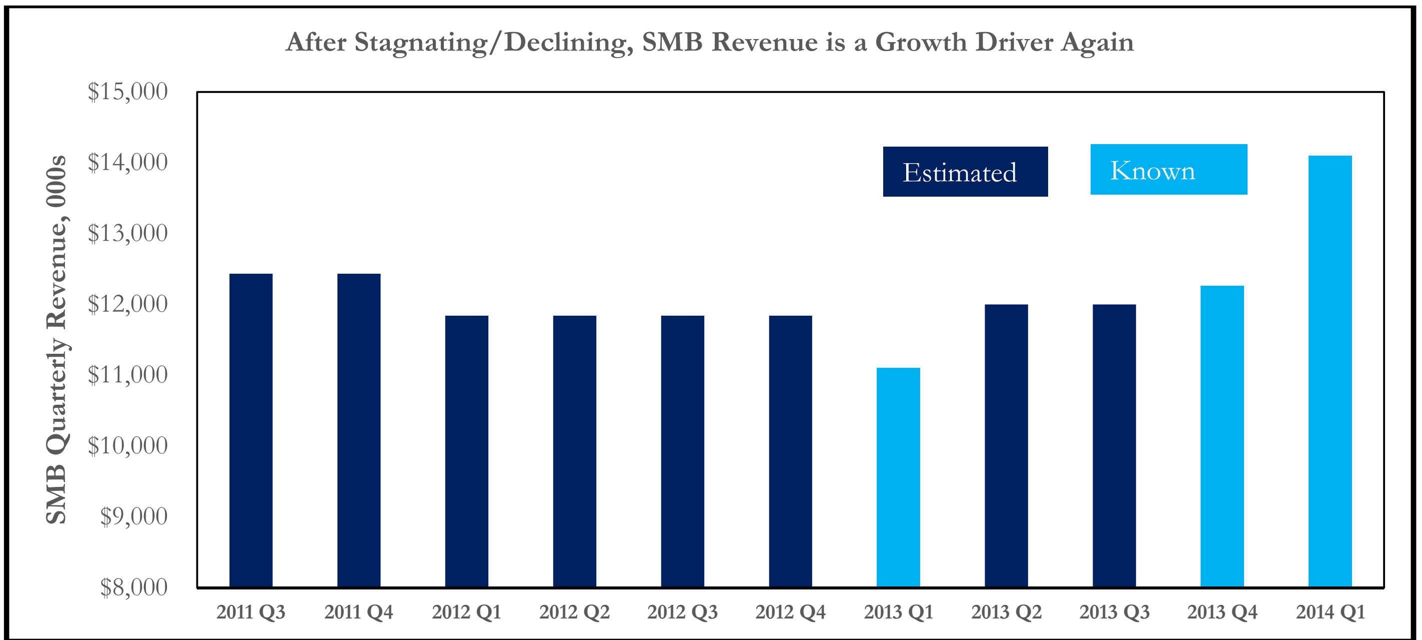
Acquisitions Act as Growth Drivers

Normally, we are not crazy about acquisitions. However, AVG has shown a distinct pattern of buying sound technology that simply needs a much larger, established user base for scale, at very low risk prices. To this end, they are using their large freemium user base to maximize profits. Below is a table of the three material acquisitions the company has made since 2010 (acquisitions above $10 million dollars):

Close Date	Deal Title	Transaction Value ($MM)	Comment
July 1st, 2013	LPI Level Platforms	$20.0	SMB sales grew 25% y/y in latest quarter
Oct 10th, 2011	TuneUp Software GmbH (Germany)	$40.0	$50 million in 2013 sales, at at least company average margins
Nov 9th, 2010	DroidSecurity Ltd.	$10.0	100 million downloads on the Google Play store, 80 million+ active users

To point out the obvious, the company has been selective and disciplined in their "major" acquisitions, cumulatively spending about $70 million over four years (although they have made a number of $3-5 million acquisitions). Of the three acquisitions above, we would classify two of them as unqualified successes (PC TuneUp and DroidSecurity). We have already touched on PC TuneUp as an exemplary case of plugging a product into their user base (now 20%+ of subscription revenues), and continue to believe it will be a growth driver for the company. We will talk a bit more about DroidSecurity momentarily.

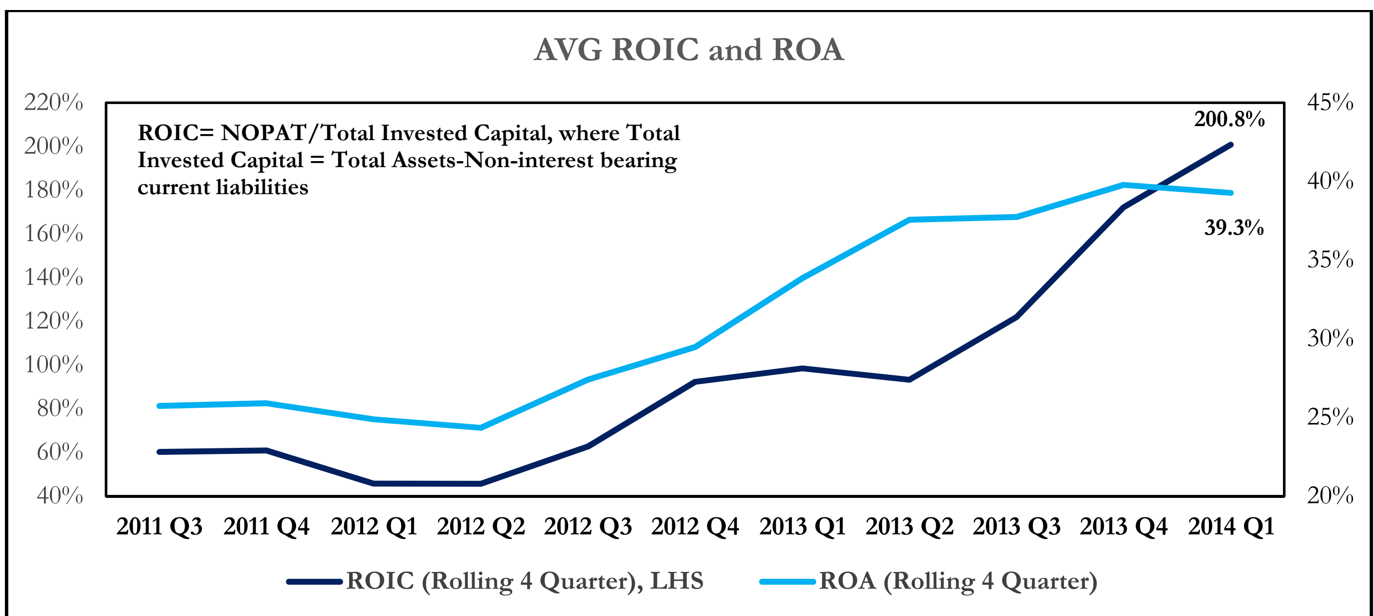
It is the Level Platforms acquisition (July 2013), which management guided for 14 million in revenue 2014 when they acquired it (and 6-10 cents in EPS contribution, initially), that is already starting to show signs of reinvigorating their flat to down Small and Medium Business (SMB) segment, and can act as a 2014 and 2015 growth driver (in tandem with PC TuneUp). Level Platforms, combined with the other Cloud Care features, is meant to provide SMBs with a "one stop shop" for their security needs, with security going from antivirus to remote mobile device management (MDM). While it does not have all the features that a larger enterprise would need, AVG believes with Level Platforms they have fleshed out everything a smaller business, or an MSP (Managed Service Provider) would need. In the most recent quarter, management did something we are always fond of: *increase transparency*. For the first time, the company broke out their SMB vs. Consumer Subscription revenues, while also providing some historical context: SMB revenues for the quarter were $14,100, 15% sequentially higher and 24% higher year over year. Given other disclosures the company has made (including commentary on SMB being down year over year in 2012 and nearly flat in 2013), we have estimated SMB revenues over the last several quarters (we know the last two quarters and 2013 Q1 exactly, but are estimating the rest).



We believe this business is showing similar trends as the PC TuneUp business did in 2013, and that the bullish investors could expect even more acceleration from this business in the back half of the year. Kovacs commented that:

> *"We are **beginning** to see results from our strategic investments with both managed workplace and cloud care contributing to revenue growth in the quarter. Annual monthly recurring revenue from our software-as-a-service products increased 15% sequentially and reached nearly $15 million in total. We continue to build out of our North American sales and channel teams, and have also laid the groundwork for further rollout into Europe, Middle East, and Africa in the second quarter and beyond. We believe our SMB business is set to continue to contribute nicely to the top line in the second half of 2014."- Gary Kovacs, Q1 Earnings Call, May 7th, 2014*

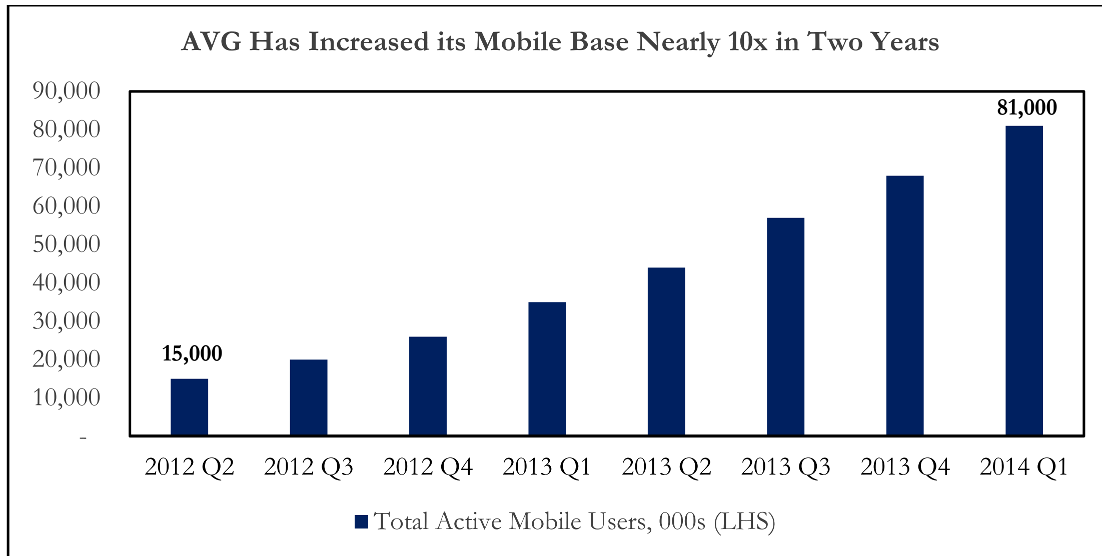
Taking a step back: We invite the reader to ponder what happens to a company's ROIC when they make successful acquisitions like this, combined with a shrinking debt balance, lower tax rate, and an already asset light model? Well, it gives AVG one of the highest ROIC's in all of technology, and an ROIC that is accelerating to almost comical highs. Note that typically we would subtract out Excess Cash in the Invested Capital calculation, but this gave AVG an ROIC of 900% in the most recent quarter, so we believe this a more conservative view of their ROIC. Given the impact that Deferred Revenues (liability) has on the calculation, we have also included ROA. Very few technology companies can approach either of these levels, except perhaps Tesla in a Utopian Society.



The Mobile Lottery Ticket

A corollary to the bear case argument that AVG is tied to PCs is that the company is "missing" mobile. Or, more accurately, the entire antivirus community is missing mobile because nobody has figured out how to monetize it yet. We would submit that if there is one company that is capable of getting significant dollars out of mobile, it is AVG with its freemium approach.

As discussed, AVG acquired an Android application called DroidSecurity in 2010 for ~$10 million. This application became the mobile antivirus backbone for AVG. Since then, their mobile user growth has been nothing short of phenomenal, with the company first reporting the mobile user number in 2012 Q2:

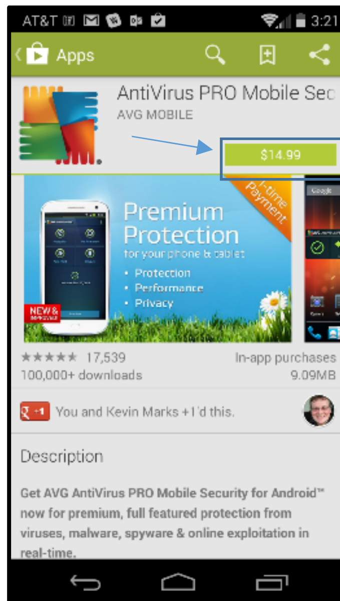


Last quarter, the company maintained its 20% sequential growth while posting over 130% y/y growth, off a now gigantic user base of over 80 million. A quick check on the Google Play store notes there have been over 100 million downloads of the core, free, antivirus application. Let's be clear that there are very few applications out there that have that many downloads, and this base was built with "very limited" marketing spend. AVG is in prestigious company with these numbers. Equally important is the large lead AVG is building on competitors. We compiled the following table of key antivirus apps, noting that AVG is the clear leader, along with nearly identical ratings to from users:

Google Play App	Downloads*	Store Rating (5 is Tops)
AVG	100,000,000	4.4
Avast	50,000,000	4.4
Lookout Security	50,000,000	4.5
Norton	10,000,000	4.4
Antivirus Free (Creative Apps)	10,000,000	4.5
Qihoo (mostly China)	10,000,000	4.4
CM Security	10,000,000	4.7
Mcafee	5,000,000	4.4
Kaspersky	5,000,000	4.6
Trustgo	5,000,000	4.6

** Precise download number not known, are listed in ranges (AVG is greater than 100 million, Avast is between 50 and 100 million, etc.)*

Second, AVG has begun considering ways to harvest this gigantic user base. We were able to locate on the Play store a paid AVG antivirus application, with screenshot below. When we asked management about this, they told us they were "always testing" various products and price schemes. We believe they are fiddling around with various pricing options in an effort to see what sticks best. We expect more details on mobile monetization to emerge in the coming quarters.



Finally, AVG is also rolling out additional mobile applications (currently all free) that seem to suit the mobile use case more clearly. For instance, there is a "PC TuneUp equivalent" called AVG Cleaner that has over 5 million downloads, a battery saving application called "AVG Battery Saver & Tuneup" that has over 1 million downloads, an "AVG Privacy Fix" app with 500,000 downloads that allows users to more accurately show what they are sharing on social websites like Facebook/Linked In/Twitter, and "AVG Uninstaller", an app that assists in quickly removing unwanted apps (with over 1 million downloads). Management recently started reporting the "average apps downloaded per mobile user," a number which rose from 1.05 to 1.07 in Q1 2014.

We would like to make clear we are not modeling any revenue from mobile for AVG in our DCF. However, some quick sensitivity analysis shows that even tiny penetration of this user base could result in meaningful revenue upside:

		User Base: Paid Penetration				
Yearly Revenue Per User		**1%**	**2%**	**3%**	**4%**	**5%**
	$6	$7,800,000	$15,600,000	$23,400,000	$31,200,000	$39,000,000
	$9	$11,700,000	$23,400,000	$35,100,000	$46,800,000	$58,500,000
	$12	$15,600,000	$31,200,000	$46,800,000	$62,400,000	$78,000,000
	$15	$19,500,000	$39,000,000	$58,500,000	$78,000,000	$97,500,000
	$18	$23,400,000	$46,800,000	$70,200,000	$93,600,000	$117,000,000

Assumes a 130 million user base, growing from a current 81 million

The company currently monetizes approximately 15% of their PC users and charges $39.99 a year for its basic antivirus package. A monetization level of $1 a month ($12 a year) at 3% of their user base could add nearly $50 million in incremental, presumably high margin revenue. While some may view even this exercise as far-fetched, given the inability of any company to monetize mobile security thus far, we would like to conclude with one more positive initiative that, if nothing else, improves the probability the company can begin mining its mobile goldmine.

AVG Zen Platform: Putting it All Together

"Everything Zen, everything Zen" - Bush

Much of the company's Analyst Day in March was spent talking about AVG Zen, currently an application available on mobile and desktop that is being slowly rolled out to the user base (with management stating they hope to complete the roll out by the end of 2014). AVG Zen is not a new *product*, per se, but rather a user interface for managing all of one's devices. AVG Zen will ultimately *be* AVG. So, if my family has 3 phones, 2 tablets, and 3 PCs, AVG Zen is a dashboard that allows quick management of all those devices in one place. AVG Zen is a clever way to both increase customer dependence/loyalty and to more effectively cross-sell. Or to put it in subscriber metric terms, it should increase the lifetime value of the customer.

For instance, if a user has a Mac with AVG Antivirus and then buys an Android phone, Zen would be smart enough to figure out that same user has a new device, and would ask the user if they would like AVG protection on their phone. In this way AVG potentially blends

the line between PC and mobile, and becomes more of a one stop security shop. It seems to be inspired by their Cloud Care/Level Platforms product for SMBs, but with a consumer focus. Management pointed out that AVG Zen could help cross-sell a free mobile user to pay for PC anti-virus (thus monetizing mobile indirectly). The company has also hinted that Zen would become a platform over time for other companies to put their security applications on. While we are a bit skeptical AVG Zen becomes a full-fledged application distribution platform, we do believe there are certain select companies that might make sense for AVG to partner with (e.g. anti-theft protection apps).

More simply, we view Zen as yet another potential growth driver in 2015. Cumulatively, between PC TuneUp, SMB, Mobile, and Zen, we think there is more than enough potential to drive at least double digit growth in 2015.

Additional Positives

- ☺ **Attractive Takeout:** We know, we know, everyone is an M&A target lately, but we assure you that very little of our investment case rests in a takeout. However, consider that there are many American technology companies with cash overseas that might like to gobble up a company like AVG that generates lots of cash, would be immediately accretive, and would be a tax efficient use of said cash.
- ☺ **Auto-renewal program:** The company has been pushing for auto-renewal in most of their products. The CFO commented at Analyst Day that 77% of new users are now selecting Auto-renewal, and that PC TuneUp was "just added" to that program. The CFO believes this will be a "multi-year" tailwind for renewal rates and revenues.
- ☺ **Visibility of 2014 Revenue:** We have hammered on the visibility of revenue, but here we are quantifying it. The CFO noted that 50% of the midpoint of subscription guidance is "already on the balance sheet," meaning it resides in deferred revenue. This, combined with auto-renewal, growth initiatives, and Q1 beat, gives us stronger conviction that the higher end of subscription guidance is most likely.

Additional Risks

Although we have discussed in detail the three key Bear points, we would like to add a few additional risk factors to consider:

- ☹ **Google Renewal:** The Platform contract with Google is up for renewal in November. As we have stated ad nauseam, the Platform does not need to be an important part of the story for AVG to have substantial upside. We also believe Google will renew the contract like they always have and note that AVG is way less dependent on Google now, so in reality this could be a "buy the news" positive catalyst. Nevertheless, this could create volatility in the stock in the coming months.

  "Google, where is thy sting?" – *AVG in the future*
- ☹ **Holder Concentration:** Okumus Fund Management, a fund known for having balls of steel, err I mean, taking massively concentrated bets, has been selling down their stake in AVG and now owns 6.2% of AVG (~3 days average volume), with AVG

previously representing over 42% of the fund's portfolio. In the last filing, Okumus continued to reduce its exposure to AVG, selling over 3.8 million shares in the last three months. We would prefer the investor base to be more diversified, and consider an aggressive liquidation by Okumus, or PE owners TA Associates (a 19.4% owner), or Enterprise Investors Corporation (at 10.0% owner), a potential overhang. Dariusz Pronczuk from Enterprise Investors left the AVG Board in December 2013 and while Enterprise still owns 10%, they may want to shed their stake soon.

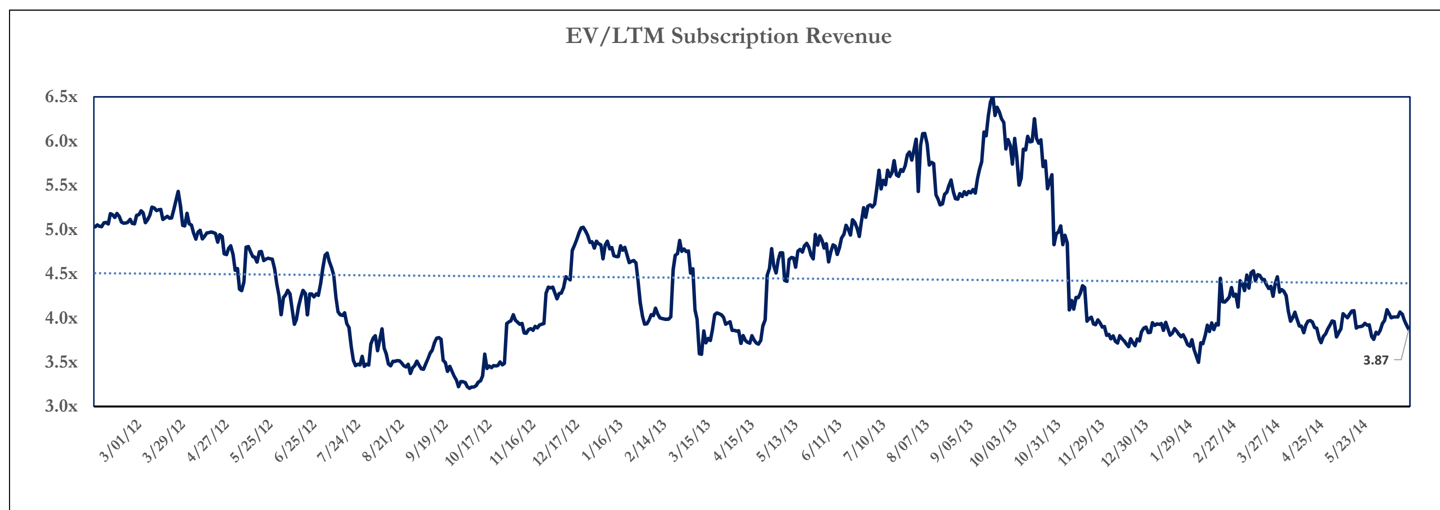
- ☹ **Billings Trailed Revenues, Missed Estimates Last Quarter:** Management states that the spike in billings last year when PC TuneUp was taking off made the billings number challenging in the past quarter. They also stated they fully expected billings to "return to growth" in the next quarter. Nevertheless, billings are an important metric for a subscription focused company and bears watching.
- ☹ **Lack of Defining Event Catalyst:** The most obvious catalyst to us will be the switch in focus from Platform revenues to Subscription revenues. We feel it is inevitable this will occur in the next four quarters as either Platform will form "a new base" or it will start to become less material to the total revenue base (or both). That said, it is hard to know exactly when it will occur. It is possible Platform could very slowly keep grinding down, leading to a more prolonged period of negative sentiment.

Price Targets

We have chosen to use three different valuation methods for AVG: Multiples (EV/Subscription Revenue and EV/FCF), a Relative Valuation, and a traditional DCF. In each of these methods we attempt to stress test the price target with a Bear, Base, and Bull Case.

Target Multiple:

We believe the most straightforward way to value AVG is to look at the EV/Subscription multiple, both what is has received over time and what is a fair intrinsic value of $1 in subscription revenue. Note that FCF margin has been fairly consistent over time, and something management focuses on, so we can then extrapolate a rough EV/FCF multiple as well. This method *implicitly removes the Platform business*, as Platform revenue does not have a recurring/subscription element, so it has an element of conservatism embedded in it. Since it went public, AVG has traded in a range between 3.25-6.50x LTM subscription revenues, with a very flat trend line of 4.50x.



Nevertheless, we believe a true range is closer to between 3x and 5x, and will vary based on perceived long term growth, margins, and stability of the subscription base.

Why 3x to 5x?

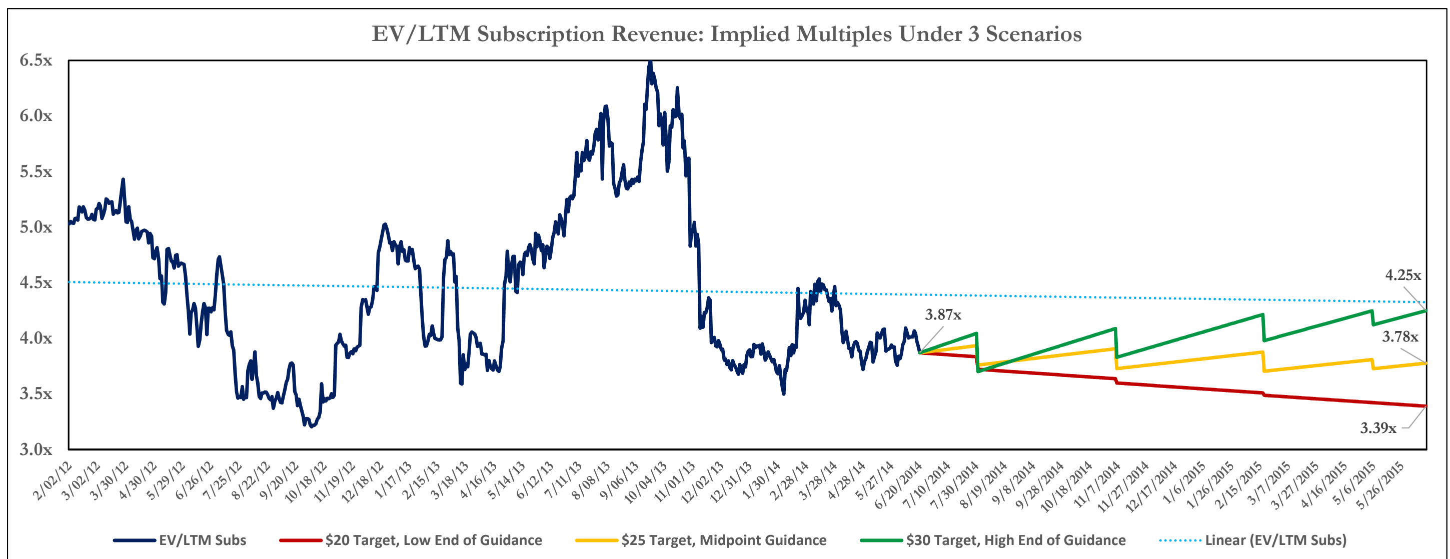
In any subscription business, we believe there are expense levers you can pull, mostly on the Sales & Marketing side, that would improve profitability but lower growth (or raise churn), or vice versa. Thus, there is some spectrum that one can act across balancing profitability and growth.

AVG's Subscription Multiple Spectrum	Harvest Mode ◄					► Growth Mode
Take $1 Dollar in Subscription Revenue	**$1.00**	**$1.00**	**$1.00**	**$1.00**	**$1.00**	**$1.00**
Operating Margin	70%	60%	50%	45%	40%	30%
Tax Rate	12.50%	12.50%	12.50%	12.50%	12.50%	12.50%
Post-Tax Value	**$0.61**	**$0.53**	**$0.44**	**$0.39**	**$0.35**	**$0.26**
Perpetual Growth (implied churn/lost new subs)	-10%	-5%	0%	3%	5%	7%
Discount Rate	11%	11%	11%	11%	11%	11%
Take Post-tax/(Discount Rate-Growth)						
Implied Multiple	**2.99x**	**3.39x**	**4.17x**	**4.92x**	**6.36x**	**7.50x**

In aggregate AVG achieved a 37% operating margin last quarter and has gravitated between very high 20% and 40% operating margins. We believe that if the company simply stopped investing, they could achieve an operating margin close to 70%, but at the cost of -10% growth a year. On the opposite end of the spectrum, the company could probably grow long term 5-7% if they spent a much higher percentage of sales on marketing and came at a lower Operating Margin. These numbers very much depend on the situation of the company, but with a 90% gross margin, 37% operating margin business still growing at 20%, we believe they are reasonably valid and perhaps conservative. At the bottom of the table below you can see the implied multiple for a dollar of subscription revenue, with the inputs being Operating Margin, Tax Rate, Perpetual Growth, and a Discount Rate. In full Harvest Mode, at 70% operating margin and -10% growth, the implied multiple is 3x. At 45% operating margin and 2.5% growth, the multiple is closer to 5x.

We believe it is both fair and conservative to put a multiple range in one of the first four columns, and leave the last two columns for somebody else to hold the stock (presumably when sentiment has turned and the stock is at $40+).

Here is where the cash flow compounding and growth comes in. In the chart below we have stretched out AVG's implied multiple over the next twelve months, given two compounding factors: LTM Subscription revenue will be rising, and cash will be accumulating on the balance sheet (lowering EV). Both of these factors will compress the multiple assuming the price stays constant.



The red line assumes that FCF is down 20% over the next twelve months (~$100 million) and that subscription revenue comes in at the lower end of management's guidance. In this case, one year from now the stock will still be around $20 and will be trading at nearly an all-time low multiple (and near the lower end of our hypothetical range).

The yellow line assumes the midpoint of management guidance in subscription revenue, flat FCF, and a $25 target. Thought of another way, the stock can rise by nearly 20% simply by maintaining the status quo.

Finally, the green line assumes the high end of subscription guidance, flat FCF, and a $30 target. Below is a table showing our target multiples for the stock in a Bear, Base, and Bull scenario:

Case	EV/LTM Subscriptions	Implied EV/FCF
Bear	3.4x	9.3x
Base	3.8x	9.1x
Bull	4.3x	11.2x

We would point out that management hit the high end of guidance in Q1 of 2014 (19% Y/Y growth), has high visibility for their subscription business, and in their brief history has yet to miss their subscription guidance. Given history and visibility, we believe the company has a legitimate chance to beat the high end of their guidance. Finally, addressing the super bear case, if management hits the low end of guidance, and only achieves $100 million in FCF, the stock would still be worth $18 at the low end of our multiple range (3x).

Morgan Stanley's Ultra Conservative Multiple Analysis

Morgan Stanley, along with Goldman Sachs, are the two heavy hitters that are Neutral on AVG. MS values AVG using a multiples approach, with price targets ranging from $9 in their Bear Case to $30 in a Bull case and $20 in a Base case. The Bear case of $9 uses a 5x 2014 FCF Multiple. That's a trailing 20% FCF yield for a company that, even under its Bear case, grows "at mid-single digits in 2015." The Bull Case is even more remarkable. In it, they give the company accelerating revenue growth of 17% in 2015, expansion of operating margins to 36%, stabilization and growth in the Platform business, and $176 million in FCF in 2015 (works out to 45% FCF growth from 2014-2015)…then they apply a 9x EV/FCF multiple to the name (a mere one turn improvement to current multiple). Even someone like me who personally associates more with Eeyore than naïve Pooh Bear would find these assumptions a wee-bit too pessimistic, wouldn't you agree? We would challenge anyone reading this to find a company with that profile that trades anywhere near 9x FCF.

Comparative Multiple Analysis

Finding a pure play comp for AVG is quite challenging, given the major public competitors (Norton and McAfee) are owned by larger conglomerates (Symantec and Intel, respectively), and the purer play comps (Kaspersky, Avast, and Avira) are private. Norton and McAfee also operate under different models (non-subscription), making a comparison even harder.

We have put together two groups of comps: security related companies and subscription based companies. We have intentionally omitted what we call "revenue at all cost" (RAAC) companies (*cough*, Workday, *cough*, Salesforce) to avoid presenting a distorted picture. We believe the Median represents a fair comparison of where AVG should ultimately trade, although we recognize the Platform business will likely depress valuation until it stabilizes. We believe as 2014 rolls to a close, the market will begin to see that AVG does indeed still have growth in it, and will begin to recognize that with a closer to peer valuation.

	NTM Multiples						Profitability/Efficiency			
Security Peers	**Sales Growth (FY2/I**	**EV/FCF**	**EV/EBITDA (Adj)**	**EV/Sales**	**P/E**		**CF ROIC**	**ROIC***	**Gross Margin**	**EBIT Margin**
Check Point	5.8%	14.1x	13.7x	7.9x	17.8x		23.4%	18.8%	88.6%	57.3%
Symantec	1.3%	10.4x	6.2x	2.0x	11.5x		19.1%	11.5%	83.8%	28.2%
Fortinet	12.7%	21.0x	22.0x	4.7x	44.8x		26.9%	8.1%	71.4%	17.9%
Trend Micro	2.9%	14.8x	9.4x	3.1x	22.2x		23.9%	15.3%	81.6%	27.1%
Qualys	19.6%	30.3x	28.4x	5.0x	82.0x		25.7%	1.7%	77.9%	8.0%
Subscription Based Peers										
Concur	24.2%	224.1x	35.2x	6.3x	111.8x		7.7%	-3.3%	69.6%	11.1%
Aspen Technologies	13.4%	21.2x	23.6x	9.2x	39.6x		169.1%	71.0%	88.0%	38.1%
Blackbaud	8.0%	14.5x	13.9x	3.0x	27.1x		45.2%	9.4%	57.5%	18.5%
Stamps.Com	6.3%	12.0x	11.1x	3.5x	14.5x		25.1%	31.0%	78.6%	28.9%
Constant Contact	14.5%	25.5x	12.7x	2.4x	26.8x		19.9%	3.3%	72.9%	11.4%
AVG	**11.2%**	**7.5x**	**6.9x**	**2.5x**	**9.4x**		**285.8%**	**125.4%**	**88.0%**	**33.0%**
Peer Median	10.3%	17.9x	13.8x	4.1x	26.9x		24.5%	10.4%	78.3%	22.8%

In our Base case, the company could trade at an 11.4x multiple, or 35% discount to the peer group. This multiple uses current consensus FCF estimates, and would put it just ahead of Symantec, a company who has nearly flat revenue growth and whose CEO just stepped down after attempting a failed turnaround. It would still be well below all other peers we have identified.

In a Bear case, we have given the company a 65% discount to the group, below where it is now. For this to occur the company would have to miss their subscription estimates and have their platform revenues continue to not form the elusive "base."

If the right chain of events occurred AVG could trade on par or at a premium to this group…consider the excitement that would be generated for the stock if they became a "mobile" story, or if the euphoric markets began employing an EV/Mobile user valuation like analysts did when Facebook bought WhatsApp. For now our Bull Case is a 20% discount to the group, in-line with another consumer

oriented subscription business (Stamps.com) that has seen revenue growth slow and has some secular bear issues plaguing it (decline in mail, etc.).

	Discount to Peers	Implied EV/FCF Multiple	EV Target	Implied Target	Upside/Downside
Bear Case	-65%	6.3x	$ 924.47	$ 18.10	-9.1%
Base Case	-35%	11.6x	$ 1,716.87	$ 33.00	65.8%
Bull Case	-20%	14.3x	$ 2,113.07	$ 40.45	103.2%

DCF Analysis

We have put together a 5-year Base Case DCF below, with a one year $34.12 price target (68% upside). Most of our assumptions, in our view, range from "conservative" to "very conservative" (although we'll leave "most conservative" for our Goldman Sachs analysis below). Most critically, for 2014 our total revenue sits $5 million below the midpoint of guidance, with Subscription slightly above and Platform well below. We have gross margins consistent with Q1 results. Per management commentary, we have increased R&D as a % of sales from historical levels while slightly lowering G&A and keeping S&M constant. Longer term, we straight line subscription growth down to our perpetual growth rate, 3%, while having platform revenues decline 48% in 2014 and then slowly flattening out by 2016. Per management commentary we keep the tax rate at 12.5% until 2018, at which point we raise it to 15% for added conservatism. The Cost of Equity, at 11.5%, is based on a 3.5% RFR, 8% risk premium, and a 1.00 Beta. While we believe the Beta should be lower than this, and its actual Beta is significantly lower than this, we again err on the side of conservatism. This Base case analysis leads to 12 month upside of 68%.

AVG DCF Base Case

	2013A	2014E	2015E	2016E	2017E	2018E
Subscription Revenue	$250,839	$300,402	$330,442	$356,878	$381,859	$400,952
Y/Y Growth	*27.4%*	*19.8%*	*10%*	*8%*	*7%*	*5%*
Platform Revenue	$156,274	$82,969	$78,821	$78,821	$78,821	$78,821
Y/Y Growth	*-1.8%*	*-46.9%*	*-5.0%*	*0.0%*	*0.0%*	*0.0%*
Total Revenue	$407,113	$383,371	$409,263	$435,698	$460,680	$479,772
Y/Y Growth	*14.4%*	*-5.8%*	*6.8%*	*6.5%*	*5.7%*	*4.1%*
Subscription Gross Margin %	86.3%	87%	87%	87%	87%	87%
Platform Gross Margin %	75.2%	80%	80%	80%	80%	80%
Gross Margin Dollars (GAAP)	$338,268	$327,725	$350,541	$373,540	$395,274	$411,885
Gross Margin % (GAAP)	83%	85.5%	85.7%	85.7%	85.8%	85.8%
Operating Expenses as % of Sales						
Research and development	15.1%	18.0%	17.0%	16.0%	16.0%	15.0%
Sales and marketing	25.0%	25.0%	25.0%	25.0%	24.0%	23.0%
General and administrative	19.6%	18.0%	18.0%	18.0%	18.0%	18.0%
EBIT (GAAP)	$95,531	$93,869	$104,983	$116,478	$128,080	$143,212
EBIT Margin (GAAP) %		24.5%	25.7%	26.7%	27.8%	29.8%
Share-based compensation	2.2%	2.5%	2.5%	2.5%	2.5%	2.5%
Acquisition Amortization % of Sales	3.0%	5%	5%	5%	5%	5%
Other Adjustements % of Sales	2.1%	1%	1%	1%	1%	1%
EBIT Margin (Adjusted) %	31%	33.0%	34.2%	35.2%	36.3%	38.3%
EBIT (Adjusted)	$125,305	$126,455	$139,771	$153,512	$167,237	$183,993
Cash Tax Rate	15.6%	12.5%	12.5%	12.5%	12.5%	15.0%
NOPAT	$105,732	$110,648	$122,299	$134,323	$146,333	$156,394
Depreciation as % of Sales	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Capex as % of Sales	**4.3%**	4.0%	4.0%	4.0%	4.0%	4.0%
Change in Working Capital as % of Sales	**6.0%**	3.0%	1.0%	1.0%	1.0%	1.0%
Net Free Cash Flow	$128,557	$122,149.39	$126,392	$138,680	$150,940	$161,192
FCF Margin	33.1%	31.9%	30.9%	31.8%	32.8%	33.6%
Share Dilution		2.5%	2.5%	2.5%	2.5%	2.5%
Fully Diluted Shares		53,177	54,507	55,870	57,266	58,698
FCF/Share		$ 2.30	$ 2.32	$ 2.48	$ 2.64	$ 2.75
Discounted FCF/Share		$ 2.18	$ 1.97	$ 1.89	$ 1.80	$ 1.68

Cost of Equity	
Risk Free Rate	3.5%
Beta	1.0
Risk Premium	8.0%
Cost of Equity	11.5%
WACC	
Current Equity Value (000s)	$ 1,076,300
Total Debt	$ 5,000
Cost of Debt	6.0%
Tax Rate	12.5%
WACC	11.5%
Terminal Multiple	
Perpetual Growth Rate	3.0%
WACC	11.5%
Terminal Multiple	11.8x
Sum of Discounted FCF/Shares	$ 30.01
Current Shares	53,177
Total PV of Operations	$1,595,723
Cash	$36,367
Debt	$5,000
Equity Value	$1,627,090
Current Intrinsic Value	$ 30.60
DCF Value 1 Year Target	**$ 34.12**
Current Price	19.9
1 Year Upside	**71.4%**

Terminal	
$	33.39
$	20.48

For added rigor, we have put three additional DCF cases in our Appendix: A Bear Case that assumes subscription revenue growth comes to a halt in 2015 and that platform continues its decline, a Bull Case that assumes subscription growth can maintain 10% for at least two more years, and a "Subscription moves to Zero" analysis where subscription revenue goes to zero by 2016.

The Curious Case of Goldman Sachs (DCF)

Given that we struggled to find downside in our analysis, we sought out another DCF to compare to. The only true DCF we could find for AVG was the Goldman Sachs model, and what we found confirms that a) Goldman is extremely conservative about the company, some may say excessively conservative, and b) there are several easy tweaks Goldman could make that would gave AVG a lot more upside and look a lot more attractive. We go over a few of the most egregious items in the DCF below (they are boxed in red for reference)

1) **Operating Margin and FCF margin flat/declining.** We understand the flat to decelerating revenue growth for AVG that Goldman has provided. Fine. But, if the company is truly only growing at 4-5% on the revenue line, that operating margins would stay essentially flat and FCF margins would decline 1,000 basis points over the years seems overly conservative (and given their 37% operating margin last quarter). Digging deeper on the FCF margin, we find…
2) **Cash Tax Rate.** Per the previously discussed tax section, management has made it clear that their cash tax rate for the next 10 years will be 12.5% or lower, based on an agreement with the Dutch government. Goldman has it there through 2017, then rips it higher to 25% in 2018, on its way to 30% in the early 2020s. We consider this excessive conservatism, or perhaps sloppy modeling.
3) **Capital Expenditures.** The company has generally averaged between 2-4% of revenue on capex. It seems a bit aggressive to us that capex would suddenly rise to consistently 5% or more of revenues, right as growth initiatives appear to be diminishing.
4) **Change in Working Capital.** Most of the historical working capital changes have been through growth in the liability Deferred Revenue. This is an advantage of the subscription model; cash up-front and then the revenue is earned over the subscription period. As long as growth continues, Working Capital should, in general, be a tailwind for the company, yet Goldman has it has as a 2-3% a year drag for the next five years, then a 1-2% drag for the following 5 years. Mechanically this is impossible if revenues are growing 4-5%.
5) **Beta.** Goldman has AVG's Beta at 1.2. We suppose in the end Beta is a personal choice, but we ran AVG through all kinds of Beta tests (2 year weekly vs. S&P 500, 2 year weekly vs. Russell 2000, since IPO, 1 year, using monthly data, etc.) and were unable to ever get anything close to 1.2. Our preferred general method, 2 year weekly vs. the S&P 500, produced a beta of .7, and vs. the Russell it was closer to .8. Bloomberg gives AVG a .8 Beta. Intuitively, with the more economically sensitive Platform revenue declining as a % of revenues, and antivirus software subscriptions not being particularly sensitive, we believe Beta (and hence cost of equity) should be lower or should go down over time.
6) **Price Target.** We note that even after all of these conservative/mistaken assumptions, Goldman still comes to a price target of $21, above today's price. Using Goldman's assumptions and simply changing the Beta to .8 gives us a price target of $29.88. We will try not to belabor the point, but if Goldman *were* inclined to upgrade AVG, they wouldn't have to work very hard to generate significant upside.

		Fiscal Year Ends December											2013-2023
		FY13A	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	CAGR (%)
Total Revenue		**$407**	**$383**	**$410**	**$423**	$438	$461	$484	$507	$532	$557	$582	**3.6%**
Year-over-year growth (%)		14.4%	-5.9%	7.0%	3.2%	3.6%	5.1%	5.0%	4.9%	4.8%	4.7%	4.6%	
EBIT		$136	$121	$136	$140	$144	$150	$157	$165	$173	$181	$190	**3.4%**
Operating Margin %		31.5%	33.4%	31.7%	33.3%	32.8%	32.6%	32.6%	32.6%	32.6%	32.6%	32.6%	
Cash tax rate (implied)		*29%*	*20%*	*11%*	*13%*	*12%*	*25%*	*25%*	*26%*	*27%*	*30%*	*30%*	
EBIT (1-t)		$96	$97	$121	$122	$126	$112	$118	$122	$126	$127	$133	
+ Depreciation and amortization		25	29	30	29	$26	$24	$25	$26	$26	$27	$28	
% of revenue		6.1%	7.7%	7.2%	6.8%	6.0%	5.2%	5.1%	5.1%	5.0%	4.9%	4.8%	
- Capital Expenditures		(17)	(10)	(11)	(12)	($13)	($14)	($20)	($25)	($26)	($32)	($34)	
% of revenue		-4.1%	-2.7%	-2.7%	-2.7%	-2.9%	-3.1%	-4.1%	-5.0%	-4.9%	-5.8%	-5.8%	
+ Change in working capital		24	6	(13)	(13)	($10)	($10)	($9)	($8)	($7)	($6)	($5)	
% of revenue		6.0%	1.6%	-3.2%	-3.0%	-2.3%	-2.1%	-1.9%	-1.6%	-1.3%	-1.1%	-0.8%	
Net Free Cash Flow		**$129**	**$121**	**$126**	**$127**	**$130**	**$112**	**$114**	**$115**	**$120**	**$116**	**$122**	**-0.5%**
Year-over-year growth (%)						2.4%	-13.4%	1.8%	0.3%	4.7%	-3.5%	5.8%	
Fully-diluted shares outstanding		55	54	55	56	57	58	59	60	61	62	62	
Dilution rate		7.3%	-1.4%	2.1%	2.3%	2.1%	1.9%	1.7%	1.5%	1.3%	1.3%	1.3%	
FCF/share		**$2.35**	**$2.27**	**$2.31**	**$2.26**	**$2.27**	**$1.93**	**$1.93**	**$1.91**	**$1.97**	**$1.88**	**$1.96**	**-1.8%**
FCF margin		31.6%	31.7%	30.8%	29.9%	29.6%	24.4%	23.6%	22.6%	22.6%	20.8%	21.0%	
Last Reported Quarter	1Q14A												
% Cash Remaining 1Q	75.0%												
% Cash Remaining 2Q	50.0%												
% Cash Remaining 3Q	25.0%												
% Cash Remaining 4Q	100.0%												
Year			1	2	3	4	5	6	7	8	9	10	
Discount multiplier			0.88	0.78	0.69	0.61	0.54	0.48	0.42	0.37	0.33	0.29	
PV of FCF			**$2.01**	**$1.81**	**$1.57**	**$1.39**	**$1.04**	**$0.92**	**$0.81**	**$0.74**	**$0.62**	**$0.58**	

Cost of Equity	
Risk free rate	3.5%
Beta	1.20
Risk premium	8.00%
Cost of Equity	**13.10%**

WACC	
Current equity value	$1,061.95
Total debt	5.0
Cost of debt	6.00%
Tax rate	30.0%
WACC	**13.06%**

Terminal Multiple	
Perpetual growth rate	4.00%
WACC	13.06%
Terminal Multiple	**11.0x**

Price Per Share		
Total PV of Projected FCF	$611	
PV of terminal value	351	
Total PV of operations	962	
+ Cash	36.5	
- Debt	(5.0)	
Equity value	994	
Shares outstanding	53.2	
Current Value Per Share	**$18.69**	
Current Share Price	**$19.97**	5/19/2014
DCF Value	**$21.14**	
Discount/Premium to Current Value	*-6.4%*	

Conclusion

In the 1990 World Cup quarterfinal match, the heavily favored and much lauded England side was trailing Cameroon 2-1 when England converted a penalty kick in the waning minutes of regular time and pulled off a nail-biter, eventually winning 3-2 in extra time. After the game when England coach Bobby Robson was asked if he had underestimated the Cameroon team, he replied:
"No, no, no, we didn't underestimate them. They were just a lot better than we thought."
Perhaps the bears are not underestimating AVG, *it's just a lot better than they think*.

Thank you for your kind attention and allocating some of your valuable time to reading this lengthy write-up. We are happy to continue the discussion in the comments section.

Sources:

1: http://www.pcmag.com/article2/0,2817,2372364,00.asp
2: http://www.howtogeek.com/173291/goodbye-microsoft-security-essentials-microsoft-now-recommends-you-use-a-third-party-antivirus/

Appendix:
Platform to Zero Case

We take our Base Case and push Platform revenue to zero in 2016 and beyond. This assumes Platform declines by 52% in 2014, much worse than guidance, and then 75% in 2015 and is 0 by 2016. This still gives us a 47% upside. We believe this decline in Platform stretches credulity, but present it as a way to show how irrelevant it is to the larger AVG picture.

AVG DCF Platform to $0 Case

	2013A	2014E	2015E	2016E	2017E	2018E
Subscription Revenue	$250,839	$300,402	$330,442	$356,878	$381,859	$400,952
Y/Y Growth	*27.4%*	*19.8%*	*10%*	*8%*	*7%*	*5%*
Platform Revenue	$156,274	$74,830	$18,707	$0	$0	$0
Y/Y Growth	*-1.8%*	*-52.1%*	*-75.0%*	*-100.0%*	*-10.0%*	*-10.0%*
Total Revenue	$407,113	$375,232	$349,150	$356,878	$381,859	$400,952
Y/Y Growth	*14.4%*	*-7.8%*	*-7.0%*	*2.2%*	*7.0%*	*5.0%*
Subscription Gross Margin %	86.3%	87%	87%	87%	87%	87%
Platform Gross Margin %	75.2%	80%	80%	80%	80%	80%
Gross Margin Dollars (GAAP)	$338,268	$321,213	$302,451	$310,483	$332,217	$348,828
Gross Margin % (GAAP)	83%	85.6%	86.6%	87.0%	87.0%	87.0%
Operating Expenses as % of Sales						
Research and development	15.1%	18.0%	17.0%	16.0%	16.0%	15.0%
Sales and marketing	25.0%	25.0%	25.0%	25.0%	24.0%	23.0%
General and administrative	19.6%	18.0%	18.0%	18.0%	18.0%	18.0%
EBIT (GAAP)	$95,531	$92,322	$92,961	$99,926	$110,739	$124,295
EBIT Margin (GAAP) %		24.6%	26.6%	28.0%	29.0%	31.0%
Share-based compensation	2.2%	2.5%	2.5%	2.5%	2.5%	2.5%
Acquisition Amortization % of Sales	3.0%	5%	5%	5%	5%	5%
Other Adjustements % of Sales	2.1%	1%	1%	1%	1%	1%
EBIT Margin (Adjusted) %	31%	33.1%	35.1%	36.5%	37.5%	39.5%
EBIT (Adjusted)	$125,305	$124,217	$122,639	$130,260	$143,197	$158,376
Cash Tax Rate	15.6%	12.5%	12.5%	12.5%	12.5%	15.0%
NOPAT	$105,732	$108,690	$107,309	$113,978	$125,297	$134,620
Depreciation as % of Sales	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Capex as % of Sales	**4.3%**	4.0%	4.0%	4.0%	4.0%	4.0%
Change in Working Capital as % of Sales	**6.0%**	3.0%	1.0%	1.0%	1.0%	1.0%
Net Free Cash Flow	**$128,557**	**$119,946.67**	**$110,800**	**$117,547**	**$129,116**	**$138,629**
FCF Margin	33.1%	32.0%	31.7%	32.9%	33.8%	34.6%
Share Dilution		2.5%	2.5%	2.5%	2.5%	2.5%
Fully Diluted Shares		53,177	54,507	55,870	57,266	58,698
FCF/Share		$ 2.26	$ 2.03	$ 2.10	$ 2.25	$ 2.36
Discounted FCF/Share		$ 2.14	$ 1.73	$ 1.60	$ 1.54	$ 1.45

Cost of Equity	
Risk Free Rate	3.5%
Beta	1.0
Risk Premium	8.0%
Cost of Equity	11.5%
WACC	
Current Equity Value (000s)	$ 1,076,300
Total Debt	$ 5,000
Cost of Debt	6.0%
Tax Rate	12.5%
WACC	11.5%
Terminal Multiple	
Perpetual Growth Rate	3.0%
WACC	11.5%
Terminal Multiple	11.8x
Sum of Discounted FCF/Shares	$ 26.07
Current Shares	53,177
Total PV of Operations	$1,386,522
Cash	$36,367
Debt	$5,000
Equity Value	$1,417,889
Current Intrinsic Value	$ 26.66
DCF Value 1 Year Target	**$ 29.73**
Current Price	19.9
1 Year Upside	**49.4%**

Terminal	
$	28.72
$	17.62

Bear Case

We assumes the company comes in just below the low end of their subscription guidance, misses their Platform guidance by 5%, subscription goes to 0% growth perpetually starting in 2015, Platform declines 10% a year from 2015 to 2018, and Change in Working Capital becomes a 1% a year headwind since there is no growth. We assume some small operating margin improvements from our Base Case as the company goes to "harvest mode" over time.

AVG DCF Bear Case

	2013A	2014E	2015E	2016E	2017E	2018E
Subscription Revenue	$250,839	$286,804	$286,804	$286,804	$286,804	$286,804
Y/Y Growth	*27.4%*	*14.3%*	*0%*	*0%*	*0%*	*0%*
Platform Revenue	$156,274	$76,373	$68,736	$61,862	$55,676	$50,109
Y/Y Growth	*-1.8%*	*-51.1%*	*-10.0%*	*-10.0%*	*-10.0%*	*-10.0%*
Total Revenue	$407,113	$363,177	$355,540	$348,666	$342,480	$336,912
Y/Y Growth	*14.4%*	*-10.8%*	*-2.1%*	*-1.9%*	*-1.8%*	*-1.6%*
Subscription Gross Margin %	86.3%	85%	85%	84%	83%	80%
Platform Gross Margin %	75.2%	78%	75%	72%	70%	70%
Gross Margin Dollars (GAAP)	$338,268	$303,355	$295,335	$285,456	$277,021	$264,519
Gross Margin % (GAAP)	83%	83.5%	83.1%	81.9%	80.9%	78.5%
Operating Expenses as % of Sales						
Research and development	15.1%	18.0%	17.0%	16.0%	16.0%	15.0%
Sales and marketing	25.0%	25.0%	24.0%	23.0%	23.0%	22.0%
General and administrative	19.6%	18.0%	17.0%	16.0%	16.0%	16.0%
EBIT (GAAP)	$95,531	$81,816	$89,122	$93,690	$88,657	$85,955
EBIT Margin (GAAP) %		22.5%	25.1%	26.9%	25.9%	25.5%
Share-based compensation	2.2%	2.5%	2.5%	2.5%	2.5%	2.5%
Acquisition Amortization % of Sales	3.0%	5%	5%	5%	5%	5%
Other Adjustements % of Sales	2.1%	0%	0%	0%	0%	0%
EBIT Margin (Adjusted) %	31%	30.0%	32.6%	34.4%	33.4%	33.0%
EBIT (Adjusted)	$125,305	$109,055	$115,788	$119,840	$114,343	$111,224
Cash Tax Rate	15.6%	12.5%	12.5%	12.5%	12.5%	15.0%
NOPAT	$105,732	$95,423	$101,314	$104,860	$100,050	$94,540
Depreciation as % of Sales	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Capex as % of Sales	**4.3%**	4.0%	4.0%	4.0%	4.0%	4.0%
Change in Working Capital as % of Sales	**6.0%**	3.0%	0.0%	0.0%	0.0%	0.0%
Net Free Cash Flow	**$128,557**	**$106,318.17**	**$101,314**	**$104,860**	**$100,050**	**$94,540**

	2013A	2014E	2015E	2016E	2017E	2018E
FCF Margin	33.1%	29.3%	28.5%	30.1%	29.2%	28.1%
Share Dilution		2.5%	2.5%	2.5%	2.5%	2.5%
Fully Diluted Shares		53,177	54,507	55,870	57,266	58,698
FCF/Share		$ 2.00	$ 1.86	$ 1.88	$ 1.75	$ 1.61
Discounted FCF/Share		$ 1.89	$ 1.58	$ 1.43	$ 1.19	$ 0.99

Cost of Equity		
Risk Free Rate		3.5%
Beta		1.0
Risk Premium		8.0%
Cost of Equity		11.5%
WACC		
Current Equity Value (000s)	$	1,076,300
Total Debt	$	5,000
Cost of Debt		6.0%
Tax Rate		12.5%
WACC		11.5%
Terminal Multiple		
Perpetual Growth Rate		0.0%
WACC		11.5%
Terminal Multiple		8.7x
Sum of Discounted FCF/Shares	$	15.70
Current Shares		53,177
Total PV of Operations		$834,854
Cash		$36,367
Debt		$5,000
Equity Value		$866,221
Current Intrinsic Value	$	16.29
DCF Value 1 Year Target	**$**	**18.16**
Current Price		19.9
1 Year Upside		**-8.7%**

Terminal	
$	14.04
$	8.61

Bull Case

In the Bull Case we give the company close to 10% total growth over the next two years, after posting 21% growth in subscription and -47% growth in Platform in 2014. Slow growth resumes for Platform in 2015 at +5%. We leave margins the same as in our Base Case except we have moderately lower G&A as a percentage of sales over time to 14% of sales, as we assume some additional operating leverage. We make some other minor alterations to changes in working capital assumptions and slightly lower Beta from 1.0 to 0.9.

AVG DCF Bull Case

	2013A	2014E	2015E	2016E	2017E	2018E
Subscription Revenue	$250,839	$302,345	$338,626	$372,489	$402,288	$426,425
Y/Y Growth	*27.4%*	*20.5%*	*12%*	*10%*	*8%*	*6%*
Platform Revenue	$156,274	$82,969	$87,117	$91,473	$95,132	$97,986
Y/Y Growth	*-1.8%*	*-46.9%*	*5.0%*	*5.0%*	*4.0%*	*3.0%*
Total Revenue	$407,113	$385,314	$425,743	$463,962	$497,420	$524,411
Y/Y Growth	*14.4%*	*-5.4%*	*10.5%*	*9.0%*	*7.2%*	*5.4%*
Subscription Gross Margin %	86.3%	88%	88%	88%	88%	88%
Platform Gross Margin %	75.2%	85%	85%	85%	85%	85%
Gross Margin Dollars (GAAP)	$338,268	$336,587	$372,041	$405,542	$434,875	$458,542
Gross Margin % (GAAP)	83%	87.4%	87.4%	87.4%	87.4%	87.4%
Operating Expenses as % of Sales						
Research and development	15.1%	18.0%	17.0%	16.0%	16.0%	15.0%
Sales and marketing	25.0%	25.0%	25.0%	25.0%	24.0%	23.0%
General and administrative	19.6%	18.0%	17.0%	16.0%	15.0%	14.0%
EBIT (GAAP)	$95,531	$101,546	$120,852	$141,084	$161,295	$185,848
EBIT Margin (GAAP) %		26.4%	28.4%	30.4%	32.4%	35.4%
Share-based compensation	2.2%	2.5%	2.5%	2.5%	2.5%	2.5%
Acquisition Amortization % of Sales	3.0%	5%	5%	5%	5%	5%
Other Adjustements % of Sales	2.1%	1%	1%	1%	1%	1%
EBIT Margin (Adjusted) %	31%	34.9%	36.9%	38.9%	40.9%	43.9%
EBIT (Adjusted)	$125,305	$134,297	$157,040	$180,521	$203,575	$230,423
Cash Tax Rate	15.6%	12.5%	12.5%	12.5%	12.5%	12.5%
NOPAT	$105,732	$117,510	$137,410	$157,956	$178,128	$201,620
Depreciation as % of Sales	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Capex as % of Sales	**4.3%**	4.0%	4.0%	4.0%	4.0%	4.0%
Change in Working Capital as % of Sales	**6.0%**	3.0%	2.0%	2.0%	1.0%	1.0%
Net Free Cash Flow	**$128,557**	**$129,069.50**	**$145,925**	**$167,235**	**$183,103**	**$206,865**
FCF Margin	33.1%	33.5%	34.3%	36.0%	36.8%	39.4%
Share Dilution		2.5%	2.5%	2.5%	2.5%	2.5%
Fully Diluted Shares		53,177	54,507	55,870	57,266	58,698
FCF/Share		$ 2.43	$ 2.68	$ 2.99	$ 3.20	$ 3.52
Discounted FCF/Share		$ 2.31	$ 2.30	$ 2.32	$ 2.24	$ 2.23

Cost of Equity	
Risk Free Rate	3.5%
Beta	0.9
Risk Premium	8.0%
Cost of Equity	10.7%
WACC	
Current Equity Value (000s)	$ 1,076,300
Total Debt	$ 5,000
Cost of Debt	6.0%
Tax Rate	12.5%
WACC	10.7%
Terminal Multiple	
Perpetual Growth Rate	3.0%
WACC	10.7%
Terminal Multiple	13.0x
Sum of Discounted FCF/Shares	$ 41.37
Current Shares	53,177
Total PV of Operations	$2,199,901
Cash	$36,367
Debt	$5,000
Equity Value	$2,231,268
Current Intrinsic Value	$ 41.96
DCF Value 1 Year Target	**$ 46.45**
Current Price	19.9
1 Year Upside	**133.4%**

Terminal

$ 47.30

$ 29.96

Company Description

AVG Technologies NV is engaged in providing software and online services and solutions. The company designs antivirus and Internet security products. Its product portfolio targets the consumer and small business markets, and includes Internet security, personal computer performance optimization, online backup, mobile security, identity protection, and family safety software. The company was founded in 1991 and is headquartered in Amsterdam, Netherlands.

Price	LTM EPS	LTM PE	Price/Book	Market/Enterprise Value
19.75	1.16	17.0x	48.4x	1,050/1,012
52 Wk H/L	**FY1 EPS**	**FY1 PE**	**Price/Sales**	**Shares Outstanding (MM)**
26.6/ 15.2	2.03	9.7x	2.7x	53.2
YTD Chg.	**FY2 EPS**	**FY2 PE**	**Price/EBITDA**	**Annual Dividend**
14.8%	2.25	8.8x	-	0.00
1 Yr. Chg.	**NTM EPS**	**NTM PE**	**EV/Sales**	**Dividend Yield**
7.0%	2.13	9.3x	2.6x	0.00%
Beta	**L.T. Growth**	**PEG** LTM PE	**EV/EBITDA**	**Dividend Payout**
1.08	-	-	-	-

Address	Website	FactSet Sector	FactSet Industry
Gatwickstraat 9-39 Amsterdam, Noord-Holland 1043 GL Netherlands Netherlands	-	Technology Services	Internet Software/Services

Income Statement

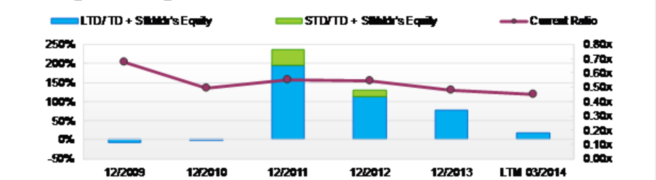
All figures in local millions.

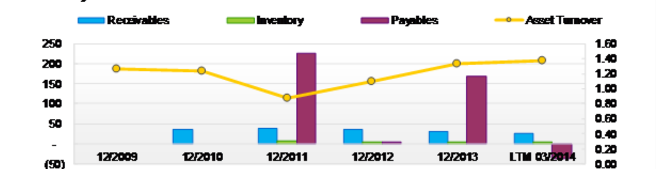
	12/2009	12/2010	12/2011	12/2012	12/2013	LTM 03/2014
Revenue	182	217	272	356	407	396
Y/Y Growth	59.8%	19.4%	25.4%	30.7%	14.4%	4.8%
Cost of Goods Sold	31	29	31	50	69	68
Gross Profit	151	188	241	306	338	328
Y/Y Growth	68.4%	25.0%	28.1%	26.7%	10.7%	2.5%
Gross Margin	82.7%	86.7%	88.5%	85.9%	83.1%	82.8%
SG&A	90	123	173	215	222	219
Y/Y Growth	50.7%	36.3%	40.8%	24.5%	3.5%	-3.3%
SG&A % of Sales	49.4%	56.4%	63.4%	60.4%	54.6%	55.2%
EBITDA	65	75	80	98	136	-
Y/Y Growth	83.5%	15.5%	6.3%	22.4%	39.0%	-
EBITDA Margin	35.7%	34.5%	29.3%	27.4%	33.3%	-
EBITDA/ Int. Exp.	2596.9x	3259.6x	4.9x	4.6x	17.0x	-
EBIT	59	67	68	79	111	-
Y/Y Growth	90.3%	14.1%	0.7%	15.9%	40.7%	-
EBIT Margin	32.4%	31.0%	24.9%	22.1%	27.2%	-
Interest Expense	0	0	16	21	8	-
Pretax Income	59	67	51	57	103	97
Pretax Margin	32.4%	31.0%	18.9%	16.1%	25.2%	24.5%
Tax Rate	11.1%	14.0%	-95.3%	20.3%	38.0%	41.1%
Net Income (before XOI)	52	58	100	46	64	57
Y/Y Growth	78.7%	10.3%	73.4%	-54.4%	39.1%	-3.6%
Net Margin	28.8%	26.7%	36.9%	12.9%	15.7%	14.5%
ROA	-	36.2%	41.2%	14.4%	20.2%	18.5%
ROE	-	-	-	-	-	465.9%
Earnings per Share	0.56	1.01	1.95	0.73	1.02	1.16
Y/Y Growth	-	78.7%	92.9%	-62.5%	39.8%	38.1%
Shares Outstanding	92.9	57.4	51.6	62.8	62.5	49.3
Capital Expenditures	7	12	11	18	17	16

Balance Sheet

All figures in local millions.

	12/2009	12/2010	12/2011	12/2012	12/2013	LTM 03/2014
Cash & Equivalents	48	64	61	52	47	43
Accounts Receivable	19	25	32	38	30	24
Receivable Turnover D	-	37.0	37.9	35.7	30.4	25.4
Inventories	-	1	1	1	1	1
Inventory Turnover Day	-	-	8.2	5.7	4.6	3.7
Current Assets	88	112	123	122	111	101
Current Ratio	0.68x	0.49x	0.55x	0.54x	0.48x	0.45x
Quick Ratio	-	0.49x	0.54x	0.54x	0.48x	0.44x
Net PP&E	5	10	12	15	15	15
Total Assets	144	176	312	323	307	289
Y/Y Growth	-	22.4%	77.1%	3.8%	-5.2%	-12.7%
Asset Turnover	1.3	1.2	0.9	1.1	1.3	1.4
Short Term Debt	-	-	41	12	-	-
Accounts Payable	5	5	11	9	11	7
Payable Turnover Days	-	-	226.6	5.7	168.4	(35.8)
Current Liabilities	130	226	223	224	230	226
Long Term Debt	1	1	184	85	30	5
LTD/ TD + Stkhldr's Eq	-7.3%	-1.3%	193.8%	113.9%	76.6%	18.7%
TD/ TD + Stkhldr's Eq	-7.3%	-1.3%	237.0%	130.2%	76.6%	18.7%
TD/ EBITDA	0.02x	0.01x	2.83x	1.00x	0.22x	-
Total Liabilities	160	256	442	346	298	267
Preferred Stock	192	-	192	-	-	-
Stockholder's Equity	(16)	(81)	(130)	(23)	9	22
Total Liabs. & Stk. Equity	144	176	312	323	307	289





Source: Factset