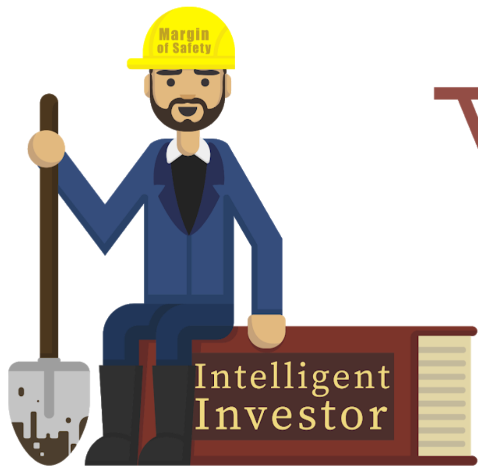
Value Ventures: October 2019
Long-term thinking in a world of short-term orientation.



Finding Great Businesses That Don't Screen Well & LiveChat, Inc. (LVC)

by Brandon Beylo on 07 October 2019

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Last Month's Must-Reads

Each month I collect various articles, blog posts, research materials, etc. and deposit them here. This month's collection covers capital allocation, banking reform and knowing what you own.

CEO Guide to Capital Allocation, ***Behavioral Value Investor***

This is one of the best articles I've read in 2019. *Behavioral Value Investor* claims that too many CEOs don't understand capital allocation. This is unsettling. If management doesn't know how to allocate capital -- what good is that capital?

The article highlights two purposes for capital allocation:

1) Provide for ongoing operations of the business

2) Optimize long-term intrinsic value per share of company stock

Optimization of long-term intrinsic value per share is key. As value investors that's all we should care about. Can management grow the long-term intrinsic value of my stake in the company? If not, why are we invested?

The article then outlines the five principles of capital allocation:

1. **Reduce debt**
2. **Internal Growth Projects**
3. **Share Buybacks**
4. **Dividends and Acquisitions**.

Clifford Sosin Whitepaper on Banking Reform, ***Papers.ssrn.com***

Clifford Sosin runs CAS Investment Partners. The fund is a value-oriented shop investing in a concentrated number of businesses. Besides running a partnership, Sosin spends his time thinking about other things. Such as bank reform.

In this co-authored white paper with Peter Blaustein, Sosin offers a solution to the main problem of banking. Procyclicality. Their solution? PBERNs. Curious about what PBERNs are? Read the paper!

Art and Science of Knowing What You Own, ***Magnetar Capital***

Knowing what you own is important. Proper diversification is important as well. Yet many investors choose arbitrary diversification methods (i.e., 60% equities / 40% bonds) and call it a day. Magnetar Capital suggests that this way of thinking is dangerous.

Magnetar Capital makes three points in this PDF:

1. Investors benefit from risks that are accessible, transparent, affordable and measurably useful
2. The evolution of investment risk occurs through cycles of innovation
3. Innovation and disruption benefit investors

THIS MONTH'S
PHILOSOPHY CORNER

Stocks That Don't Screen Well: Why It Happens & How To Find Them

I like fishing. It takes my mind off markets and gets me out in nature. There are many parallels between fishing and value investing. When fishing, you want to fish where the fish are and the people aren't. As value investors, this is music to our ears.

In most cases, these great fishing spots hide in the shadows. They're off the beaten path. You have to crawl under branches. Weed through thorn bushes. Spots you wouldn't otherwise find should you continue on the foot-trafficked path. But once you cut through the thicket, a honey-hole awaits.

It's at this point you catch as many fish as you can. Do you tell everyone about the new fishing hole? Yes, of course. But only after you've caught all the fish you can take. Once word gets out, the spot dries up. No more fish.

Stock screeners are investing's fishing holes.

Instead of fishing for bass, we're fishing for shares of undervalued companies. But the principles still apply!

When you run a traditional "value" stock screener, you're doing two things:

1. **You're "fishing" where every other investor is fishing.**
2. **Reducing your odds of finding something off-the-beaten path.**

Using stock screeners prevents you from finding great, unknown companies.

Let's dissect two types of businesses that *won't* appear on any traditional value stock screener:

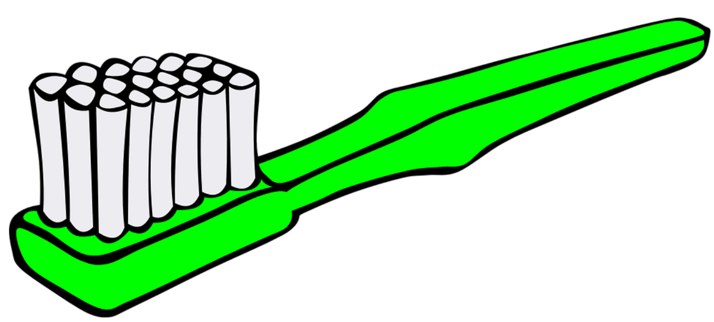
1. Good Co. / Bad Co. Dynamic
2. SaaS model Businesses

The Good Co. / Bad Co. Dynamic

The Good Co. / Bad Co. Dynamic is one of my favorite special situation-type investments. Through the following example you'll learn the power behind this dynamic, and how to profit when you see it.

The Toothpaste and Toothbrush Example

Imagine you find a company, BRUSH Inc. (XYZ) trading for $10/share. BRUSH Inc. makes two products: toothpaste and toothbrushes. The toothbrush business is a great business. It boasts high margins, attractive variable cost structure and tremendous brand power. This segment



generates $1.50 per share in operating earnings for the company.

At its current stock price, you could buy XYZ for 6.6x earnings. Not bad.

But remember XYZ's other business, toothpaste manufacturing. Unfortunately for XYZ, the toothpaste business isn't a good business. They can't mix the right product. Sales are shrinking. Management's R&D investments turn into burnt cash. Margins are slim and they're losing market share. Due to the above factors, XYZ loses $1.00 per share in operating earnings from its toothpaste division.

This is where things get interesting.

What GAAP (Generally Accepted Accounting Principles) Sees

According to GAAP, BRUSH Inc. generated $0.50 in operating earnings. How did they arrive at $0.50? GAAP subtracted the negative earnings from the positive earnings.

So instead of a 6.6x earnings multiple, investors are paying 20x earnings for the same business. A higher multiple and a lower earnings yield. Double whammy.

Why Screens Don't Pick Up These Companies

In general, this type of company will have a high P/E ratio. This makes intuitive sense. The business generates lower total earnings based on its two operating segments.

We also know that many traditional value screens have a filter for P/E ratios. Most of which are below 20 - 25x.

In other words, most people aren't looking at these companies. And it's not because they don't have the capacity. Rather they don't even know they exist. They stayed on the beaten path.

This becomes an opportunity for investors like us. Investors that are willing to look under the hood and get our hands dirty.

Why it Pays To Find These Companies

Finding Good Co. / Bad Co. companies can be an extremely profitable venture. These businesses have potential catalysts at their fingertips. Once triggered, these catalysts can reward investors regardless of broader market trends.

The biggest catalyst for a Good Co. / Bad Co. business is the removal of the unprofitable operating segment. This requires management to check their ego at the door, admit something isn't working and move on. Easier said than done. But what rewards would shareholders reap?

Let's go back to our toothbrush/toothpaste example to see the benefits.

Shutting down the toothpaste division flips BRUSH Inc. from earning $0.50/share to $1.50. The stock goes from 20x earnings to 6.6x. The earnings yield catapults from 5% to 15%.

With one simple change, BRUSH Inc. now looks like a classic value stock trading at a massive discount to future earnings. Screens will pick up on this change after a while. Soon enough millions of investors will come to find the stock you knew existed all along.

This is why the good co. / bad co. dynamic is so powerful. If you find these types of businesses you can, in essence, fish where nobody else is fishing.

Which Ones Should You Buy?

Now this isn't to say that all stocks with Good Co. / Bad Co. dynamics are good investments. Like most off-the-beaten-path areas of the market, discretion is advised.

One way to add a margin of safety is to invest in companies that are growing their profitable operating segment. You don't want a business with a shrinking profitable segment. Soon you'll end up with two negative operating segments and one bad investment.

Insider purchasing is another helpful indicator. If management's about to make a change that will affect the stock price, this is where they'll tip their hat. Remember, people sell for a variety of (legitimate) reasons. But they only buy for one: appreciation.

Knowing How Much To Pay

I like to calculate how much I can buy the good operating segment for, and in turn, get the bad business for free. If you've read previous Value Ventures letters, you know this is one of my favorite strategies.

I want to find companies where I don't have to pay for a lackluster part of their business. Plus, if we think the business would be better off without the negative earning segment, why should we pay for it?

Software-as-a-Service (SaaS) Models

To understand why SaaS companies don't screen well, we need to know a few key items. First, we need to know how they get customers. Second, we need to know how they receive revenue from those customers. Finally, we need to know the difference between the cost associated with acquiring the customer and the revenue generated from that customer.

The last part is often referred to as the Lifetime Value of the Customer (or LTV for short). Let's use an example from a fictitious company, XYZ Software Solutions (SOFT).

Understanding Lifetime Value of the Customer

XYZ Software (SOFT) sells customer relationship management software on a subscription basis. They charge their customers $100/month with average contracts lasting 3 years. Let's also assume they have high profit margins, around 75%.

This means that each customer generates around $3,600 in revenue and $2,700 in profit. **This is our LTV.**

Yet we know customers aren't free. Given its sales & marketing spend, XYZ estimates its customer acquisition cost around $400.

On the surface, things look great. XYZ spends $400 to receive $2,700 in profit value *per customer.* Who wouldn't want to invest in a model like that?

There's just one problem. GAAP Accounting doesn't see it that way.

What GAAP Sees

Under GAAP, XYZ must recognize the costs (expenses) to acquire the customer up-front. XYZ then recognizes revenue once XYZ provides the service. Instead of booking $3,600 as revenue from the customer, you have to recognize it over time, say per-month.

Doing that clouds the financial performance of the company. Now you have $400 of expenses up-front and only $300 of revenue coming in the door. That's -$100 in losses for each new customer. That looks nothing like our above assessment of the company's LTV.

GAAP accounting creates a natural distortion between the costs associated with acquiring the customer, and the profit from that customer. As you can see, this translates to optically negative financial statements. Which in turn, leads many SaaS businesses off value stock screens.

We're Investors, Not Accountants

When it comes to analyzing SaaS businesses, GAAP won't help us all that much. Instead, we should focus on four metrics:

1. **Bookings (or sales)**
2. **Monthly Recurring Revenue**
3. **Churn Rate**
4. **Recognized & Deferred Revenues**

Let's dive into each category.

Bookings (Sales)

Think of this as the dollar value of the contract each customer signs. For example, if XYZ signs a $200K contract for their software, that's $200K in bookings.

Remember, we can't count all $200K as recognized revenue. This is the amount of revenue the business expects to receive over the lifetime of the contract. Tracking this figure provides a more realistic picture of top-line revenue growth.

Monthly Recurring Revenue

Many SaaS companies use Monthly Recurring Revenue (MRR) as their Key Performance Indicator (KPI). MRR serves as a baseline for all revenue the company generates on a monthly basis.

For example, if XYZ has five customers with $200K/year contracts, they're Monthly Recurring Revenue (per customer) is $16,666. This becomes **recognized revenue** at this point. I'll explain why.

Recognized & Deferred Revenue

As the name suggests, recognized revenue is revenue that is booked by the company *after* they provide the service requested in the contract.

Deferred revenue is simply the opposite. These are revenues that are "booked" (see bookings above), but the company hasn't yet provided the actual service.

Under GAAP, Deferred Revenues are liabilities on the balance sheet.

This makes intuitive sense. When XYZ signed the $200K contract, they hadn't provided a years worth of service to that customer. In other words, deferred revenues would be $200K on day of contract. Check out the photo on the right for an example:

Deferred revenue decreases while recognized revenue increases as the company provides their service.

Churn Rate (Customer vs. Revenue)

Customer Churn Rate is the percentage of customers that stop their subscription during a given period of time. For example, say XYZ had 100 paying subscribers in Q1. But by the start of Q2 that number fell to 75.

The Customer Churn Rate would be 25% since a quarter of their customers churned through their subscription during the quarter.

Revenue Churn is the same principle as above, but uses revenue as the input instead of number of customers. Revenue Churn is a much more important metric for SaaS businesses that offer various pricing packages/deals. Why? Let's break down the difference between the two.

Losing five customers sounds worse than losing one customer. And in some cases that's true. If everyone pays the exact same amount, losing five is worse than losing one. Yet many SaaS business models offer varying pricing packages.

Things look different if a business loses one large "Enterprise" customer paying $150/month versus losing five "Starter" customers paying $10/month.

Example: SharpSpring, Inc. (Scott Miller of Greenhaven Road)

SharpSpring is a great example of the power of looking beyond GAAP accounting and quantitative screens.

I found the idea from one of Scott Miller's quarterly letters. His thesis for the company played out well. There is one key aspect about SharpSpring that makes it a great case study. *It hasn't generated an operating profit.*

So what did Miller see in SHSP?

- High recurring revenue business model with tremendous unit economics.
- The LTV per customer was significantly higher than their customer acquisition cost.

So, SHSP did what any reasonable company *should do* in that situation. **They plowed all their profits into acquiring as many customers as they could.** This makes sense.

Yet by investing all their cash back into the business, they had nothing left to show for "earnings".

What did Miller have to say about SHSP's capital allocation strategy?

> "*The right way to run this business [high LTV/CAC ratio], in my opinion, is to spend every available dollar on sales and marketing to build the customer base,* ***not worrying about short-term profitability.***"

How To Find Stocks That Don't Screen Well (How To Beat Machines)

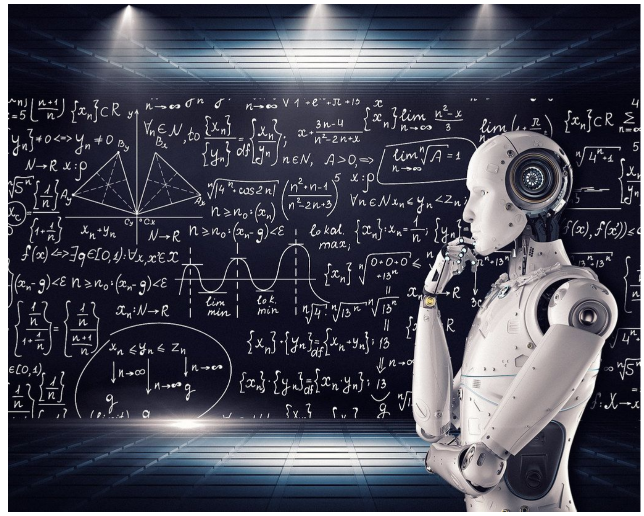
This isn't going to be a popular answer. It's not one you'd see on a Motley Fool ad, either. The best way to find these types of companies -- the ones that don't screen well -- is through **brute force work**.

I know. We live in an age where automatic processing is eating the world. Computing power reaches new levels each day. Yada yada.

Yet the only way to *beat the machines* is to find things that machines *can't* pick up.

Quant-centered funds run exclusively on (you guessed it), quantitative data. Moreover, these funds, strategies and screens focus on *historical data.* They're backwards looking.

Here lies the opportunity.



We have the benefit of being able to look forward into the future. Three to five years beyond the immediate horizon. We can make reasonable guesses as to where a business might end up in the next five years. Quants don't care about that. They only care about what the company did in the past.

This isn't a fault of quants themselves, but the strategies they use. Algorithms use old data to make buy/sell predictions about the current price. What these algorithms don't (and can't) understand are special situations when things change. Sometimes dramatically, sometimes due to GAAP accounting.

Method 1: Download Excel File of Ticker Symbols

You read that correctly. The first method to find stocks that don't screen well is to download an Excel file and go through each stock symbol.

There's three main benefits to doing this grunt work:

1. You learn about *a lot* of different businesses, economic models and management teams.
2. It improves your ability to quickly say "No" and quickly put companies in the "too hard" bucket.
3. You'll find hidden gems -- if you look hard enough.

This is obviously the most time consuming method of finding companies that don't screen well. But if you're serious about investing, this is the *best* method. No time is wasted as you learn about businesses, say no to companies quicker and find your preferable industry.

Method 2: Change *How* You Screen

The tendency when screening is to focus on one objective: refine, refine, refine. If you're going to use screens, cast a wider net.

The best way to widen your screen is to focus on higher-level variables. Variables like:

- Market Cap
- Enterprise Value
- Insider Ownership

- Debt/Equity

These types of variables aren't as dependent on financial or balance sheet metrics. They provide a more qualitative feel to your screen.

My Favorite Screens

If I'm not going through companies one-by-one, I like to use a screen filtered by insider ownership. The screen still spits out 300+ names. I'll then go through each of those one-by-one.

Concluding Remarks

Ronnie Coleman is one of the greatest bodybuilders of all time. When asked what it took to reach his level, he had this to say:

> "*Everybody wants to be a bodybuilder, but nobody wants to lift no heavy ass weights.*"
>
> Change a couple words and the quote applies to value investing.
>
> "*Everybody wants to be a value investor, but nobody wants to research no long ass list of stocks* A-Z"

Value investing isn't about hitting home runs and watching your gains fly. Yes, that can be an end result. Value investing is about the desire to understand businesses at deeper levels. It's a longing to learn as much as you can. A lifetime of discovery.

Read further for this month's **Deep Dive!**

THIS MONTH'S
DEEP DIVE

The fastest way to help your customers

Cliff-Notes: LVC

- **What We Like:**
  - **Founder-led / Owner-operator**
  - **Insiders own over 40% of the business**
  - **Overlooked (trades on Polish stock exchange)**
  - **Underfollowed (zero write-ups on SumZero and only 32 SA followers)**
  - **High-growth, recurring revenue business model**
  - **Premium product within its market**
  - **Long tailwinds for industry growth**
  - **It's cheap / potential buyout candidate**

- **What We Don't Like:**
  - **Potential for product commoditization**
  - **Competes with freemium model rivals**
  - **Hard to buy shares**
  - **Larger competitors could prevent from taking market share**

- **What We Think It's Worth:**
  - **Pessimist: $6/share (~40% downside)**
  - **No-growth: ~9/share (current share price)**
  - **Optimist: ~$17/share (>80% upside)**

Deep Dive: LiveChat, Inc. (LVC/LCHTF)

LiveChat, Inc (LVC/LCHTF) is a small-cap Polish software business. The company offers premium chat-based customer service software from start-ups to Fortune 500 companies.

The bull case is simple. LVC hits nearly every single one of our benchmarks for investment. The company is founder-led with management owning over 40% of shares. They sport high EBITDA and FCF margins with a SaaS business model. The company's balance sheet is strong with loads of cash to cover *all liabilities* 9x over. Finally, once implemented, LVC's software incurs high switching costs for customers.

LiveChat isn't "basement" level cheap. But we think paying 15x this years earnings for a growing, high margin, no debt software business is usually a good idea.

What Do They Do?

LiveChat provides chat-based customer service software for start-ups, Fortune 500 companies and everything in between. They have over 27K customers in 150 countries. Take a look at some of their customers below:

Source: Investors presentation

LiveChat is a tool for quick contact between clients and the company using a chat application embedded on the company's website. The product is mainly used for customer service and online sales.

Those little chat windows that pop-up on your favorite sites? Most likely LiveChat's software.

LVC's vision for its software is that it "connects you with the customer, no matter the situation." We'll touch on why this is important in our thesis.

LVC software ranks as one of the highest in the G2 Grid for Live Chat Function (based on Performance, Market Presence, Satisfaction. The company also ranks as a leader in Software Reviews survey. Here's who they beat-out:

- Microsoft Dynamics 365 for Customer Support
- Zendesk Support
- Salesforce Service Cloud
- Oracle Service Cloud

LiveChat's Products & Services

The company offers three other products: **ChatBot, KnowledgeBase and HelpDesk**

ChatBot

ChatBot allows for the creation of conversational chatbots to handle various business scenarios. ChatBot has batteries included: integrating with LiveChat's software as well as other tools (FB Messenger).

LiveChat wants ChatBot to be the best (and simplest) self-learning conversational chatbot on the market. The product ranks as a High Performer in G2's Bot Platform performance grid.

KnowledgeBase & *HelpDesk*

KnowledgeBase lets companies create their own knowledge bases. Employees and clients can both access these knowledge bases. HelpDesk is LiveChat's ticketing system. This system creates a one-stop-shop for customer support to receive customer cases for quick resolution.

How Does LiveChat Make Money?

LVC generates revenue through their four subscription plan offerings. Their Starter Plan is $16/month if you pay annually or $19/month if you do month-by-month. The next level is Team. Prices range from $33/month on an annual contract, or $39/month on month-by-month.

The top tier of pricing plans are Business and Enterprise. The business package is $50 or $59 per month depending on the billing cycle. The Enterprise package varies by individual company.

How The Packages are Structured

The company charges on a "per-seat" basis, or logged in agent. In other words, you can only have one agent per seat. If you have a team of 15 people that need access to this, its 15 x amount/month billed either monthly annually.

Benefitting Both Sides of the Transaction

LiveChat offers improved experiences for both their business clients and the end consumer. Because of this duality of satisfaction, LiveChat turns into a sticky product. Businesses don't want to switch once they realize the improvements in customer support and sales. Customers want businesses to keep LiveChat because of faster response times, better customer service and human-to-human connection.

Benefits for Businesses

There's three main benefits to businesses if they use LiveChat's software:

1. Improved Response Time & Customer Captivity
2. Increased ROI with Customer Service Staff
3. Increased Sales Conversions

Let's break each one down.

Improved Response Time & Customer Captivity

Traditional customer service communication revolves around the phone and email. While both of these mechanisms work well, they don't work fast enough. Customers wait days for an email response. And nobody likes waiting on hold even though "your call is very important to us."

LiveChat strips away the fat and gets to the heart of the problem -- response time. If you're using LiveChat's software, you can answer your customer's questions in real time. You can even see what they're typing before they send it!

While it's easy to track the quantitative improvement in response time, another benefit happens underneath the surface. **Increased customer retention**.

Solving customer problems quickly is one of the best ways to not only keep a customer, but create a customer for life. Who has the advantage in keeping a customer? The business that takes 24-48 hours to respond to a question? Or the business that responds within 24-48 seconds?

Increased ROI for Customer Service Staff

Phone calls offer a one-on-one conversation between the customer and the business support staff. If a business relies on phones for their customer support, the only way to scale their support staff is by hiring more bodies. This creates higher costs while keeping the incremental support staff efficiency stagnant.

LiveChat turns this idea on its head. It's here where you start to see the power of LiveChat's offering to businesses.

With LiveChat, one agent can service as many support questions as they can tolerate. There's no longer a 1:1 correlation between service staff and customers supported.

Looking from the business side of things, this *feels like* a no-brainer. If you're looking to cut costs, simply reduce the amount of service agents while retaining the best ones. Knowing that your best service agents can handle the additional work.

In other words, spend half as much while getting the same amount of productivity. That's an easy pitch.

(Potential for) Increased Sales Conversion

LiveChat lets you know how many people are browsing your website in real time, what page they're on and how long they've been there.

This is valuable information. LiveChat's pitch is that every person that browses your website is a potential customer. Why not reach out and see what they need?

Many companies reported an increase in sales of up to 30% after installing LiveChat's software. You wouldn't get a chance to make these incremental sales if you don't have LiveChat (or something similar). In fact, depending on the growth, increased sales might end up paying the majority of your LiveChat bill.

Check out some of these reviews from business owners on LiveChat's software:

> **Overall:** I find LiveChat very easy to set up and use daily, and I'm not a tech person at all. Everything is designed in a way that's logical and clear, so most of the time I can navigate around and do everything myself. They also have a lot of optional free plug-ins which you can install, or not, to enhance the functionality of the system. And if you need help, use their Live Chat (of course!) for quick and friendly assistance. Their help department reps are live people who actually help you and don't just send you canned responses.

> **Overall:** We've been using LiveChat for almost 2 years now. It's been so helpful to see who's on our site when they are actually there and to be able to help them when they need it (which keeps them from straying)! We are an incorporation services provider and people often have lots of questions when they are searching for a provider in this field. Though we have the answers to most of those questions on our site, people often want to clarify or they may feel lost when ordering. Having LiveChat makes it easier for our potential clients to reach out to us without having to leave our site or even to pick up the phone. Instant gratification! Thanks to LiveChat, we've been able to quickly convert those people with questions into clients.

Benefits to Customers

Customers enjoy LiveChat for two main reasons:

1. Their questions/problems are answered quicker.
2. Real-time Customer Support Ratings & Saved Chat History

Let's break these down.

Your questions, answered quicker.

Nobody wants to hop on the phone and talk to someone in 2019. Chatting is this generation's natural method of communication. Most of the time a customer's question has a simple, easy answer. The problem surfaces when arriving at the answer is harder than the question.

Customers also feel more appreciated if their questions are answered on time. Maybe this causes them to buy an extra pair of socks? A customer will reward a business for solving their problems.

Real-time Customer Support Ratings & Saved Chat History

For those "can I speak to the manager" folks reading this (you know who you are), this feature is a deal-maker.

If you want to keep the history of your chat with a customer service agent, LiveChat makes that easy. At the end of each chat, a customer can request a transcript to their email.

LiveChat also offers real-time customer service ratings for each chat. This is important because the onus to provide great service is on the business. If an agent is rude on the phone, it's unlikely the customer will spend 25 minutes and call the corporate office.

Yet a customer can leave a 'thumbs down' review in seconds within the LiveChat chat. It's no wonder the average customer satisfaction rate for LiveChat businesses is over 94%.

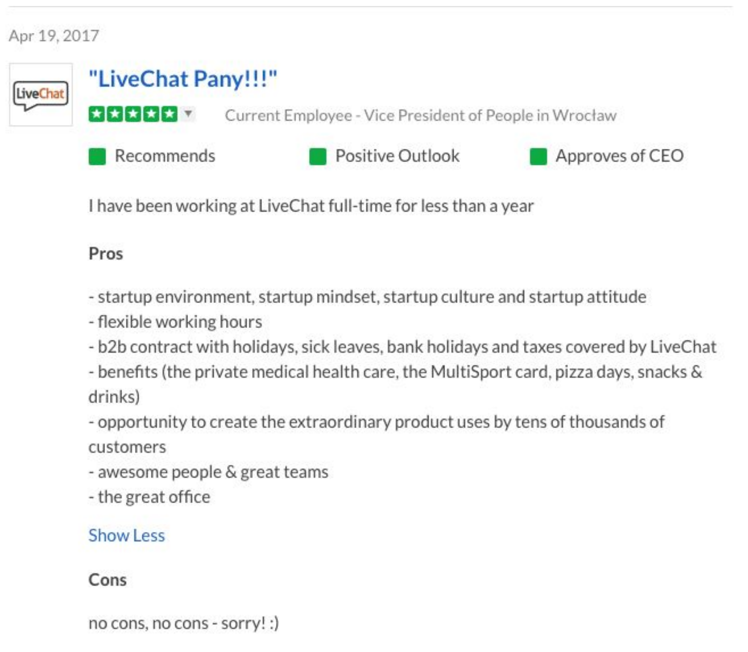
Management & Market Position

CEO Mariusz Cieply is one of the founders of LiveChat. He also owns 15% of the company, making him the largest shareholder amongst his C-suite peers. Management owns over 40% of the company. The Chairman of the Board, Maciej Jarzebowski and Board Member Jakub Sitarz both own over 12% of the company.

One thing I noticed when going through LVC's reports were Cieply's investor letters. Cieply seems to genuinely care about the product, the customers and employees. This isn't an attempt to judge personal character. But his letters stood out. Why they stood out, I can't quite pinpoint. Maybe it was how straightforward the letter was:

Here's what we did → Here's where we want to go → Here's how we'll get there

LiveChat also boasts high reviews on Glassdoor from current and former employees. The company sports an average rating of 5 stars. Granted there's only six reviews. But still, the feedback is positive. Take this excerpt for example:



Market Position Within Live Chat Landscape

The company expects the live chat market to hit roughly $700M in value. Management believes this figure will grow over time thanks to a few major tailwinds. Most notably online retail shopping. Online retail accounted for over 10% of *total global* retail sales. That's good for $2.3 trillion; with a t (source: *eMarketer*).

The trend is likely to continue. eMarketer estimates that global e-commerce sales will grow 20% over the next three years. If that happens, it would mean 380 million people shopping online.

LiveChat's poised to capture the rapid influx of businesses looking to acquire and retain customers for life.

The company isn't the lowest-cost operator, and that's on purpose. In one of their investor presentations, management explains (emphasis mine):

> *"Positioning LiveChat in the premium category and developing its market position based on features such as the variety of features and integrations available, the quality of customer service, as well as reliability and data safety* ***instead of price-based competition****, makes the company* ***resistant to pressure from popular solutions available free of charge.****"*

When reading LiveChat product reviews, I couldn't help but notice a common thread amongst reviewers. It went something like this. "LiveChat is definitely one of the higher priced products on the market. In fact it can be 300% more expensive than other options."

But 9/10 times it would end with: "But I'm glad I chose them. They're worth every dollar."

Going After Enterprise Market

There's an element of consumer psychology at play here. Consumers subconsciously perceive higher-priced products or services as greater value than their lesser cost alternatives. And when you're going after the Enterprise business market, offering a higher price makes *business* sense, not *economic* sense.

But it's more than a high price. The company believes their price is fair given the level of customer support, integration capabilities and customization options that aren't available with other offerings. Management remarks (emphasis mine):

> *"For these reasons, **free solutions are not seen as a direct competition**, since Live Chat is **addressed primarily to the more demanding clients with larger and more advanced needs** both in terms of available features and the speed and effectiveness of customer support."*

Taking Share From Zendesk

Zendesk Chat is one of LiveChat's strongest competitors. The company generates significantly higher revenues and sports a much larger customer base. Yet for the last five quarters, LiveChat's grown their customer base while Zendesk's has shrunk.

Take a look at the chart on the right (source: Investors Presentation):

	31.03.2018*	30.06.2018*	30.09.2018*	31.12.2018*	31.03.2019*
Zendesk Chat (paid)	47.700	47.600	46.800	46.100	45.300
Quarter-over-quarter growth	+700	-100	-800	-500	-800
LiveChat (paid)	24.065	24.891	25.398	26.010	26.714
Quarter-over-quarter growth	+958	+826	+507	+612	+704

These are favorable trends. Five consecutive quarters isn't something to scoff at.

Why has LVC been able to steal market share? Simply put, the product is better. Much better.

LiveChat is Better Value on a 'Per-Feature' Level

The quarter-over-quarter growth trend above makes sense when comparing the two products side-by-side. An interesting way to breakdown the value of each service is to take the total cost of the product; then divide by the number of features available at the product level.

Let's start with the list of features. LiveChat offers 40 features to Zendesk Chat's 11. Using basic plan pricing, you pay $0.40/feature for LiveChat and $1.02/feature for Zendesk. LiveChat, 1. Zendesk Chat, 0.

Next category is languages supported. LiveChat prides itself on being the one choice for global firms, and they back that up with their language support. LiveChat offers 13 language options compared to Zendesk's one, English. So, it costs $1.23/language for LiveChat and $11.20/language for Zendesk.

LiveChat, 2. Zendesk Chat, 0.

Finally we have Integration Capability. Integrations include things like Salesforce, Facebook Messenger, Twitter, Wordpress, Shopify, etc. In total, LiveChat offers over 170 integration capabilities through their Marketplace (read: app store). Zendesk on the other hand offers a whopping *seven* integrations.

Dividing the cost by integrations gets us $0.12/integration for LiveChat and $1.60/integration for Zendesk Chat.

LiveChat, 3. Zendesk Chat, 0.

It's no wonder more people are leaving Zendesk and heading towards LiveChat. LVC appears more expensive than Zendesk at first glance. However, when you break it down on a unit-basis of features, offerings and integrations its clear. LiveChat is actually the *cheaper* product.

LiveChat's Success Reflected in Financials

The company's grown top-line revenues above 15% for the last few years. And like most SaaS businesses, their economics are enviable:

- 83% Gross Profit Margins
- 68% EBITDA Margins
- 64% EBIT Margins
- Over 50% Net Profit
- 105% ROE
- 93% ROA

What's more impressive is the company maintained (and even grown) these metrics over the last year *while nearly doubling their workforce.*

Fortress Balance Sheet

The company also sports a robust balance sheet. Almost half of their total assets are in cash ($8M). That's good enough to pay-off all liabilities 4x over. Management hasn't diluted shareholders in the process, keeping the number of shares consistent at 25.7M. This makes sense given such high levels of insider ownership.

Giving Away Nearly All of Their Cash

Like most European companies, LiveChat loves their dividend policy. The company distributes nearly all their profits in the form of dividends. Yet LiveChat generates *so much cash* that they recently started a *forward* dividend policy. This means they're distributing advanced dividends ahead of their fiscal reporting year.

The company wants to grow. I don't think they'll have this much cash on a run-rate basis as they expand their team, invest in R&D and grow their product offering.

This takes us into thinking about capital allocation strategies. I would rather see the company buyback their stock instead of distributing dividends. I say this for two reasons. First, buybacks are a more tax-efficient strategy of returning capital to shareholders. Secondly, dividends are subject to "double tax". In other words, the dividends are subject to ordinary income tax. This is *on top* of that tax you already have to pay for capital gains.

What is LVC Worth?

Paying 15x earnings doesn't seem like "basement level" value investing at first glance. Yet keep in mind two things. First, you're paying 15x *this year's* earnings. Second, LiveChat generates significant amounts of cash flow with high operating margins. 15x earnings doesn't look that bad in that shade.

What happens if we look out over the next five years? Let's categorize the next five years into three buckets: Pessimist, Stagnant and Optimist.

Pessimist Outlook

The Pessimist view assumes -5% top-line revenue growth, margin compression and no multiple expansion. How would LVC get here? Failure to increase ARPU. Inability to land Enterprise Level contracts and higher expenses due to hiring.

In this scenario, we'd end up with 2024 revenues of $21M, $10M in FCF and $140M in Enterprise Value. Subtracting out net debt gets us $148M in Market Cap. Divide that by the number of shares and we get $6/share in intrinsic value. Around 40% downside from where prices are now.

I don't think this scenario is likely. The odds of LiveChat losing 5% in revenue a year for the next five years is low.

Stagnant Outlook

In our stagnant view, we assume zero top-line growth after FY2019. We'll also assume historical gross and EBITDA margins, but no multiple re-rating. In this scenario, we end 2024 with $27.40M in revenues, $15M in FCF and $193M in Enterprise Value.

Subtracting out net debt gets us Market Cap of $201M, or $8/share (16% downside). This is close to where it's currently trading. In other words, the market doesn't look like it's pricing in any future growth for LVC.

I don't think this scenario is likely going forward. It's hard for a company that's generated historical 15% annual top-line growth to *stop* growing. Especially in an industry with major tailwinds.

Optimist Outlook

In our optimistic view, we assume 15% top-line revenue growth with a small improvement in EBITDA margins (reflecting company's adjustments to hiring more people).

We're also assuming a slight multiple re-rating from 12x to 15x EBITDA based on increased ARPU, more users, high free cash flow generation and net cash position.

In this scenario, the company will generate $54.7M in 2024 revenue, $38M in EBITDA and $30M in FCF. We end 2024 with Enterprise Value well over $400M (doubling from current EV). Subtracting out net debt and dividing by shares outstanding get us **over $17/share in intrinsic value.** That's good enough for an 80%+ upside.

What's Most Likely?

I never assume that my optimistic scenario works. In fact, I tend to assume the worst case. I do this because if I'm wrong and the company does do well, the upside takes care of itself. I think LiveChat will fall somewhere in between my conservative optimist view.

Risks

There's four main risks when investing in LiveChat:

1. Freemium options
2. Currency Risk
3. Failure to achieve higher ARPU
4. Failure to bring on more Enterprise Level businesses

Freemium Options

LiveChat claims that they don't compete with the freemium alternatives, but this is still a risk for two reasons. First, it could create a 'race to the bottom' pricing environment where everyone reduces until all margin evaporates.

Second, smaller companies with limited budgets will look to freemium options before considering LiveChat. This makes it harder for LiveChat to siphon off customers from other products should they switch from freemium to a paid version.

Currency Risk

LiveChat recognizes revenues in USD and expenses in USD / PLN. This leads to currency risk. Right now you can get 1 Poland Zloty for $0.25 USD. Over the last five years the spread between low and high was $0.23/1 PLN and $0.29/1 PLN.

Failure to Achieve Higher ARPU & Less Enterprise Level Contracts

These two risks are co-dependent. If LiveChat fails to grow their Enterprise Level business they will in turn reduce ARPU. This is their growth driver over the next five years. If they can't get this working, the investment won't take off. ARPU sits around $970/user as of today.

Value Ventures Portfolio Review

Company	Ticker	Price at Issue	Current Price	% Change
S&W Seed, Co., Inc.	SANW	$2.79	$2.38	-14.70%
Covetrus, Inc.	CVET	$12.61	$11.00	-12.77%
Carbo Ceramics	CRR	$1.75	$2.05	17.14%
LiveChat, Inc.	LVC (Warsaw Stock Exchange)	34.15	34.15	0.00%

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700 Lavaca St. Ste 1401, Austin, TX 78701