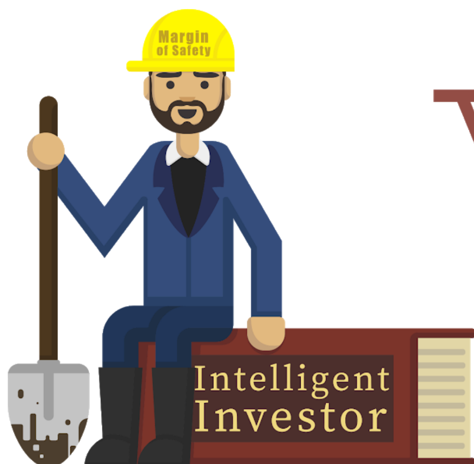
Value Ventures: January 2020
Long-term thinking in a world of short-term orientation.



Value Ventures

Six Types of Business Models (Part 1) & Paragon Technologies (PGNT)

by Brandon Beylo on 09 January 2019

Table of Contents

Six Types of Business Models (Part 1) & Paragon Technologies (PGNT) **1**
Table of Contents 1
Six Types of Business Models: A Beginner's Guide (Part 1) **3**
The Add-on Model **4**
Why The Model Works 4
Pros & Cons of Add-on Model 4
Real Life Application of Add-on Model 5

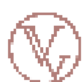
Example #1: Car Companies 5
Example #2 Low-Cost Airlines (SAVE) 6
Example #3: Mobile Games 6
Research Papers on Add-on Model 7
Glenn Ellison's white-paper in 2003, A MODEL OF ADD-ON PRICING 7
Stocks That Fit This Model 8

The Bait-and-Hook Model 10
Real Life Application of Bait-and-Hook Model 11
Elevator and Aircraft Engine Sales & Services 11
Inkjet Printers 11
Nespresso Coffee Makers / Keurig Machines 11
Research Papers on Model 11
Stocks That Fit This Model 12

The Freemium Model 14
Pros And Cons of Freemium 14
Research Papers on Model 15
Type #1: Time Limited 16
Type #2: Feature Limited 16
Type #3: Seat Limited 16
Type #4: Customer Type Limited 16
Stocks That Fit This Model 17
Company #1: Dropbox (DBX) 17
Company #2: Match Group (MTCH) 18
Company #3: Slack (WORK) 19
Company #4: Spotify (SPOT) 20

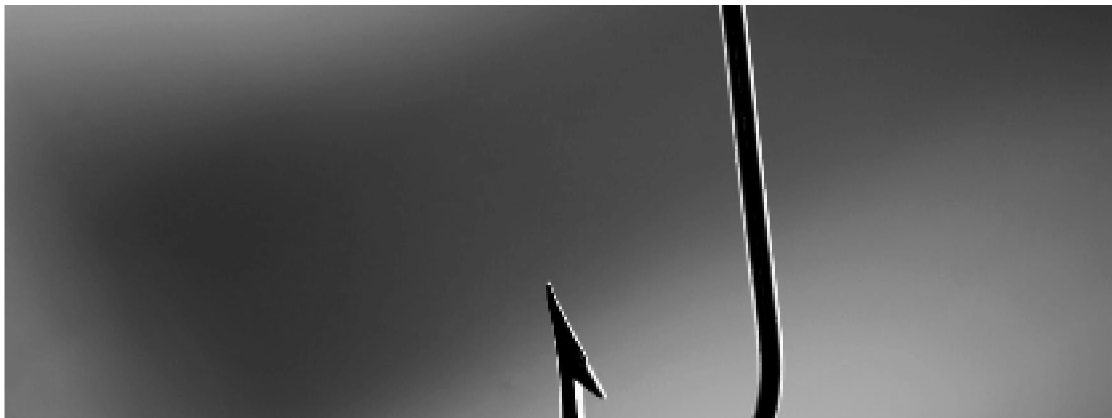
Concluding Remarks 20
Cliff-Notes: Paragon Technologies, Inc. (PGNT) 21

Deep Dive: Paragon Technologies (PGNT) 22
Hesham Gad Background 22
Company Background 22
Operating Segment Breakdown 23
Automation 23
Distribution 24
Real Estate 24
Investments 25
Large Discount To NAV 25
Checking Operating Segment Financials 25
Accounting For Investment Gain 26
Manager's Skin In The Game 26
Valuation 26
Risks 27
1. Executive Risk 27



2. Leverage 27
3. Inconsistency 27
4. Currency Risk 27
Value Ventures Portfolio Review **28**
Last Month's Must-Reads 28

THIS MONTH'S
PHILOSOPHY CORNER



Six Types of Business Models: A Beginner's Guide (Part 1)

I stumbled across one of the best websites on the interwebs: bmtoolbox.net. For those unfamiliar, bmtoolbox.net breaks down business models into easy-to-understand segments.

They call these models, "patterns". It's not an exhaustive list by any means. But there's six types of models to learn:

1. Add-on
2. Bait-and-Hook
3. Freemium
4. Subscription

5. Sharing Economy
6. Customer Data Monetization

We'll spend the first two months of 2020 learning these six models. First three this month. Last three next month. We're diving deep in this issue. Fleshing out academic papers and real-life examples of these models in action.

You can't but help learn something after reading this section.

Let's learn!

The Add-on Model

In the Add-on model, companies offer a basic product (or service) at low to no profit margin. Then, they offer *extra* products that *enhance* the basic product for high-profit margins. Sometimes businesses give away their basic product for free to gain traction. We'll talk about that later, though.

Why The Model Works

This model works for businesses with sticky, loyal customers. Or those looking to develop such aficionados. Think of McDonald's adding fries to your burger and Coke. Or upgrading to first class on your favorite airline. If you already love a business' product or service, odds are you'll pay up for greater utility. In for a penny, in for a pound.

Another reason why this model works is because it provides the business with a low-risk/high-reward customer acquisition and retention strategy. A basic (but satisfactory) product or service allows the business to gauge initial customer interest. While at the same time providing a pulse on what that customer prefers (or doesn't prefer) for more features.

Then, with that knowledge, the business can create add-on products or services with high margins. **This is where the profit lies.**

But before diving into some real-life examples, we need to understand the pros and cons of the model.

Pros & Cons of Add-on Model

We mentioned a few pros in the paragraphs above. But this model doesn't come without its cons. Let's review both sides.

Pros

- Easy customer acquisition model: Offer a basic, free product to attract a customer base. Free products make customer-building easy. There's no opportunity cost for a potential customer to try your *free* product. If they don't like it, they stop using. But they *don't* lose money.
- Customer-Centric Customization: In an add-on model, a customer only has to pay for additional services if she desires them. In other words, a customer can tailor the product to them. This makes it unique and lends to a stickier customer.

- Constant Innovation: A benefit to the add-on model is the constant tweaking/innovation on the product level. Your add-on products deliver *exceptional* utility to your customers. This gives you a heightened pulse on your customers' tastes and expectations.

Cons

- Constant Innovation: I know, it's also a pro. Constant innovation is great, if you can do it. Yet it requires loads of investment in research, beta-testing and technology. All these investments happen *before* you know that customers will love the add-on service/product. This presents the potential for sunk-cost investment into failed add-on innovations.

- Inadequate Basic Product: An add-on business model is as good as its least loyal customers. That starts with the basic product. The initial service or gadget that makes someone's life better, for little (to no) cost. It doesn't matter how great your add-on product is if your basic product sucks.

Real Life Application of Add-on Model

Example #1: Car Companies

Most people understand the basic components of a car purchase. You get four wheels, one steering wheel, seatbelts and a radio. Yet auto companies play the add-on game to perfection. They know their most loyal customers (their fanatics) will pay up for additional features. Heated seats that provide massages. Heads-up display. A few-hundred extra horsepower.

Remember, add-on features are high-margin by nature. Each incremental addition onto an entry-level product raises that product's overall margin.

An article on Upstream.auto suggests that the add-on business model is in early innings for automakers. One big reason: technology.

Whether its AI, autonomous driving or electric capabilities -- it's all tech-heavy. With that comes increased services and features. All of which are add-ons.

Example #2 Low-Cost Airlines (SAVE)

The best example of an *add-on* heavy airline is Spirit Airlines (SAVE). Spirit's model is simple:

1. Offer *extremely* low flight tickets.
2. Charge additional fees for everything else.

Want to pick your seat? Pay up. Want to check *any* bag? I'll need to see your credit card. Decide to change your check-in arrangements? That'll cost you. Need to use the restroom? Well, they haven't gone *that far* yet.

Customers pay for what they want -- nothing more.

This Harvard Business School article highlights more of the company's adherence to the add-on model. If you're not a believer in the efficacy of an add-on business model, think again. Check out SAVE's net profit per plane in 2011.

Margins also increased from 17% in 2013 to 27% in 2015. The model works.

Example #3: Mobile Games

One industry reaping the add-on model benefits is mobile gaming. Leading the way in that department? Fortnite.

Fortnite is the most popular game in video game history. The game made over $2B last year. Those are staggering numbers when you realize the entire game is free. That's right. You *never* have to pay for the actual game.

Fortnite generates $2.5B in revenues from in-game purchases and $10/quarter Battle Pass subscriptions. In other words, Epic Games made $2.5B from add-ons within the game.

The game's business model was so successful, other game makers took notice. Call of Duty and Battlefield soon offered Battle Royale modes. There's even

rumors floating around that Call of Duty will unveil a free Battle Royale game.

Ryan Cropp wrote a great article on Medium about Fortnite's model. Here's a snippet from the essay (emphasis mine):

> *"In principle, Fortnite's business model is simple: release a free to play game for everyone to try, include fun character outfits with no effect on the core gameplay, **let players buy the outfits individually or through a leveling system**. In practice, Epic executed the strategy to give all players from the most frugal to the most invested a way to play the game the way they want."*

But it begs the question … Why is Fortnite successful at add-on purchases?

The secret is individuality and self-expression. I know, I sound postmodernist. But stay with me! *Who Purchases and Why?*, a 2019 whitepaper on Fortnite consumer behavior backed up this claim:

Items	Loadings	
To look unique	**.84**	.11
I want to look different from other people	**.82**	.24
I want to express my individuality	**.80**	.10
Because my friends bought it	.02	**.88**
Because it's popular	.15	**.83**
I want to show others I am a serious player	.40	**.70**

Table 1. Factor analysis of why users buy in-game items.

Fortnite built a $2.5B money-printing machine by giving players the ability to express their individuality. That's incredible! It's one of the reasons I want to spend an entire Value Ventures deciphering the video game industry (that's a teaser!).

The game shines a light on the greatest advantage of the add-on model. Additional products make the game better for you without providing a competitive advantage to the basic product.

Buying a new skin (outfit) doesn't give you special advantages in-game. All it does is make you look different than your friends. In turn, the game remains competitive across socioeconomic status and gaming skills.

Research Papers on Add-on Model

Glenn Ellison's white-paper in 2003, A MODEL OF ADD-ON PRICING

Ellison hypothesized *why* firms adopt add-on pricing models. He offers five reasons:

1. Advertising costs determined by search patterns
2. Tacit Collusion
3. Exploitation of Boundedly Rational Consumers

4. Per-product advertising costs
5. The difficulty of under-cutting a non-posted price

Ellison also argues that add-on models translate into higher profits. And over time, those excess profits *should* fall back in line with fixed costs, creating equilibrium.

Readability Scale: 3.5/10

Stocks That Fit This Model

There's loads of businesses that engage in the add-on model. But for our sake, let's review the real-life examples through the public market eyes:

- Spirit Airlines (SAVE)

Quick Hits:

Market Cap - $2B

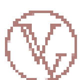
Enterprise Value - $4B

EV/EBITDA - 8x

P/E - 8x

Debt/Equity - 1.46x

Annual FCF - $33M



- Car Companies: F, FCAU, VOW:DE

Quick Hits:

Market Cap - 86B

Enterprise Value - 247B

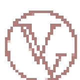
EV/EBITDA - 5.4x

P/E - 6.50x

Debt/Equity - 2.0x

Annual FCF - -6.66B

- Video Games: EA, TTWO, TCEHY



Quick Hits:

Market Cap - $31.34B

Enterprise Value - $25.32B

EV/EBITDA - 23x

P/E - 11.70x

Debt/Equity - 0.17x

Annual FCF - $1.62B

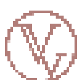
The Bait-and-Hook Model

> *"The basic product is sold at a very cheap price in order to make profit by selling complementary products/refills for a high price or simply increase sales of the profitable complementary product."* - Bmtoolbox.net

Here's the kicker. It's not the *mere* fact that the "hook" product is sold at a low cost. Rather the "bait" product -- i.e., the secondary offering -- *completes* the product or service. You *need* the bait to make the hook work. And it's the bait that's the high-margin, high turnover product.

If you're thinking this sounds like the Gillette 'razors and blades' model, it's because it is. Same model, different name. You pay a low cost for the razor handle and a high cost for the blades. The razor doesn't mean anything if you don't have the blades.

Beyond the obvious Gillette example, let's take a look at other real-world applications of the bait-and-hook (or razor-and-blade) model.



Real Life Application of Bait-and-Hook Model

Elevator and Aircraft Engine Sales & Services

Companies such as elevator and aircraft engine manufacturers make most of their money on the service, *not the sale* of their products. Take Otis Elevator for example. According to this Wall Street Journal article, 45% of their revenue comes via new product sales, 55% servicing existing products.

Inkjet Printers

Printers are another great example of the bait and hook model. What good is a printer if you don't have ink cartridges? In fact, most printer manufacturers sell their printers *at a loss*. Why? Because they *know* once you buy *their* printer, you have to use *their* ink cartridges. And they jack those cartridge prices through the roof.

If you want a deeper look into the world of inkjet printers and cartridges, check out this *Business Insider Nordic* video. Here's a few things that caught my eye while watching:

- A gallon of printer ink costs $10,000.
- The HP Envy costs $120 to make and HP sells it for $70. A clear loss.

But they don't care. The narrator explains this concept well, saying (emphasis mine):

> *"Once you've bought a printer that uses cartridges you're trapped in a cycle. You have no choice but to buy them, or throw away your printer. As a printer is typically a one-time purchase, companies don't mind selling them at a loss and making the money back through cartridge sales."*

Nespresso Coffee Makers / Keurig Machines

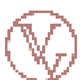
Coffee lovers understand the bait-and-hook business model more than anyone. Nespresso and Keurig used this strategy to generate huge profits.

In fact, a 2013 Business Journal article profiled Nespresso's success. Here's my favorite paragraph on Nespresso's model (emphasis mine):

> *"Nespresso **does not profit from the coffee machines**. Instead, they earn money primarily through Nespresso capsule sales. The Nespresso **capsule gross margins are estimated to be around 85 percent**, compared with 40 percent to 50 percent for regular drip-coffee brands (Levine, 2011)."*

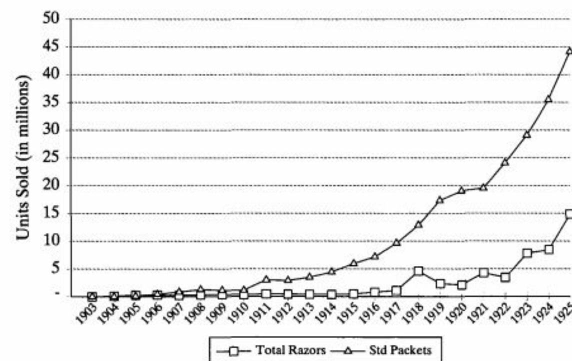
It's the perfect summary of the bait-and-hook model.

Research Papers on Model



We found a few research papers on the bait-and-hook model. Our favorite was the *Razor-and-Blades Myth* by Robert Picker. Picker uncovered two *major* pillars of the bait-and-hook strategy. These pillars, if not in place, send the entire model crumbling. They are:

- Customer loyalty
- Near monopoly on the market



He notes in the paper (emphasis mine), *"You cannot lock in anyone with a free razor if someone else can give him another free razor. Indeed, all of this suggests just the opposite: **if you want to create switching costs through the razor, then the razor needs to have a high price, not a low one.** High-priced razors mean that consumers face substantial switching costs if the alternative is to buy another high-priced razor."*

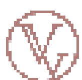
Business Models, Business Strategy and Innovation also mentions the razor-and-blade model. In one section they describe the razor-and-blade model of jet engine manufacturers (emphasis mine):

> *"Jet engines for commercial aircraft are priced the same way. Engine manufacturers know that engines are long-lived, and maintenance and parts is where Rolls Royce, GE, Pratt & Whitney and others make their money. So **engines are sold relatively inexpensively but parts (and service) involve considerable mark-ups and represent an income stream that may continue for decades.**"*

Stocks That Fit This Model

There's a couple stocks that fit the bait-and-hook business model. Here are the names:

- Keurig (KDP)



Quick Hits:

Market Cap - $40B

Enterprise Value - $54.56B

EV/EBITDA - 23x

P/E - 37x

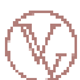
Debt/Equity - 0.69x

Annual FCF - $2.07B

- Rolls Royce (RR)

Quick Hits:

Market Cap - 13.9B



Jan. 09th, 2020

Enterprise Value - 15.3B

EV/EBITDA - 25x

P/E - N/A

Debt/Equity - N/A

Annual FCF - 1.88B

The Freemium Model

Fred Wilson is a venture capitalist. His definition of freemium is thorough. It cuts right to the model's purpose (emphasis mine):

> "***Give your service away for free***, *possibly ad supported but maybe not, acquire a lot of customers very efficiently through word of mouth, referral networks, organic search marketing, etc.*, ***then offer premium priced value-added services*** *or an enhanced version of your service to your customer base.*"

Fun fact: *the word 'freemium' wasn't coined by Fred, but via his blog reader, Jarid Lurkin.*

The freemium model smells a bit like the add-on model, but there's one key difference. The add-on business tailors to the specific users' utility from the service. In a freemium model, the premium version increases the value for *every* user.

The goal of the freemium model is to turn your free customers into paying customers. The higher the conversion rate, the more successful your business.

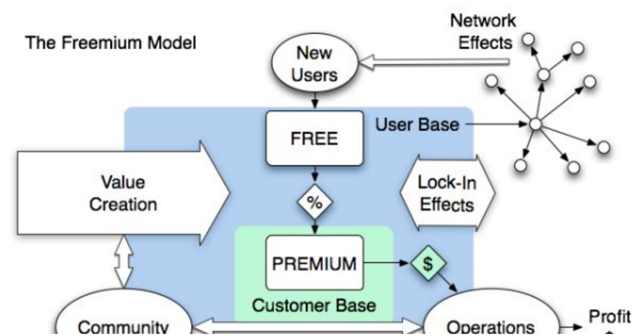
Like any business model, there are pros and cons.

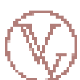
Pros And Cons of Freemium

Pros

One obvious benefit is the potential for **rapid customer adoption**. If there's zero cost then there's zero friction for the customer to try the service. In other words, a potential customer has *nothing to lose* in a free service.

The second major advantage of a freemium model is network effects. Network effects provide a positive feed-back loop of user growth. It goes something like this:





- More users make the platform better
- A better platform attracts more users
- More users make the platform *even* better

The flywheel repeats.

We'll see the power of network effects in our examples. But let's move on to the cons.

Cons

The big con to the freemium model is the risk that users don't pay for the premium service. Inside of this risk is another, larger risk: lack of user growth.

Remember, the freemium model is a numbers game. If you gather enough users of your free service, over time, *some* of those users will pay up.

You don't *have* to have a lot of paying users, either. The percentage of paying users to non-paying users depends on a few variables:

- Cost of premium service
- Breakeven cost of providing service
- Cost of users on free platform

For example, if you charge a high price for your premium service, you might only need 1 paying customer to support 5 free users.

But -- and this is where the math gets hard for companies -- if you charge a cheaper price, one user might only pay for 1-2 free customers. In this situation, you *need* a lot more paying users to verify your business model.

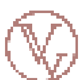
Enter the second con of the freemium model. A company *must* invest into R&D, sales and marketing, etc. to run the product/service. But only a small portion of their customers *actually* pay for it. And the larger that dichotomy between free users and paid users, the more strain on the business to maintain the free service.

The final con is that once you offer something for free, you *cannot* take it away. The classic bait-and-switch. This means you better make sure you can offer that free service into perpetuity.

Let's move on to a couple of research papers that flesh out the concepts of freemium.

Research Papers on Model

The first research paper is *Exploring the Freemium Business Model* by Erlend Vihovde Reime. What I liked about Erlend's piece is he broke down freemium models into four types:



Type #1: Time Limited

A company offers the service for a trial period (30 days, etc.) The customer has a choice to make. They either purchase the premium version or they stop using their service. This isn't a *true* freemium strategy, according to the whitepaper. It's more of a sales pitch.

Type #2: Feature Limited

In the second type of freemium, you're offered a basic version for free. Then, the company charges a premium for an enhanced, sophisticated version of that software.

This model presents unique challenges. If the free version has *too many* features, customers won't justify the cost switch. But if there are *too few* features, you don't attract enough customers to your service.

Type #3: Seat Limited

The third type of freemium -- Seat Limited -- offers Free usage up to a certain volume. If you're thinking of DropBox (DBX) or Box.com (BOX) you've got it.

I like this model because "volume-based" businesses have 'sticky' characteristics. File back-ups and storage units are integral parts of a company's internal procedure.

According to the paper, the 'Seat Limited' Freemium model is a *true freemium* model. It's harder for a customer of a Seat Limited model to switch if all their files are stored on that service.

Type #4: Customer Type Limited

The final type of Freemium model is the Customer Type Limited. In this model, the company offers its service for free to those that *normally* couldn't afford it. With the hope that one day those customers turn into paying subscribers.

Erlend also designates Type 4 as "true freemium".

——————————————

The second paper, *Freemium: attributes of an emerging business model* by Nicolas Pujol. This paper dives into an important part of freemium's strategy: gaining *mindshare*.

What is Mindshare?

The paper reveals why freemium transactions don't make sense when viewed through traditional, micro-economic lenses (emphasis mine):

> *"Given such demand generation is attained through a product or service and not a traditional advert (banner, catalogue placement, generally, a message), freemium is often seen as a* ***product strategy with a zero price, an odd transaction where the***

recipient receives a free product without counter party, no requirement to purchase now or later."

What traditional economic lenses fail to capture is this idea of *mindshare.*

According to the paper, mindshare is "the development of awareness for the provider's brand and the consideration for the purchase of future commercial products and services". It helps to think of mindshare as a form of currency.

Thinking About Sales Cycles in Freemium

Nicholas breaks down the freemium sales cycle into two steps. Moreover, he bifurcates the sales process between *pre-sales* and *transactions*. In short, the freemium model acts as *both* a zero-price product offering *and* an advertisement for a more commercialized (premium) product. The table from the paper explains it in greater detail:

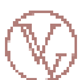
Table 1: comparison of traditional sales cycles with freemium

	Pre-sales	Transaction
Traditional sales cycle	Advertising (banner, ad words, message) – step 1	Sale of commercial product or service – step 2
Freemium sales cycle (step 1)	Free product or service wins on basis of zero price, value proposition and viral marketing	Free product or service is sold at price of zero. Currency: user's mind share.
Freemium sales cycle (step 2)	Free product acts as the advert for related commercial goods	Sale of commercial product or service. Currency: money.

Stocks That Fit This Model

A myriad of public companies fit the freemium model. Because of this, we're combining the "Real Life Examples" section with our "Stocks That Fit This Model". The stocks we'll profile are:

Company #1: Dropbox (DBX)



Freemium Model: Seat Limited, Customer Type

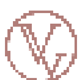
Dropbox (DBX) offers file storage, backup and file collaboration services. DBX operates under the *Seat Limited* and *Customer Type* models. Users can get 2GB free usage of the platform (Dropbox Basic), forever. Anything over 2GB and you have to open the wallet.

If you choose to pay, Dropbox offers a few options: Standard, Advanced and Enterprise. You have the option to pay monthly (for a higher charge) or annually (discounted rate).

Here's the interesting part about DBX. You get *way more* storage as soon as you pay. This seems obvious. After all, that's what you're paying for, right? The free version is 2GB. The standard plan is 5TB (5,000GB). That's quite a jump.

Company #2: Match Group (MTCH)

Freemium Model: Feature Limited



Match Group (MTCH) owns popular online dating apps like Tinder, Match, OkCupid and BlackPeopleMeet.com. All these services operate under the *Feature Limited* freemium model. Users can use basic functions on each site/app for free. For example, Tinder, the world's most popular dating app, allows users to swipe left and right for free.

Yet the basic features are that, basic. If a user wants more or is serious about finding a partner, the premium features make more sense. Match does this to perfection. In the free version of Match users can search for and view matches, create a profile, send and receive "winks," use Match.com's message center and use the app.

But you can't *message* Match.com users unless you're a paid subscriber. In other words, it's the perfect freemium model. Find the love of your life. Realize you can't message them. Pay the monthly subscription.

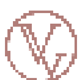
Company #3: Slack (WORK)

Freemium Model: Seat Limited, Feature Limited, Customer Type Limited

Slack's goal is to replace conventional email. Many popular US companies have already made the switch: EA, Airbnb, SHOP and Macro-Ops. Slack's free offering to consumers includes:

- 10k searchable messages
- 10 apps and integrations
- 1-to-1 video calls
- Two-factor authentication

After that, users (or companies) subscribe to the premium tiers: Standard, Plus or Enterprise Grid. Upgrades include access to entire message history, unlimited app integrations, group calls and shared channels.



Slack is a testament to the margin power of a freemium, software-based model. The company generates near 90% gross margins.

Company #4: Spotify (SPOT)

Freemium Model: Feature Limited

Spotify (SPOT) operates a *Feature* Limited freemium model. Users can experience the free version of Spotify at the cost of intermediate commercial breaks. Free users also experience lower audio quality and reduced playback capabilities.

The paid version offers off-line downloads and real-time song/album releases.

The company generates around $400M in annual FCF, has $980M in net cash and generates 26% return on equity. As of writing, the stock trades at its IPO price.

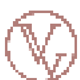
Concluding Remarks

Take a breath! We covered *a lot* over the course of this section. It may feel like drinking from a firehose. But these sections are guides. Refer to these pages, re-read if you'd like. The principles remain the same, regardless of what year you're reading.

In part one, we covered the following business models:

- Add-on
- Bait-and-Hook (Razor-and-Blade)
- Freemium

Each model presents its own unique benefits, challenges and market opportunities. Each model offers different levers to pull for value creation. The goal is to understand these



levers. Know how they work within the model. This gives us an advantage when it comes to forecasting future cash flows and valuation.

Like Munger, we're adding to our lattice-work of mental models.

THIS MONTH'S
DEEP DIVE

Cliff-Notes: Paragon Technologies, Inc. (PGNT)

- **What We Like:**
    - **Owner-operator with skin in the game (30% ownership)**
    - **Owner is a deep value investor at heart (wrote the book *The Business of Value Investing*)**
    - **60% discount to NAV**
    - **45% operating income yield**
    - **Under the radar & off-the-beaten-path (Illiquid)**

- **What We Don't Like:**
    - **Company has debt (1.5x net debt/EBITDA)**
    - **Executive Risk (play on CEO/Chairman)**
    - **Currency Risk with major distribution business**
    - **Potential over-exaggeration on investment gain accounting adjustment**

- **What We Think It's Worth:**
    - **NAV Scenario: $4/share (60% upside)**
    - **No-growth Scenario: $5.66/share (127% upside)**

- **5% Top-Line Growth Scenario: $7.64/share (207% upside)**

Deep Dive: Paragon Technologies (PGNT)

Paragon Technologies (PGNT) is an overlooked, under-the-radar, illiquid micro-cap. It's right up our investment alley. The company trades at a 60% discount to NAV with *profitable* operating segments. These segments generated close to $2M in operating income last year. At current stock prices, you can get these operating segments for a 60% discount to NAV. It's less than free.

The company's run by a Benjamin Graham disciple, Hersham "Sham" Gad. He owns 30% of the business. Interests are aligned.

Like most overlooked, under-the-radar stocks, PGNT comes with its share of hair. Yet we believe the current market price offers an attractive risk/reward opportunity. An opportunity to invest in an Old-School Buffett disciple enacting sound capital allocation principles.

Let's dive in.

Hesham Gad Background

The company is run by Hesham "Sham" Gad. Sham is a deep value, Benjamin Graham style investor. He runs Gam Partners Fund which averages over 20% annualized returns.

Here's his old blog: http://shamgad.blogspot.com/. He hasn't posted since 2012, but his old posts are worth a read. My favorite post is "A *Thought on Investing*". You can read it here.

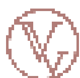
He also runs an investment partnership, Gad Partners Fund.

Sham is also the author of *The Business of Value Investing: 6 Essential Elements To Buying Companies Like Warren Buffett*. So he's a tried and true value investor at heart.

Let's take a look at his company, Paragon Technologies (PGNT)

Company Background

Sham joined the board of PGNT in the second half of 2010. By March of 2012, in a unanimous decision, shareholders elected Sham Chairman of the Board.



In short, the company is a value investor's dream. Read Sham's annual shareholder letters. A true value investor can't read those letters and *not* get excited.

The company feels like a public version of Brent Beshore's private equity fund. Check out PGNT's Investment Acquisition Criteria:

- *We seek established companies with a demonstrable track record of revenues and positive operating earnings.*
- *We seek companies with management in place. We don't supply managers. We seek long-term partnerships – we buy for keeps.*
- *We are not a private equity firm. We want to own operating companies indefinitely.*
- *Our ideal business size is annual revenues between $5 – $25 million.*
- *We are industry agnostic. What we focus on are businesses we understand, with quality people, and a culture of integrity. Expect nothing less from us as your partners.*

The above criteria sounds much like Beshore's approach. This is a good thing. Sham modeled PGNT after Buffett's early Berkshire acquisition days. They own subsidiaries that engage in diverse business activities. They're looking to buy great businesses at great prices. Reap the cash-flow and hold forever.

Sham's emphasis on corporate culture is clear in his inaugural Chairman's letter. Check out this snippet:

A successful value-creating business, in our view, is one ingrained with a culture of performance. For such a corporate culture to flourish, a business should have:

- *a strong and ethical management team*
- *a low-cost structure*
- *a consistently strong balance sheet*
- *an intense focus on maximizing intrinsic value per share*
- *the passion to execute on that focus.*

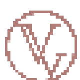
PGNT breaks down into four business segments:

1. Automation
2. Distribution
3. Real Estate
4. Investments

Let's dive deeper into each segment.

Operating Segment Breakdown

Automation



The company engages in Automation through its wholly-owned subsidiary SI Systems. According to company filings, SI Systems "provides productivity-enhancing material handling solutions, including complete systems, subsystem technologies, products, software and services for automated material handling and order processing applications. SI Systems supports both its install base and the broader industry install base with support, upgrade services, and aftermarket parts, as well as rejuvenation and retrofit engineering services."

SI Systems' automated material handling systems are currently used by manufacturing, assembly, order fulfillment, and distribution operations customers located primarily in North America, including the U.S. government.

The segment generates the bulk of its revenue from a select number of contracts. So there's built-in customer concentration risk.

Distribution

The company's distribution segment operates through SED International de Colombia (SEDC, not ticker symbol). SED distributes IT hardware products from worldwide leading IT manufacturers such as Hewlett Packard, Lenovo, Dell, Samsung, LG, Epson, Ricoh, etc.

SEDC breaks down its business into three units:

- Value
- Transactional and Consumer Electronics
- Integrated Services

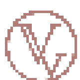
The value segment sells more specialized products that carry higher margins. These products are geared towards enterprises and large business projects. Products sold include servers, workstations, networking, high-end printers and power protection systems.

SEDC's Transactional and Consumer Electronics segment focuses on retail resellers and e-tailers. The segment also sells products to small and medium sized businesses. These products include notebook computers, desktop computers, printers, projectors, etc.

The final segment, Integrated Services, offers managed services, outsourced printing, electronic document management and invoicing. This segment is somewhat involved in ownership of extended warranties and maintenance agreements.

The company acquired SEDC through its wholly-owned subsidiary Ark Investments. It's an 80/20 ownership split with PGNT owning 80% and CEO Ronell Rivera owning 20%.

Real Estate



PGNT created a subsidiary to buy cash-flowing real estate properties. The company's goal for this subsidiary is to "generate positive cash flow for the foreseeable future". Simple enough.

So far the company's bought two residential properties in Las Vegas, NV for $750K (2017 and 2018). These properties produce marginal cash flow (less than $80K/year). Gad’s targeting 5-6% cash-on-cash returns for those properties.

Investments

PGNT uses excess cash generation to invest in public securities. The company's investment policy allows investment in equities, bonds, US treasuries, etc.

Hesham Gad makes the investments. Knowing his Ben Graham roots, we're confident Gad can make accretive investments.

There's one part of the Investment Policy that struck my eye. "Prohibition of short-selling, margin trading and the use of leverage".

I like that. Margin, if gone awry, can deplete excess cash fast.

Large Discount To NAV

The company has a net asset value of $6.81M as of 3Q 2019 financial report. At the latest quoted stock price and share count, it has a market value of $4.23M.

That's a 60% discount to net asset value. This doesn't include the company's profitable operating business segments. In other words, you can buy PGNT for a 60% discount to NAV, and get the operating segments for free.

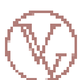
Looking at the balance sheet alone, the company becomes an interesting idea. But there *are* profitable business segments. So what do those look like?

Checking Operating Segment Financials

PGNT's increased revenues from $8.5M in 2016 to $85M in 2018. A cool 300% three-year CAGR. Yet during that same time-span, gross profit only increased 277%, $2.29M to $8.6M.

What this tells us is there's little operating leverage. Or there hasn't been over the last three years.

Regardless, the company generated close to $2M in operating income in 2018. That implies a 2.1x multiple on 2018 operating income at current market prices. Adding back D&A we get around $2.4M in 2018 EBITDA (3.6x EV multiple).



PGNT's distribution business accounts for 90% of revenues and 80% operating income. Think about it another way. You can buy the distribution business for 5.7x operating income. Then, get the automation, real estate and investment segments for free.

Accounting For Investment Gain

Looking at three-year financials, investors can wonder why EPS shrank from $1.56/share in 2017 to $0.56/share in 2018. The answer lies in the company's acquisition of SEDC. I'm a skeptic when it comes to companies writing in investment gains on the income statement (I.e., BABA's accounting wizardry). So let's see how PGNT accounts for this figure.

The company broke down the $4.23M gain on investment in its Q3 10-Q. The math is simple. The company bought SEDC for $1.395M out of Chapter 11 bankruptcy. For that $1.395M, PGNT bought $23.7M in total assets and assumed $18.1M total liabilities. That gives us a NAV of $5.621M (compared to $1.395M purchase price).

If you remove the $4.23M gain from investment, the company lost around $0.88/share in 2017 and generated $877K in EBITDA.

Manager's Skin In The Game

We profiled Hesham's investment philosophy and management style earlier in the post. It's no surprise that Sham owns 30% of the business.

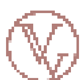
Check out this paragraph from the 2019 Chairman Letter:

> *"As Chairman, CEO, and chief capital allocator at Paragon, I also am the Company's largest shareholder. My financial net worth and that of the Gad family is fully hitched to the Paragon wagon. I will win alongside our shareholders, not at your expense. More importantly, I will experience the greatest financial pain as a result of any deterioration in Paragon's value. I believe this alignment of interests between management and shareholders to be a fundamental tenet of long-term business success."*

Valuation

The company trades at a 60% discount to NAV with a collection of profitable businesses and assets. Let's take a look at their earnings.

PGNT did a little over $2M in FCF in 2018. For our valuation purposes, we're assuming a 50% reduction in 2018 FCF over the next four years. In other words, we're expecting around $1M in FCF each year.



Discounting those FCFs back to the present gets us a present value of $4.12M (near current market price). Applying a terminal value to our 2023 $1M FCF gets us $16M and an EV of $14M.

Subtracting our net debt of around $4.4M gets us $9.63M in market cap. That's 127% higher than the current share prices. Remember, this is assuming zero top-line or margin expansion. Steady-state.

If we add a modest 5% top-line growth rate, our market cap jumps to $13M (207% higher than current prices).

Risks

There's a few risks associated with these dark, illiquid stocks. Here are three major ones:

1. Executive Risk

The company lives and dies by Sham Gad. This isn't terrible given his relatively young age of 41. If Gad's investment process deviates from his Buffett roots it's a cause for concern.

2. Leverage

I tend to stay away from micro-caps with little (if any) debt. Yet here we are. PGNT has a modest amount of debt (1.5x net debt/EBITDA). And if the company generates consistent cash flow this shouldn't be a problem.

This brings us to our third risk.

3. Inconsistency

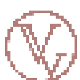
PGNT's profit/loss statement feels like a rollercoaster. And I hate rollercoasters (both in real life and on accounting statements).

Profits one year. Losses the next. Fortunately, rollercoaster P&L appears to be a thing of the past.

4. Currency Risk

SEDC's primary business is in Latin America. This makes the company susceptible to currency fluctuations throughout the year. Yet Gad doesn't appear worried. In his latest letter he said:

> *"We spend no time trying to engage in hedging activities. We accept the fact our ownership of a foreign subsidiary creates currency fluctuations but more importantly, we believe that the long-term net results of hedging currencies are generally negative. Our time is better spent focusing on what we know, as opposed to speculating on the unknown gyrations of currencies."*



Even so, it's worth keeping our eyes on.

Value Ventures Portfolio Review

Company	Ticker	Price at Issue	Current Price	% Change	Notes
S&W Seed, Co., Inc.	SANW	$2.79	$2.15	-22.94%	
Covetrus, Inc.	CVET	$12.61	$13.43	6.50%	
Carbo Ceramics	CRR	$1.75	$0.24	-86.29%	Exit price: $1.40
LiveChat, Inc.	LVC (Warsaw Stock Exchange)	34.15	42.8	25.33%	
Grupo BMV	BOLSA (MXN)	42.61	42.22	-0.92%	
Bio Pappel	CADGF (USD)	$1.20	$1.10	-8.33%	
Surge Components, Inc.	SPRS	$2.85	$2.30	-19.30%	
Paragon Technologies	PGNT	$2.40	$2.40	0.00%	

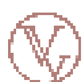
Last Month's Must-Reads

Each month I collect various articles, blog posts, research materials, etc. and deposit them here. This month's collection features Brent Beshore's Annual Letter,

2019 Adventur.es Annual Report, ***Brent Beshore***

Brent and company buck the trend of traditional private equity. Don't believe me? Check out this paragraph:

"We take no fees on the capital we raise and cover all our own costs, including travel, dead deal-related expenses, and all overhead. We buy with no intention of selling, typically use



no debt, and like to keep leadership teams intact post-close. If you're familiar with private equity, that makes no sense."

I love that. This is a great framework for future private equity funds. But also for investment partnerships. It echoes Buffett's early partnership days.

Brent nails it when he asks the question, "if the traditional PE model is broken, why don't people change?" The answer? Career risk.

Customer-Based Corporate Valuation for Publicly Traded Non-Contractual Firms, *Daniel McCarthy & Peter Fader*

This whitepaper dives into valuing a company via its customers. In short, the model breaks down revenues and cash-flows to their most basic level: the individual customer. I love this idea. At the end of the day, our job as investors is to find the *main drivers* of growth/value.

Customer-based valuation offers the analyst a unit-economic level look into the business. According to McCarthy and Fader, this model removes the dangerous mindset of "growth at any cost".

There's four (sub) models we need to understand before starting the CBCV method:

1. Customer Acquisition Model: Forecasts the inflow of new customers
2. Customer Retention Model: Forecasts how long customers will remain active
3. Purchase Model: Forecasts how frequently customers will transact with a firm
4. Basket-Size Model: Forecasts how much customers spend per purchase

It's a 52-page academic research paper. A grind. But well worth it.

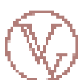
Value Investing with Legends Podcast *Bruce Greenwald*

Bruce Greenwald is a value investing legend. He's author of Value Investing: From Graham to Buffett and Beyond. He also teaches at Columbia University.

Greenwald sat down with Tano Santos to chat all things value investing. Here's a break-down of my favorite topics (from show-notes):

- The value investing oral tradition (10:30)
- Applying a value orientation to your investment search strategy (12:11)
- Why you need to be a specialist (13:24)
- What you can learn from Warren Buffett about specialization (14:56)
- Paul Hilal's approach to investing by first spending the time to learn (16:28)
- How to approach the valuation of a moat business (24:11)
- The factors to consider when calculating your return (26:51)
- The importance of active research for value investors (34:14)

It's a tremendous interview.



Valuing Subscription-Based Businesses Using Publicly Disclosed Customer Data, *Daniel McCarthy & Peter Fader*

Another whitepaper from McCarthy and Fader. As the title suggests, the men dive into valuing subscription-based businesses. The best part is they use public data. Schmucks like us -- without hedge-fund budgets -- can use this model.

Here's the model's framework in one paragraph:

"We start by describing our model for the retention process. This assumes we know how many customers the firm acquires each month. We then describe our model for the customer acquisition process, one that takes into consideration the possibility of reacquiring customers who have previously churned, and then examine how to jointly estimate the parameters of these two models. Finally, we present a simple model for the evolution of ARP U(m), and then outline how to bring together all of these submodels to generate the desired projections of R(m)."

More firms are switching to subscription-based revenue models. It's vital we know how to value such models.

Macro Ops
700 Lavaca St. Ste 1401, Austin, TX 78701