11/13/2020: Another Busy Week For Our Portfolio Companies + A New Turnaround Idea in Education

Operators,

Hope you had a great week! Last week we trekked through most of our portfolio companies' Q3 earnings reports. If you didn't read that Round-up, check it out here. In short, ***all our companies killed it***. Each report left us ***more confident*** in our long-term bullish thesis.

While this week was quieter than last, we still have some positive news/announcements to review, including:

- New Investments: Jumbo Interactive (JIN) & Fairfax India (FIH.U)
- RDVT Reports Q3 Earnings
- POWW Starts Uplisting Process
- New Ideas: Pearson (PSON) & Tencent Music (TME)

Let's get after it!

New Investment: Jumbo Interactive (JIN) & Fairfax India (FIH.U)

We initiated a new investment in Jumbo Interactive this week. You can find our original write-up on the company here. A month after our initial write-up we wrote how JIN killed its latest quarterly earnings report. In that report we mentioned a 10YR Binding Letter between JIN and Lotterywest.

This week JIN finalized that 10YR binding offer. The stock responded by rocketing nearly 10% Friday. Luck plays a role in this business and nowhere was that better seen than our initial entry price. We bought our starter stake a few days before the breakout.

As we've said before, JIN is one of the most competitively advantaged companies in our portfolio. It scores a blistering **84.8** on the *MOCS* Rating. Here's a few reasons we love the company:

- 80%+ Gross Margins
- Fortress Balance Sheet
- Founder/CEO w/ Skin In The Game
- Recurring Revenue
- Recession-Proof Business

We'll update you on any additions we make to our starter stake. Our average cost basis is 13.06 ($9.47USD). Let's turn to our second new investment this week: **Fairfax India (FIH.U).**

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We've had FIH.U on our watchlist since June. We waited for the chart to firm up to give us a solid entry point, and we got that this week (see below).

The stock broke above its 50MA and 200MA offering a great Reward/Risk entry. We got long at 8.80 ($6.70USD) with a stop at 6.74 ($5.13USD).

Here's the FIH.U elevator pitch:

> *FIH.U trades at 2.5x earnings and half of book value. The company's assets are long-term equity investments (some private, most public). These assets have a stated book value of $3.2B. Over the next three-to-five years, we believe these assets will trade at substantially higher share prices as they begin to reflect their true intrinsic value. In turn, FIH.U's NAV will rise along with its share price as investors realize the massive value disconnect.*

You can read our write-up on the company here. And for our more time-constrained Collective members, here's the TL;DR:

- FIH.U owns interests in a collection of Indian businesses (both private and public)
- The holding company trades at a severe discount to the sum of its parts
- Bangalore Airport is the largest investment in the company and is worth nearly half its book value
- You can buy the holding company for 2.5x earnings and half of book value
- The businesses inside FIH.U are great businesses with durable competitive advantages, economies of scale and (in some cases) fast growth

FIH.U is one of the only ways to gain direct exposure to India. There's a few risks with our thesis, namely that sum-of-the-parts stories almost never work. We're also betting on Prem Watsa to make good investments and hold them for the long term. If he doesn't then the holdco should *always* trade at a discount.

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Red Violet (RDVT) Reports Q3 Earnings

RDVT reported Q3 earnings Tuesday and we're happy with the results:

- Total revenue increased 12% to $9.3 million
- Platform revenue increased 27% to $9.0 million
- Net loss narrowed 7% to $0.9 million
- Adjusted EBITDA increased 84% to $2.1 million
- Gross profit increased 24% to $5.5 million
- Gross margin increased to 59% from 54%
- Adjusted gross profit increased 28% to $6.6 million
- Adjusted gross margin increased to 71% from 62%

One of the reasons we love RDVT is their ~100% incremental Gross Margin business model. The company pays a fixed cost for their data. This means it costs *almost nothing* to add an additional customer to its platform. 100% of that revenue is pure gross profit.

RDVT continues to grow its two core products:

- idiCORE: 380 new customers in Q3
- FOREWARN: 4,000 new customers in Q3

The stock didn't budge post-ER. It's our largest position at roughly 13% of the portfolio. Price remains in a firm uptrend on the daily chart. Wouldn't be surprised to see the stock trade down towards its 50MA and previous resistance before resuming its upward trend (see chart below).

We're not adding to our existing position.

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POWW Preps For NASDAQ Uplisting

One of our highest conviction microcap bets is Ammo, Inc. (POWW). The stock's stayed range-bound between $2-$3/share while the company's surpassed all expectations.

The next logical step for POWW to generate *serious* buzz is an uplisting on the NASDAQ. That's the only way the company gets their word out to the masses (and in return, send our shares flying high).

This week POWW filed a 13M share offering with an amended S-1. Here's why we like this offering. The share issuance will only go into effect ***if the company uplists to the NASDAQ*** (see filing snippet below).

We're happy with this trade-off. In fact, we anticipated at least one more equity financing round before the company fully leverages its fixed costs.

> We are offering an aggregate of __________ shares of our common stock, $0.001 par value per share.
>
> Our common stock is presently quoted on the OTCQB under the symbol "POWW". We have applied to have our common stock listed on the Nasdaq Capital Market under the symbol "POWW". No assurance can be given that our application will be approved. If our application is not approved, we will not complete this offering. On November 4, 2020, the last reported sale price for our common stock on the OTCQB was $2.03 per share.

For those interested in learning more about the NASDAQ uplisting process, check out this article. It breaks down the uplisting process from a company-first perspective. There's also this handy reference guide:

Requirements	Equity Standard	Market Value of Listed Securities Standard*	Net Income Standard
Listing Rules	5505(a) and 5505(b)(1)	5505(a) and 5505(b)(2)	5505(a) and 5505(b)(3)
Stockholders' Equity	$5 million	$4 million	$4 million
Market Value of Unrestricted Publicly Held Shares	$15 million	$15 million	$5 million
Operating History	2 years	---	---
Market Value of Listed Securities	---	$50 million	---
Net Income from Continuing Operations (in the latest fiscal year or in two of the last three fiscal years)	---	---	$750,000
Unrestricted Publicly Held Shares	1 million	1 million	1 million
Unrestricted Round Lot Shareholders**	300	300	300
Market Makers	3	3	3
Bid Price OR Closing Price***	$4 $3	$4 $2	$4 $3

We'll update you on any breaking news. If POWW succeeds in uplisting we could see the stock fly past $3 in short time.

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New Turnaround Idea: Pearson (PSON)

This week I wrote about AI in Education and the vast opportunities available in that space. One of those opportunities is Pearson Education (PSON). PSON is the world's largest education publishing company and a classic print-to-digital turnaround story.

Here's our write-up …

Pearson (PSON) built its legacy business selling overpriced textbooks to college students. Then Chegg came along and eliminated the need for those expensive hunks of paper. The company recognized this and is now leading an effort to turnaround the antiquated model. If it works, PSON will transform from a publisher of overpriced books to a fully digital learning platform powered by AI and massive amounts of student data. Mr. Market still values PSON like a textbook publisher. The stock trades <2x EV/Sales and <10x EV/EBIT.

The Problem: College Textbooks Are A Scam

College textbook prices are one of the largest scams in the US. Prices have risen a cool 1,216% since 1977. For context, healthcare prices increased 835%, housing increased 439% and inflation another 404%. The reason for the price increase is equally sinister. College professors mandate certain textbooks (usually written by the professor) as prerequisites to pass a class. Don't have a textbook? You won't pass the course.

This forced students (or their parents) to pay *whatever cost* for that "required" textbook. Not to mention paying for the class itself.

And we can't forget the classic "updated" textbooks. You know the ones with an extra chapter for brand new material? Or an updated version that rearranges pages and chapters. These tactics ensure publishers and professors get paid at the expense of students' wallets.

The Workaround Solution: Re-used Books and E-Books

Students eventually adapted to the highway financial robbery. They bought used textbooks and shared notes on Chegg. This led publishers to introduce e-textbooks, which seemed like the logical thing to do. Yet the early e-books weren't made for a digital-first world. They were clunky with terrible user interfaces (UI). E-textbooks also led publishers to include one-time activation codes in physical textbooks. That meant students had to buy the *physical copy* of the book to get access to the online edition.

The one-time activation codes led to the *same problem* students encountered with "next edition" physical textbooks. You can't resell a one-time activation code.

Against this backdrop it's easy to see why Chegg's (CHGG) stock price rocketed over 500% since IPO. CHGG has generated a 50% CAGR since IPO.

At the same time, traditional hard-copy publishers like Pearson experienced declining sales and lower stock prices. Check out the 10YR stock chart of PSON. It's ugly.

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That's quite the difference in performance.

So now textbook publishers have a choice. They can either stick with the hard-copy book sales and one-time fees that rob students. If they do that they don't have to overhaul their business plan. They can keep the status quo. That puts them at risk for insolvency as companies like CHEGG take more market share over time.

The other option is to accept that the future of textbook/learning material is fully digital. While this seems like the smart choice, it's a difficult one to make. Accepting that reality means entire organizations rearranged to optimize in a digital-first world.

Pearson Bites The Bullet

PSON accepted this reality in 2012 under the direction of then-CEO John Fallon. Fallon's 2012 Shareholder Letter revealed insights into how PSON thought about the initial transformation. The letter also puts things in perspective. By 2012 PSON generated nearly 50% of its revenue from digital sales. A turnaround of this magnitude for a company of PSON's size takes time.

The company became the first education publisher to take a digital-first approach to textbook publishing and education content delivery.

Here's a few of my favorite quotes from the letter (emphasis mine):

> *"We wanted to* ***make a radical shift from traditional print products to digital and services businesses****, and, for the first time in Pearson's history, those now account for half of our revenues. We aimed to become a significant player in the world's most dynamic education markets, and Pearson is now a meaningful education company in China, India, Brazil and Southern Africa."*
>
> *"This shift to digital is profoundly changing the business model for content:* ***it means one-off sales will diminish while subscription sales, most bundled with services, will grow.*** *That same shift to digital causes considerable change and consolidation in the retail channel, with a dramatic shift to online sales and different sales patterns for physical and digital formats."*
>
> *"We need to* ***shift resources more quickly from textbook publishing activities, primarily in the developed world, where demand is flat or declining, so we can invest more quickly in our fast-growing digital and services businesses****, with a special emphasis on emerging markets."*

Despite this commitment to digital transformation, the company's struggled to grow revenue and profits. Check out the declines in each category since from 2012-2019:

- Revenue: -$1B
- Gross Margin: -$761M
- Operating Profit: -$214M

There's a few reasons to explain the decline in PSON's operating metrics. First, the company continues to churn print sales to digital sales. Print sales commanded 80% of PSON's business in 2010.

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A legacy revenue base that high takes time to flow through the income statement. Second, digital sales look different than print sales. PSON could charge hundreds of dollars per physical textbook. Under a digital subscription-based platform PSON relies on textbook rentals, which they charge roughly $40/book. That's a huge difference.

In other words, you wouldn't see the business' transformational success if you only look at the financials.

But financials *do* matter. Eventually PSON needs to grow revenues, expand margins and increase profits to command higher market multiples.

Let's see how they plan to do that.

The Pearson of Tomorrow: Digital First

PSON grew its digital sales from 20% of revenue in 2012 to 66% in 2019. The company expects its core US Higher Education Courseware (largest segment) to be ~100% digital by 2022. To catalyze the transition to fully digital, Pearson will rely on three product innovations:

- Aida: The world's first AI-enabled Calculus app
- Pearson Learning Platform
- Next Generation Pearson eText Textbooks

In fact, we can distill PSON's future success down to its Pearson Learning Platform (PLP). The PLP acts like an operating system for students and teachers. A way to share educational content and learning material in a one-stop-shop environment.

It feels like a Netflix distribution model. Pearson provides the platform for viewers (students) to consume content (ebooks, interactive learning, etc.) on the platform. It also allows teachers and authors to revise texts and material on an "as needed" basis.

By slashing costs and controlling distribution, PSON's model becomes a lot more attractive to students and investors. This allows them to generate more data on students than any other learning company. How? Because they're the largest publisher of education content on the planet. And that entire library (1,500+ titles) becomes digital and data-able. Over time, that creates a *Data Dominance* amongst students and universities that other companies can't copy.

The idea of PSON as the "Netflix of Education" isn't new. CIO Albert Hitchcock mentioned this in a2018 [Forbes Interview]. Here's a snippet of the conversation (emphasis mine):

> *"The intention of the message was to have the viewpoint that we needed to move to a platform type of model where we have all our products, services, and capabilities that we deliver to our customers in a single ecosystem. A great deal has been written around this model at Pearson, and that is especially relevant as our company grew through acquisitions. Ours is a diverse business that is over 170 years old and has had many different types of companies under the umbrella of Pearson for many years."*

Hitchcock elaborates further, saying "It would be game-changing for not only Pearson, but for the entire industry if we could create that single platform, similar to Netflix, Spotify, and Amazon. This platform would be

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highly scalable, global in nature, high-quality, and a platform that could deliver all our experiences around the world to millions of learners."

Let's dive deeper into Pearson's Learning Platform. Jack Graham, who ran UI/UX at REVEL was tapped to help Pearson's Learning Platform. He has an entire blog post about his journey with PSON. Here's what we learned:

> *"We created a series of definition statements across the three main user roles expected to exist in the software. From these, we were able to derive focused "How might we?" questions to advance during ideation. Based on what we learned during the discovery process, we felt it would be a high priority to improve the experience for creating new courses and assigning material within them over past products."*

> *"In a marketplace where premium products are subject to disruption by free alternatives, proving the efficacy of their products was key to Pearson's strategy. Equipping instructors with timely feedback on student mastery of learning objectives was one way of implementing this strategy."*

On one hand we can say PSON's platform benefits from "Netflix-like" distribution capabilities. But there's another competitive advantage at play: Name Recognition.

Like Moody's or S&P for bond ratings, the Pearson name carries weight in the education community. As the world leader in education publications, the PSON name brings with it a sense of quality and dominance. When people think of college textbooks, they think of Pearson.

Numbers To Narratives

PSON has an opportunity to take share as the go-to digital learning platform for the next generation of learners and educators. If they do, they'd rapidly transform their business from a lower-margin print business to a high-margin software company.

Let's assume the company can turn things around and complete this transformation. What would their run-rate margins and cash flow look like? What type of multiple would the market pay for that type of company?

We can use Blackboard as a proxy for what a digital-first education company's margins would look like. Blackboard generated ~21-25% operating margins. Let's assume PSON gets to 25% OM by 2025. Revenues will take a hit this year (-10%), but should bounce back in 2021 forward. BY 2024 PSON would generate 4.27B in revenue.

The transition to a digital-first business brings with it higher margins. We're assuming PSON grows GM % from the low-mid 50s to the low 60s. This gives us 2.65B in 2024 Gross Profit. At the same time, they'll spend less in SG&A, decreasing from mid-40% to low 40%. That gets us to 22% operating margins by 2024, or 940M in OI, 779M in after-tax income and 800M in FCF.

This gives us 7.3B in PV of Terminal Value. Adding our cash flows gets us 9B in EV. Subtract net debt and we're left with $12/share in shareholder value (100% upside).

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If the company manages the turnaround, they'd increase Operating Cushion from 8% to 22% and sport a 17% FCF Growth Profile.

Risks

PSON is a turnaround with myriad risks. The company hired Andy Bird to replace John Fallon, indicating a bit of a CEO carousel.

The company also sports a -2 NPS rating. Who would've thought a company known for ripping-off college students with soon-to-be outdated textbooks would have negative consequences.

Finally, price is in a sustained downtrend. This makes it harder for the stock to turnaround as it faces overhead selling pressure.

Reading The Tape

The stock is coiling ready for a breakout. We've got the fundamental insight into the potential turnaround. Now we wait for the price to confirm a new trend.

New Trade Idea: Tencent Music Entertainment (TME)

Tencent is the largest music entertainment platform in China with 80% market share. The company provides music streaming, online karaoke, and live streaming services in the People's Republic of China.

It offers QQ Music, Kugou Music, and Kuwo Music that enable users to discover and listen to music in personalized ways; and WeSing, which enables users to have fun by singing and interacting with friends, sharing their singing performances with friends, and discovering songs that others have sung.

TME spun-off Tencent (TCEHY) which holds 78% of the voting shares.

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The company has its foot in every music category in China. It's easier to think of TME as two operating segments:

- Online Music Subscription Services
- Social Entertainment Services

From subscription-based long-form podcast revenue to online live concerts. Unlike its peer Spotify (SPOT), TME generated 70% of its revenue from social entertainment services like virtual gifts, premium memberships for online karaoke and live streaming services.

There's three competitive advantages TME enjoys versus its peers:

1. Largest Player In Industry = Network Effects

TME has 650M MAUs on its platform. This compares to a mere 80M on the next closest competitor: NetEase Cloud Music. The massive lead in users allows TME to sign the best artists to exclusive deals. This drives more users to the platform, creating more of an incentive for the best artists to use TME's platform. Which brings us to the second competitive advantage.

2. Exclusive Content

One of the main advantages of having the largest platform is *all the best* artists want to perform on *your* platform. That's what makes TME's live online concert segment so successful. No other online music entertainment service can compete. How can you expect NetEase to grow from 80M to 700M and overtake TME's user base? They won't.

3. Tencent Benefits

TCEHY owns 78% of TME's voting shares. That gives TME access to TCEHY's 1B+ users with myriad ways to monetize TME's platform. TME's competitors don't have that.

Reviewing TME's Financials

TME has grown revenue a cool 490% since 2016 (122.5% CAGR). During that time they've increased gross margins 600bps from 28% to 34% and expanded Operating Margins from 2% to 16%. These numbers trounce SPOT. For example, SPOT has 28% Gross Margin and -0.82% EBIT margin.

The company's expected to grow ~15% in top-line revenue this year and another 22% next year. Like SPOT, the two main metrics to gauge TME's bull thesis are:

1. Monthly Active Users (MAUs): Currently ~880M (650M online music / 230M social entertainment)
2. Average Revenue Per User (ARPU): Currently 8.8 RMB/User

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We're still doing work on the name but we liked the chart enough to get some exposure. We're starting small (50bps risk) and will look to add to the name as we learn more and increase our confidence in the long-term thesis.

Reading The Tape

The stock broke out of a beautiful symmetrical triangle above the 50MA and 200MA.

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