

Mossberg's Investor Digest

August 2015

Issue #86

From the Editor...

Thank you for your subscription to Mossberg's Investor Digest.

This month's issue features, Cosi Inc., which operates a chain of 110 "fast casual" restaurants. Since its IPO, the Company has been under the leadership of six different CEOs and has accumulated \$318 million in losses. However, in March 2014, the Company brought in its most successful franchisee, R.J. Dourney, as CEO. Mr. Dourney, who owned and operated 13 very successful and profitable franchised units in Boston, has been leading an effort to apply the same practices that drove the success of his franchise units across the entire chain.

Our "back of the envelope" calculation yields \$0.16 in EPS for 2017. A 20x multiple of earnings would yield a stock price of \$3.15, which equates to potential upside of 170%. With a recent capital infusion and reaching cash flow breakeven on a unit level during the second quarter, there seems to be limited downside risk. In addition to clearly demonstrating traction with its turnaround plan, the \$250 million NOL provides a backstop for valuation that approaches the current market cap of the stock.

As always, I appreciate your feedback.

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August 2015 Issue

Every month we hear ideas suggested from our large network of professional investors. Here are four of the ideas we heard this month, but have not reviewed in detail...

American Water Works (NYSE: AWK) - AWK is the largest water utility company in the U.S. and has been an active consolidator of what is a highly fragmented industry. With an aging infrastructure and capital investment worldwide, AWK has a very strong track record of executing a plan that allows for a win-win-win for the municipality, the consumer and AWK Shareholders. Return on Equity is 9.4% and the dividend yield is 2.5%.

Cavco Industries (Nasdaq: CVCO) - After seven years of clearing excess inventories, production levels in the mobile home industry have finally begun to recover from their 60-year industry lows. Cavco has been an active consolidator of some great assets during the downturn and is a clear number two player behind Berkshire's Clayton Homes. As the industry recovers to 75% to 80% of capacity, Cavco will maintain, or grow, its share and the strong incremental contribution margin should allow for \$6 to \$7 in earnings power, implying a high single digit/ low double digit multiple of earnings.

CUI Global (Nasdaq: CUI) - Shares of this maker of gas chromatographs have been hit by two major non-fundamental factors including selling by one of its largest institutional shareholders and the exit from the Russell 2000 index. While CUI's technology is clearly a better solution, they have had to overcome inertia in an industry that is slow to adopt new technologies. Based on recently reported 20% revenue growth and other announcements, the company's technology is increasingly gaining traction.

UR-Energy (NYSE: URG) - This producer of uranium for nuclear power production has 60% of its production sold at prices that will yield attractive margin for the next several years. Given the potential for political disruption that could be caused by low oil prices, (particularly in resource-dependent developing economies such as former Soviet bloc countries, which supply 40% of uranium used by U.S. utilities), this uranium miner with low production costs could be an attractive hedge for a potential "black swan" event.

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Best Idea Profile:

Cosi Inc. (NASDAQ: COSI)

DESCRIPTION:

With a name inspired by Mozart's famous opera, *Così fan tutte*, Cosi Inc. (NASDAQ: COSI) has 78 company-owned and 32 franchised fast casual restaurants in 16 states, the UAE and Cost Rica.

The restaurant menu includes sandwiches, soups, hand-tossed salads, and pizza with a focus on healthy and quality ingredients. Flat bread, which is a signature item for the chain, is baked fresh in restaurant every 20 minutes in a hearthstone oven and used in sandwiches and pizza. Restaurants serve breakfast, lunch and dinner and have an average ticket price of approximately \$9.25

The Company was founded in 1998 and after it came public in 2002 it has struggled to find direction and post profits. Since its IPO, it has been under the leadership of six different CEOs and has accumulated \$318 million in losses.

However, in March 2014, the Company brought in its most successful franchisee, R.J. Dourney, as CEO. Mr. Dourney, who owned and operated 13 very successful and profitable franchised units in Boston, has been leading an effort to apply the same practices that drove the success of his franchise units across the entire chain.

Cosi Inc. (Nasdaq: COSI) Investment Data (as of 8/28/15)

Recent Price	\$1.17
52-Week Range	\$0.96 - \$2.94
Fiscal Year End	December
Dividend	N/A
Yield	N/A
Shares Outstanding	48.2 M
Average Trading Volume (3 mos)	150 k
Market Capitalization	\$56 M
Cash	\$14 M
Long-term Debt	\$11M
Enterprise Value (EV)	\$53 M
Book Value	\$0.53
P/ Book	2.5 x
TTM Revenue	\$339 M
EV/ Revenue	2.2 x
TTM EPS (consensus)	-\$0.53
P/ EPS	N/A
TTM EBITDA	-\$9.4 M
EV/ EBITDA	N/A

Mossberg's Investor Digest

KEY INVESTMENT CONSIDERATIONS:

Turnaround plan puts first profits in 14 years on the horizon... R.J. Dourney took over as CEO of Cosi in March of 2014, inheriting a Company that has not made an annual profit since its IPO in 2002 and had turned over its leadership role 5 times, or once every 2 1/2 years. However, he also inherited a company that had an established brand known for its offering of healthy, quality and good tasting food. Coming into the role, Mr. Dourney had owned and operated 13 franchise locations in the Boston area for eight years, among the few profitable units in the entire chain. Prior to becoming a Cosi franchisee, Mr. Dourney had extensive experience including joining Brinker's Chili's concept during its rapid growth phase in the 80's, a stint at Applebee's in the mid-90's and helped lead a turnaround at Au Bon Pain in the early 00's.

- **Exit unprofitable units** – A month after taking the reins, the Company shut down 10 unprofitable units that had been responsible for losses in excess of \$1.8 million in the previous 12 months. To lower its occupancy costs, the Company has also engaged Hilco Real Estate, a firm that specializes in negotiating better lease terms,
- **Taking what was successful in the Boston and applying it across the chain** – On average, the restaurants in Boston that were run by Mr. Dourney delivered \$1.7 million in annual sales and north of 20% four-wall profitability. Comparatively, stores in the rest of the system had been averaging \$1.1 million and were unprofitable. While there is plenty of room for continued improvement, taking the practices and operating systems that are successful in Boston and spreading them throughout all of Cosi has already delivered results. During 4Q14 (2 quarters into the turnaround) for the first time in 10 quarters comp stores sales turned positive, and during 2Q15 (4 quarters into the turnaround) the Company turned cash flow positive at the unit level. Cash flow breakeven is expected for the entire company by December 2015.
- **The RIGHT Management that is rewarded the RIGHT way** – Since taking over, Mr. Dourney has assembled a talented leadership team including a new VP of Human Resources, VP of Operations, VP of Information Technology and Chief Financial Officer. To align management with shareholder interests, the compensation philosophy offers lower cash/ higher stock compensation for senior staff.
- **Deploy Robust Systems** – With just 110 stores, Cosi can very quickly react and deploy new technologies that make it more efficient, improve throughput and create opportunities to sell more without adding additional expenses. For example, the Company has implemented online ordering system, and has plans for self-service kiosks, curbside to go, as well as inventory management tools.
- **Lower Overhead Costs** - The plan calls to lower corporate overhead to approximately \$9 million, which is \$3 million to \$5 million lower than spending levels from the past 5 years.
- **Give the stores a face lift** – All Company-owned stores (except the Boston Units) will receive a partial remodel by 1Q16, which will include a refresh to the store image and layout. An average of \$50,000 will be spent to refresh each store, which is expected to generate a 10% sales lift with an incremental 40% incremental contribution margin. Based on a \$1.3 million average unit volume, the refresh project should have a payback in a year or less.
- **Increase prices and average ticket size:** The Company plans to slowly implement price increases and encourage a mix shift to drive higher average ticket prices from \$9.25 to \$9.75 (5% combined effect). About half of the targeted increase will be driven by price and so far price increases in test restaurants has received zero pushback. The remaining half of the targeted ticket increase will come from putting a greater focus on programs such as "taste two", which encourages customers to purchase a half sandwich/ half salad/ and/or a side of soup.

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KEY INVESTMENT CONSIDERATIONS: (Continued)

Turnaround plan puts first profits in 14 years on the horizon... (cont.)

- **Re-ignite franchise growth with the RIGHT Franchisee Partners** – To attract and motivate the right Franchisees, it is imperative that the parent company demonstrate the potential for attractive and consistent returns can replicated in new and existing markets. Clearly Mr. Dourney has demonstrated success with his Boston units and is well under way in improving results system wide. Management has also articulated that it is taking a disciplined approach to attract franchisees with the right financial wherewithal, knowledge and operating savvy. Plans also call for the Company to focus on adding company-owned locations in certain markets where they are closer to reaching critical mass and offer franchisees new markets, as well as markets in which the company may only have one or two stores. In those cases, Cosi plans to sell its company-owned locations, which will provide incremental cash that can be reinvested in core company-owned markets and achieve greater returns.
- **Improving sales in all day parts:** While most of sales comes during the lunch hour, the company is looking to expand unit volumes by increasing sales in the breakfast and dinner day parts. For example, the company has recently parntered with Coffee Bean International and will be re-introducing coffee to customers to drive increased sales at breakfast.
- **Improving the food quality:** To maintain brand quality, the company has introduced several menu updates designed to offer customers ingredients that are “better for you”. Improvements include all-natural salad dressings, soups made with real stock and no additives, hand-crafted drinks, vegetarian-friendly oven roasted tofu, antibiotic/hormone-free chicken, and a new coffee.
- **Shrink size of the menu by 25%:** Cosi has shrunk the menu by roughly 25% while maintaining 99% of its customers. By removing slower moving items, the Company has simplified operations and made it easier for customers to get in and out of the busy restaurant. In addition, the Company is now well-positioned to introduce new items that can create incremental revenue.

Management Incentives are in the RIGHT place – In addition to senior management having significant emphasis on equity compensation, Mr. Dourney has significant ownership of the combined company. Earlier this year, Mr. Dourney sold his Boston franchise locations to the Company for 1.7 million shares. He took payment entirely in stock, which illustrates his confidence in the Cosi brand and ability to execute the turn around. Interestingly, Since July, three officers (including Mr. Dourney) and five directors have been buyers of the stock.

Secular growth in “Fast Casual” category relative to QSR and Casual dining – While the restaurant business is highly competitive with low barriers to entry, there is ample room for growth in the fast casual category relative to the quick service and casual dining segments which have dominated the industry for the past 30 years. According the Buxton Group, the “Fast Casual” category will grow at 10% this year and generate \$35 billion in sales during 2015, representing just 5% of the \$710 billion in annual restaurant sales.

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KEY INVESTMENT CONSIDERATIONS: (Continued)

Significant long-term growth potential – Cosi has significant growth opportunities from multiple areas of its business model.

- **The Cosi brand could support 10-fold expansion in # of doors over time** – There is a significant amount of white space for Cosi to expand in the U.S. and internationally. With only 110 stores in 16 states and two countries, the Company has opportunities to expand into new states/ countries, as well as further penetrate its existing markets. Relative to Panera Bread and Chipotle with roughly 1,900 North America locations each, it's not unreasonable to assume the Cosi brand could grow to 800 to 1,000 locations over a longer period of time. From its current store count, the company would have to grow units by 25% annually for the next 10 years to reach 1,000 units.
- **Same store sales growth potential** – On an average unit volume basis, there is no reason Cosi could not eventually be on par with Panera (\$2.1 million) and Chipotle (\$2.3 million). With the initiatives being implemented in the turnaround plan, it is certainly reasonable that all of Cosi's units could approach the average unit volumes of Cosi's Boston units, which are \$1.7 million. An annual same store sales growth of 10% would allow the company to achieve this level in two years.

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Valuation

Significant upside potential with limited downside in the next two years - Over the next couple of years, using base level assumptions (highlighted below) investors could see significant upside. The table below illustrates how our "back of the envelope" calculation yields \$0.16 in EPS for 2017. A 20x multiple of earnings would yield a stock price of \$3.15, which equates to potential upside of 170%. With a recent capital infusion and reaching cash flow breakeven on a unit level during the second quarter, there seems to be limited downside risk. In addition to clearly demonstrating traction with its turnaround plan, the \$250 million NOL provides a backstop for valuation that approaches the current market cap of the stock.

Potential for well above average long-term capital appreciation - Before I get carried away, I should note that most small companies that are on a long-term growth plan will likely hit speedbumps along the way that may cause inconsistent performance and variability in the stock price. However, looking beyond the next couple of years, as Mr. Dourney and his management team prove their ability to execute against the opportunity to fill out the brand in 1,000+ locations in the U.S. and internationally, this name could be a core long-term holding for any portfolio and deliver above average returns for the next 10 years. If we assume a mix of 50% company-owned and 50% franchise units and an average unit volume of \$1.7 million (consistent with the Boston stores), Cosi would generate roughly \$900 million in revenue. Conservatively assuming a 16% operating margin on Company owned stores and \$30 million in cooperate overhead, the company would generate \$150 million in operating profit. Making further assumptions that the company raises equity capital to support growth (increasing the share base by 50%), and pays a 40% tax rate (It won't pay taxes until it exhausts its \$250 million NOL), EPS would be \$1.20 per share. Assuming the same valuation multiple of 20x earnings yields long term price of \$24 per share, which is the equivalent of a 10-year compound return of 35% relative to the current valuation.

Back of the Envelope Assumptions:

- **Revenue Growth:** We assume in two years the average unit volume across all company-owned units will be able to reach \$1.7 million, which is consistent with the Boston stores. Average unit volumes from franchisee units are assumed to reach 80% of company-owned units. We assume a net 2 new Company-owned stores and approximately 10 new franchise stores are added each year.
- **Profitability:** Cost of Sales are expected to increase to 30% as the mix includes a greater portion of higher-cost ingredients and labor costs are expected to decrease to 32% of sales as the restaurants gain efficiencies. Occupancy and other costs as well as D&A costs are expected to remain in line with current per unit levels. G&A is expected to remain flat at \$9 million, which is consistent with management's run rate guidance for 2015.

		2017			
Revenue				Expense/ Profit	
# of Doors	80	30%		COGS	41
Average Unit Volume	1.7	32%		Labor	44
Restaurant Sales	136			Occupancy and Other	35
				G&A	9
# of Doors	60			D&A	3
Average Unit Volume	1.4				132
Franchise Revenue	4.9			Interest expense	1
Total Revenue	141			Net Income	8
				Shares Outstanding	50
				EPS	0.16

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Mossberg's Investor Digest Idea Performance

The table below shows the relative change in the value of the ideas published since November 2014 and the Russell 3000. **Performance data quoted represents past performance and does not guarantee future results.** Current performance of ideas may be lower or higher than the performance quoted.

Company	Pub. Date	Original Price	Recent Price	Change	Russell 3000 Change Since Pub. Date	Relative Perf. vs. Russell 3000	
Chemtura Corporation (NYSE:CHMT)	6-Nov-14	\$23.38	\$27.20	16.3%	-2.4%	20.1%	
Hilltop Holdings Inc. (NYSE:HTH)	11-Nov-14	\$21.14	\$20.65	-2.3%	-2.8%	1.8%	
Bravo Brio Restaurant Group, Inc. (NASDAQqs:BBRG)	24-Nov-14	\$13.15	\$12.75	-3.0%	-4.2%	2.3%	
Alamo Group (NYSE: ALG)	26-Nov-14	\$48.83	\$51.49	5.4%	-4.4%	10.9%	
PGT, Inc. (NASDAQ:PGTI)	12-Dec-14	\$9.00	\$13.37	48.6%	-0.9%	50.8%	
Unilife Corporation (NASDAQ:UNIS)	15-Dec-14	\$2.72	\$1.22	-55.1%	-0.2%	-53.5%	
The Dixie Group, Inc. (NASDAQ:DXYN)	19-Dec-14	\$9.21	\$9.99	8.5%	-4.2%	13.8%	
Points International Ltd. (NASDAQ:PCOM)	20-Dec-14	\$12.86	\$9.10	-29.2%	-4.2%	-23.9%	
Cascade Microtech Inc. (NASDAQ:CSCD)	19-Jan-15	\$14.02	\$15.42	10.0%	-2.0%	13.4%	
Quanex Building Products Corporation (NYSE:NX)	20-Jan-15	\$18.53	\$17.95	-3.1%	-2.1%	0.3%	
Ballantyne Strong, Inc. (NYSE:BTN)	27-Jan-15	\$4.15	\$4.80	15.7%	-2.8%	18.8%	
InfuSystem Holdings, Inc. (NYSE:INFU)	29-Jan-15	\$2.71	\$2.80	3.3%	-2.3%	6.7%	
EXO U Inc. (EXO.V)	23-Feb-15	\$1.65	\$0.24	-85.8%	-6.4%	-79.9%	
Liquidity Services, Inc. (LQDT)	24-Feb-15	\$9.79	\$7.50	-23.4%	-6.7%	-15.9%	
Smith & Wesson Holding Corporation (NASDAQ:SWHC)	25-Feb-15	\$12.89	\$18.08	40.3%	-6.6%	47.8%	
Actua Corporation (NASDAQ:ACTA)	26-Feb-15	\$16.47	\$14.23	-13.6%	-6.5%	-6.2%	
MA-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI)	28-Mar-15	\$35.81	\$29.51	-17.6%	-4.7%	-12.4%	
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	\$10.38	\$10.93	5.3%	-5.4%	11.4%	
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	\$0.27	\$0.28	3.7%	-6.5%	10.8%	
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	\$26.87	\$24.51	-8.8%	-4.8%	-3.7%	
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	\$13.43	\$10.56	-21.4%	-6.4%	-14.8%	
				Average	-5.1%	-4.1%	-0.1%

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The value proposition of the digest is essentially an "Idea Generator". During the course of my 18-year career in capital markets, I've had the chance to meet and work closely with some very smart professional investors who have consistent track records of outperforming the market indexes. Some of these investors, which include mutual fund managers, hedge fund managers, and other professional investors, are kind enough to share their best ideas with me. I conduct my own analysis of their ideas and publish summaries of those ideas I think represent timely investment opportunities. Over time, I trust the majority of these ideas will pan out and help subscribers generate index-beating returns.

The goal of the Best Idea Profiles in this newsletter is to briefly describe the most relevant investment merits and risks of a company. It is not intended to be an exhaustive report including every detail. With limited space available, I am forced to include only those data points that I feel are most important for subscribers to know before they begin their own due diligence. Thank you for your interest in Mossberg's Investor Digest.

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