

Mossberg's Investor Digest

December 2015

From the Editor...

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

Founded nearly 20 years ago in St. Louis, **Build-A-Bear (NYSE: BBW)** has a unique retail-tainment concept in which customers are able to "make-your-own stuffed animals" in the store. Customers have an interactive entertainment experience as they visit a variety of stations in order to make and customize their own stuffed animal. Over 2.5 million kids celebrate their birthday every year at one of Build-A-Bear's 350 locations. By the way, this is something you can't do with your kids by shopping on Amazon.

While there is room for improvement, BBW turns inventory about 4x per year and has total asset (less cash) turnover of 3x per year. This performance is at or above other specialty retailers like the GAP, Tractor Supply, Hibbett Sports, and Cabela's, among others. As profit margin and returns continue to improve, BBW should garner greater attention from investors and a higher valuation multiple.

Currently trading at 4.5x EV/ EBITDA, BBW has an attractive multiple considering the strength of its brand and return characteristics. Assuming 50 basis points of margin expansion and growth of 5% annually, EBITDA can grow by approximately 50% over the next three to five years. As investors begin to realize the growth and attractive returns characteristics of this business, it is likely to receive a much higher multiple of 8 to 10x, which is more in line with comparable companies. Applying these multiples would yield a valuation two to three times that of the current price over the next three to five years.

As always, I appreciate your feedback.

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

Air Transport Services Group, Inc (Nasdaq: ATSG)- Air Transport Services Group, Inc. is a leading provider of air cargo transportation and related services to domestic and foreign air carriers and other companies that outsource their air cargo lift requirements. ATSG provides the world's only comprehensive source of turn-key solutions for customers seeking midsize freighter services. Through its principal subsidiaries, including two airlines with separate and distinct U.S. FAA Part 121 Air Carrier certificates, ATSG provides air cargo lift, aircraft leasing, aircraft maintenance services, and airport ground services.

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Best Idea Profile:

Build-A-Bear Workshop Inc. (NYSE: BBW)

DESCRIPTION:

Over 2.5 million kids celebrate their birthday every year at one of Build-A-Bear's 260 locations in North America, 60 in Europe and/or in 70 international franchised locations. Founded nearly 20 years ago in St. Louis, Build-A-Bear (NYSE: BBW) has a unique retail-tainment concept in which customers are able to "make-your-own stuffed animals" in the store. Customers have an interactive entertainment experience as they visit a variety of stations in order to make and customize their own stuffed animal. By the way, this is something you can't do with your kids by shopping on Amazon. If you have children that are in, or are already through elementary school, odds are that there is a Build-A-Bear stuffed animal in your household.

There is some seasonality to the Company's business but less than you might expect. Relative to the second and third calendar quarters, the first and fourth quarters generally make up five percentage points more of annual revenue, respectively. This is primarily due to customers visiting the stores for multiple reasons including birthday parties, which represent approximately one third of sales.

The Build-A-Bear brand scores high on brand awareness and loyalty. Aided awareness is 96%, the Company has over 4 million active loyalty club members, and scored 85% on a Burke Inc. loyalty index, which incorporates ratings of earned loyalty, likelihood to recommend, likelihood to repurchase, overall satisfaction and preferred company. Comparatively, retail brands such as American Girl, Disney, Lego and Toys "R" Us scored from 75% to 82%.

Build-A-Bear Workshop (NYSE: BBW)

Investment Data (as of 12/28/15)

Recent Price	\$11.72
52-Week Range	\$11.18 - \$23.00
Fiscal Year End	December
Dividend	N/A
Yield	N/A
Shares Outstanding	16.4 M
Average Trading Volume (3 mos)	260,000
Market Capitalization	\$193 M
Cash	\$39 M
Long-term Debt	-
Enterprise Value (EV)	\$156 M
Book Value	\$5.68
P/ Book	2.1 x
TTM Revenue	\$392 M
EV/ Revenue	0.4 x
FY16 EPS (consensus)	\$1.03
P/ EPS	11.4
TTM EBITDA	\$40 M
EV/ EBITDA	3.9x

Company has approximately 900 full-time and 3,400 part-time employees in the United States, Canada, the United Kingdom and Ireland. Having the right people to manage and work in the stores and keeping them happy is critical to maintaining high loyalty ratings. According to Fortune Magazine, the Company was one of the 100 Best Companies to Work in 2015, the seventh year in a row. BBW was one of the top 5 retailers on the list.

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KEY INVESTMENT CONSIDERATIONS:

Why is this a good business? - As online retail continues to grow in popularity, it seems that most retailers with a physical presence are going to have a hard time surviving, much less competing with online retailers. I've given this some thought and have identified six (there may be more) attributes that physical retailers must have in order to successfully compete. To varying degrees Build-A-Bear has five of the six... and the sixth one isn't relevant in this case.

- 1) **Create a reason to come to the store that involves a positive experience** – Customers go to BBW to have an experience... it's fun for the kids and rewarding for the parents to see their children have a good time. An online retailer can't compete against that.
- 2) **Have your own brand and source your own products** – There is a reason why people are willing to pay \$3 for a Starbucks cup of coffee, or \$200 for a pair of Oakley sunglasses. People know and trust the brands. As I explained in the intro, Build-A-Bear has a well-known brand and is well thought of by its customers. Having a strong brand and sourcing competencies, the business has greater control over its cost and inventory levels, as well as captures greater margin.
- 3) **Sell stuff that has a high profit margin** – I imagine the bill of materials for the average teddy bear is a few dollars. Compared to the average price point of \$10 to \$25, it's easy to see that this can be a high margin business. Build-A-Bear's gross margin in the mid-40's is among the highest of any specialty retailer.
- 4) **Have a physical presence that does not require a lot of investment** – Build-A-Bear performs very well with this attribute and I think it is something that most investors are missing. While there is room for improvement, BBW turns inventory about 4x per year and has total asset (less cash) turnover of 3x per year. This performance is at or above other specialty retailers like the GAP, Tractor Supply, Hibbett Sports, and Cabela's, among others. As profit margin continues to improve, with 3x asset turnover, each percentage point improvement in profit drives a three percentage point improvement in ROE. ROE improvement from the mid-teens to the high-teens/ low-20s should garner greater attention from investors and a higher valuation multiple. While recent costs related to new store openings were not available, it appears investment required for fixtures, equipment and leasehold improvements could be as little as \$400,000 to \$500,000, which would be half to a third of other specialty retailers. Also, because many of the stuffed animals are made custom in the store, there is less inventory required per store. Basically by having low costs associated with amortizing store related overhead, a greater portion each sales dollar can be allocated to improving quality, improving the customer experience and driving greater returns for shareholders.
- 5) **Exceptional execution** – There is a new management team that has already proven its ability to execute. There is greater detail on this later.
- 6) **Sell stuff that is perishable** – This one doesn't apply to BBW, but it seems like Amazon will have a hard time taking share from the "fresh section" of the grocery store. I doubt my wife will every order avocados, cantaloupe, and/or fresh fish online.

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KEY INVESTMENT CONSIDERATIONS: (cont.)

New Leadership

- **New CEO Sharon John** joined the company in May of 2013, replacing CEO and founder Maxine Clark, who continues to serve on the board of directors. Ms. John has 15+ years in the Toy industry having worked in leadership positions at Hasbro, Mattel and VTech Industries. Most recently she led a successful turnaround at Stride Rite Children's Group, closing underperforming stores, increasing licensing, and driving industry leading positive comp store sales while improving profitability. Since taking over the CEO role at BBW, Ms. John has led an impressive improvement in results. The third quarter marked the 5th consecutive quarter of improved same store sales, the 11th quarter of improved retail gross margin, and a 134% year to date improvement in pretax income.
- **Other Management Changes** – Since 2014, there has been a major refresh to the management team. Five of the top seven chief management positions are new to the company and the chiefs of merchandising, operations, product and finance have been created and/or replaced. With experience at Coca-Cola, Stride Rite, and American Eagle Outfitters, it appears that new management talent has more direct experience at much larger organizations.

Well Executed Turnaround Plan

- **Impressive improvement in results** - Since 2012, BBW has demonstrated a successful turnaround. In 2012, the company had an adjusted net loss of (\$10 million) (\$49 million loss actual) based on \$381 million in revenue. Comparing 2012 results to analyst 2015 expectations for \$16.5 million in net profit on \$393 million in revenue, represents a \$26.5 million swing in profitability based on just \$12 million improvement in revenue. Profit and sales improvements were driven by the following:
 - 1) **Selling more product at full price** led to an approximate 300 basis point improvement in gross margin. Past marketing efforts that focused on discounts and couponing to drive customer purchases have been replaced with brand-building marketing, and as a result, discounts were down 30% since 2012.
 - 2) **Maintaining SG&A expenses relatively flat** in relation to sales levels led to an approximate 200 basis point improvement in operating expenses as a percentage of revenue.
 - 3) **Closing underperforming stores and opening new store concepts** - From 2012 to 2014, the percentage of unprofitable stores improved from 22% to 2% and sales per square foot improved from \$350 to \$409 (a 17% increase). Illustrating the improvement in productivity, the revenue base has grown approximately 3% since 2012, while the amount of square footage has decreased by approximately 13%.

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KEY INVESTMENT CONSIDERATIONS: (cont.)

Growth Opportunities – With the impressive results of the turnaround plan, management is now turning greater focus to profitable growth.

- **New Products** – BBW is introducing new stuffed animals with its proprietary brand names. For example, Honey Girls-branded animals were introduced in 2015. YouTube videos featuring animated Honey Girls characters have been viewed 2.5 million times. Last year's successful introduction the Merry Mission Reindeer is another example of a new propriety brand. The Company is also increasingly licensing the Build-A-Bear Brand into new categories such as backpacks, candy, and clothes. During 2014, the company sold 500,000 back packs with the Build-A-Bear brand.
- **Store Expansion** – With the bulk of the stores now profitable, management plans to continue to tweak the real estate portfolio to cut out underperformers and replace with new store designs. More than 70% of stores have not been updated in the past 5 years, which leaves plenty of room for improvement. The company also plans to enter new global markets both through company-owned and franchise locations. Globally it's not unreasonable to expect the Build-A-Bear Brand to support 2x its current store base.
- **Opportunities for further margin expansion** – Build-A-Bear is well on its way to delivering high single digit EBITDA margin (8-10%) in 2015, but clearly there are opportunities to drive further improvement. Incremental contribution from outward bound licensing revenue, as well as a mix shift that includes a greater proportion of proprietary brands (instead of licensed) should contribute to higher gross margin. At the same time the infrastructure is in place, such that incremental growth should allow EBITDA to return to the low teens, implying approximately half a percentage point improvement each year. If this hold true, each incremental dollar of sales will contribute 25 cents in EBITDA.

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Valuation:

	2015	2018	2020
Revenue (in \$Millions)	390	451	498
EBITDA Margins	9%	10.5%	12%
EBITDA (in \$Millions)	35	47	57
Valuation Multiple	4.5	8	10
EV (in \$Millions)	156	379	572
Cash	40	70	90
Market Cap (in \$Millions)	196	449	662
Valuation per share		\$25	\$35

The Table above shows our back of the envelop calculation for a blended revenue growth rate of approximately 5% and EBITDA Margin expansion of approximately 50 basis points per year over the next three and five years

Currently trading at 4.5x EV/ EBITDA, BBW has an attractive multiple considering the strength of its brand and return characteristics. Assuming modest assumptions described above, and a reasonable 8x EV/EBITDA Multiple, the valuation could improve 2x to 3x over the next three and five years respectively.

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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 March 2015 and the Russell 2000. **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 2000 Change Since Pub.	Relative Perf. vs. Russell 2000
M/A-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI)	27-Mar-15	\$35.81	\$41.74	16.0%	-7.3%	23.3%
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	\$9.97	\$9.93	-0.6%	-5.8%	5.2%
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	\$0.27	\$0.27	0.0%	-7.8%	7.8%
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	\$26.87	\$27.97	3.4%	-8.3%	11.7%
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	\$13.43	\$11.49	-12.4%	-6.7%	-5.7%
Cosi Inc. (NASDAQ:COSI)	31-Aug-15	\$1.17	\$0.46	-61.0%	-0.8%	-60.2%
Calloway Golf Company (NYSE: ELY).	30-Sep-15	\$8.34	\$9.45	13.6%	4.4%	9.1%
New Gold (NYSE: NGD).	31-Oct-15	\$2.47	\$2.29	-6.7%	-1.1%	-5.6%
Townsquare Media (NYSE: TSQ)	30-Nov-15	\$11.43	\$11.59	3.4%	-4.0%	7.5%
				Average	-4.9%	-4.2%
					-0.8%	

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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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