

Mossberg's Investor Digest

July 2015

Issue #85

From the Editor...

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

This month's issue features, **Potbelly Corporation (NASDAQ: PBBP)**, Potbelly is a rapidly growing quick service restaurant chain that operates approximately 340 company-operated units in 26 states and approximately 30 franchised units in the U.S. and the Middle East. The company's serves fresh warm toasted sandwiches, salads, cookies and shakes/ smoothies. The company serves both lunch and dinner with 60% of its sales coming from lunch between 11:30 to 2:30 Monday through Friday.

The Company's held a \$100 million IPO in October 2013 at \$14 per share, and share prices quickly doubled, trading in a range \$25 to \$30 in the months after the offering. Shares slowly declined back to the offering price and have remained relatively flat in the \$13 to \$14 range since July last year when the company announced disappointing same store growth performance and lowered expectations. Same store sales trends have since recovered, the brand strength remains strong, and opportunities to deliver many years of double digit growth are very much intact.

Our back of the envelope calculation yields potential 70% upside in three years from current level and assumes no expansion of the current EV/EBITA of 10x. We feel this is a very conservative multiple and it's not unreasonable to assume that a growth concept with attractive returns could command a multiple in the mid-teens, which would provide upside closer to 150% in three 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 four of the ideas we heard this month, but have not reviewed in detail...

Dynamic Materials Corp. (NASDAQ: BOOM) - Based in Boulder, CO, DMC serves a global network of customers in the energy, infrastructure and industrials markets through two core businesses: NobelClad and Oilfield Products (DynaEnergetics). The NobelClad segment is the world's largest manufacturer of explosion-welded clad metal plates, which are used to fabricate capital equipment utilized within various process industries and other industrial sectors. DynaEnergetics is an international developer, manufacturer and marketer of advanced explosive components and systems used to perforate oil and gas wells.

Digital Turbine, Inc. (NASDAQ: APPS) - Digital Turbine works at the convergence of media and mobile communications, delivering end-to-end products and solutions for mobile operators, device OEMs and other third parties to enable them to effectively monetize mobile content. Digital Turbine's solutions are used by more than 31 million customers each month across more than 20 global operators.

National Instruments Corp. (NASDAQ: NATI) - National Instruments equips engineers and scientists with tools that accelerate productivity, innovation and discovery. NI's graphical system design approach to engineering provides an integrated software and hardware platform that speeds the development of any system needing measurement and control. The company's long-term vision and focus on improving society through its technology supports the success of its customers, employees, suppliers and shareholders

Douglas Dynamics, Inc. (NYSE: PLOW) - Douglas Dynamics is North America's premier manufacturer of vehicle attachments and equipment. Dynamics portfolio includes snow and ice management attachments for the commercial market. Douglas Dynamics has a proven track record of operational excellence and success, and strives to maximize long-term shareholder value, as evidenced by our consistent industry -leading dividend yields.

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Best Idea Profile:

Potbelly Corporation (NASDAQ: PBPB)

DESCRIPTION:

Potbelly is a rapidly growing quick service restaurant chain that operates approximately 340 company-operated units in 26 states and approximately 30 franchised units in the U.S. and the Middle East. The company's serves fresh warm toasted sandwiches, salads, cookies and shakes/ smoothies. The company serves both lunch and dinner with 60% of its sales coming from lunch between 11:30 to 2:30 Monday through Friday.

In 1977, the original founder Peter Hasting began serving sandwiches in the first Chicago location, which was an antique store, to drive traffic to the store. In 1996, Bryant Keil, who at the time was 31 years old, bought Potbelly from Peter Hastings for \$1.7 million. At the time, Potbelly had one location blocks away from the Lincoln Park Zoo and DePaul University and a loyal customer base that often lined up outside the store for fresh sandwiches.

Attracting growth capital from private equity firms, including from Starbucks Chairman Howard Schultz' Maveron Capital, Keil led the growth of the business to more than 200 locations before handing the reigns over to Aylwin Lewis, the Company's current chairman and CEO. Keil remains on the board and owns approximately 3% of the company.

The Company's held a \$100 million IPO in October 2013 at \$14 per share, and share prices quickly doubled, trading in a range \$25 to \$30 in the months after the offering. Shares slowly declined back to the offering price and have remained relatively flat in the \$13 to \$14 range since July last year when the company announced disappointing same store growth performance and lowered expectations.

Same store sales trends have since recovered, the brand strength remains strong, and opportunities to deliver many years of double digit growth are very much intact.

Potbelly Corporation (Nasdaq: PBPB)

Investment Data (as of 7/29/15)

| | |
|-----------------------------------|-------------------|
| Recent Price | \$13.43 |
| 52-Week Range | \$11.00 - \$16.64 |
| Fiscal Year End | December |
| Dividend | N/A |
| Yield | N/A |
| Shares Outstanding | 30.0 M |
| Average Trading Volume (3 mos) | 313 k |
| Market Capitalization | \$404 M |
| Cash | \$62 M |
| Long-term Debt | N/A |
| Enterprise Value (EV) | \$342 |
| Book Value | \$5.36 |
| P/ Book | 2.5 x |
| TTM Revenue | \$339 M |
| EV/ Revenue | 1.0 x |
| FY15 EPS (consensus) | \$0.29 |
| P/ EPS | 46.4x |
| TTM EBITDA | \$32 M |
| EV/ EBITDA | 10.7x |

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KEY INVESTMENT CONSIDERATIONS:

Significant growth Potential – Potbelly has significant growth opportunities from multiple areas of its business model. Since the company's existing operations generate significant cash flow, the company's growth plans are self-funding and should not require what could potentially be a dilutive equity financing. In addition, PBPB should be able to easily support 12% to 15% top line growth without the potential for diluting its brand with excessive franchising, or compromising same store sales comps in existing markets.

- **Same store sales growth potential** – The company struggled with same store sales comps in the first three quarters following its 2013 IPO, which have since recovered with solid comps in Q4 and Q1 (Q2 will be reported August 4). PBPB has multiple marketing initiatives that should support its target of low-mid-single digit comp store sales growth, as well as several opportunities to drive even faster growth. For example, currently approximately 15% of the company's sales are derived from "backline" (Catering, delivery and online orders). With comparable QSR chains posting 25% to 30% of sales from this area (According to QSR Magazine), it's possible PBPB could meet growth targets for the next several years just by expanding sales in this area alone. Another area for possible expansion is in the breakfast day part, which currently represents approximately 2% of sales (versus 60% for lunch, 18% mid-day and 20% dinner). While only about 1/3 of the shops are located in central business districts or transportation centers, where it makes sense to offer breakfast, there is opportunity to grow this day part.
- **Brand could easily support 3-fold expansion in # of doors in the U.S. alone** – There is a significant amount of white space for PBPB to expand in the U.S. with locations in less than 60% of the lower 48 states. Of those states, only six have more than 20 locations and eleven have less than 3 locations. Management believes that the brand can support up to 1,000 doors in the U.S. versus approximately 350 currently, and has plans to grow locations by 10% annually. While there are plenty of opportunities for growth in the U.S., there are also opportunities to expand the brand internationally. The Company signed its first franchisee in London during the first quarter and has 15+ locations in the Middle East. Relative to Quizno's 1,500 domestic and 600 international locations, Subway's 40,000+ locations in 110 countries and Jimmy John's 2,000+ domestic locations, PBPB's target seems very reasonable.

Leadership and recent changes – Potbelly has a deep bench of management talent and experienced board members.

- **Experienced Board Members** - Starbucks Chairman, Howard Schultz, invested early on in Potbelly through his venture-capital firm, Maveron, which currently has a more than eleven percent stake in PGPB. Maveron added Dan Levitan (co-founder of Maveron) and Peter Bassi, who is the former Chairman of Yum! Brands (KFC, Pizza Hut and Taco Bell) to the board.
- **Deep Bench of Management Talent** – CEO & Chairman, Aylwin Lewis has 26 years of experience in the Restaurant industry and was previously COO of Yum Brands and CEO of Sears Holdings.
- **Changes in Leadership** – Two of the senior management positions have turned over in recent quarters, which may be cause for some investor concern. However, it appears that in both cases the changes were unrelated to poor performance. CFO Michael Coyne, who has 30 years of financial experience with large companies including CNA Financial, Sears Holdings, and Schering-Plough, replaced Charles Talbot, who left to join AthleticCo, a private healthcare services company. SVP of Operations, Julie Younglove-Webb has worked in PBPB operations since December 2008 and as planned, took over the operating leadership role from her former boss who is now has a reduced work schedule.

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KEY INVESTMENT CONSIDERATIONS: (continued)

Attractive unit-level economics – The average capital required to open a 1,800 to 2,000 square foot location is approximately \$600,000. The target is for the average store location to generate 25% in return on invested capital. This is an attractive return considering that 60% of revenue comes from just one day part. Success in growing “backline” or other day parts should drive significant leverage and even further enhance unit level economics.

How to keep the wheels from coming off a rapidly growing restaurant chain – The restaurant business is highly competitive and PBPB faces stiff competition from other sandwich chains, as well as other QSR concepts. So how do they manage growth without putting returns and the company at risk?

- **Maintain the right mix of franchise- and company-operated locations** – PBPB plans to open 48 to 55 new shops during 2015, with 40 to 45 being company-operated and the remainder being franchisee locations. This represents about 12% to 15% growth from the prior year. Potbelly appears to be taking a page from the playbook of Starbucks and Chipotle, which have both derived a large part of their success by keeping the majority of their locations as company-operated. Too many fast-growing concepts use franchising to accelerate growth as it reduces the requirement for growth capital. However, growth primarily driven by franchising makes it more difficult to maintain food quality, consistent guest experience, leadership and staff culture, and creates greater risks of destroying shareholder value, damaging brand equity and long-term success. Having a growth strategy dominated by company-operated locations also lends credibility to attractiveness of store level economics. Case in point, if the unit level economics are above average, why would the parent company want to share them with a franchisee? They wouldn't...
- **Hire and retain happy people** – Potbelly's employee turnover ratio is approximately 70%, which is among the lowest in the quick service industry, which can see turnover rates as high as 150 to 400 percent. Besides the obvious benefit of improving customer experience, a happy workforce helps create lower costs and improved returns.
- **Don't compete on price** – Selling on promotion or discounting can drive improvement in near term results, but it can also create a downward spiral that is difficult to recover from and it can also compromise the Brand's image of using fresh and quality ingredients. By staying true to its brand image and not competing on price, Potbelly is more easily able to pass on price increases related to variable commodity costs or inflation.
- **Tasty Food** – Good tasting food is ultimately the most important factor in the success of the concept. I took this part of the due diligence very seriously and have eaten at the concept twice in the last week. I even “forced myself” to sample the cookies and the shakes, and I can firmly say the concept certainly meets this criteria. My co-workers and my three teenage sons (who eat a lot by the way) were all in agreement.
- **The “Neighborhood Sandwich Shop”** – This factor is probably the most difficult one to measure, but is also among the most important to drive long-term success. Potbelly says that it strives to be the “Neighborhood Sandwich Shop” and “Best place for Lunch”, which if successful drives repeat business and word of mouth among customers telling others about their positive experience. Perhaps one way to measure the success of this goal is to look at the company's advertising spending levels, which are near 2% of sales and compares favorably to normal spending levels among other quick service restaurant chains to 4% to 6%.

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Valuation

The table below illustrates how our "back of the envelope" calculation yields potential upside of 70% in the next three years based on the following assumptions:

Revenue Growth: We assume 10% growth in the number of locations, which is management targeted growth rate. We assume comp store sales growth of 3%, which is within the range of management expectations and we feel is conservative relative to opportunities to grow backline business and other day parts.

Profitability: We assume operating margin of 20%, which is in-line with historical trends and management's target. We also assume modest expansion in the EBITDA Margin of 130 basis points. As incremental contribution margin is leveraged over relatively fixed corporate costs, which we expect will grow at approximately ½ the pace of top line growth.

Balance Sheet: We assume that cash generated from operations is capable of supporting growth and excess cash balances and share counts will remained relatively unchanged.

EV/ EBITDA multiple: We assume no expansion of the current price multiple to yield a potential valuation of \$23, which is 70% greater than current levels. We feel this is a very conservative multiple and it's not unreasonable to assume that a growth concept with attractive returns could command a multiple in the mid-teens, which would provide upside closer to 150% above current levels.

| (In \$millions) | 2015 | 2016 | 2017 | 2018 |
|---|---------|---------|---------|---------|
| Number of Doors (beginning of the year) | 335 | 375 | 413 | 454 |
| Store Growth (10%) | 40 | 37.5 | 41 | 45 |
| Average Doors | 355 | 394 | 433 | 476 |
| Rev/ Door (in ,000s) | 1,049 | 1,081 | 1,113 | 1,147 |
| Comp Store Growth | 3% | 3% | 3% | 3% |
| Revenue | \$372 | \$426 | \$482 | \$546 |
| Operating Costs | 300 | 342 | 388 | 439 |
| Operating Margin | 20% | 20% | 20% | 20% |
| EBITDA | 38 | 45 | 54 | 63 |
| EBITDA Margin | 10.2% | 10.7% | 11.1% | 11.5% |
| Multiple | 10 | 10 | 10 | 10 |
| Enterprise Valuation | \$379 | \$455 | \$535 | \$628 |
| Cash | \$60 | \$60 | \$60 | \$60 |
| Market Value | \$439 | \$515 | \$595 | \$688 |
| Shares outstanding | 30 | 30 | 30 | 30 |
| Share Price Potential | \$14.64 | \$17.16 | \$19.85 | \$22.94 |
| Current Share Price | \$13.43 | \$13.43 | \$13.43 | \$13.43 |
| Upside Potential | 9% | 28% | 48% | 71% |

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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 | \$26.76 | 14.5% | 2.3% | 12.2% | |
| Hilltop Holdings Inc. (NYSE:HTH) | 11-Nov-14 | \$21.14 | \$22.66 | 7.2% | 1.9% | 5.3% | |
| Bravo Brio Restaurant Group, Inc. (NASDAQgs:BBRG) | 24-Nov-14 | \$13.15 | \$12.59 | -4.3% | 0.5% | -4.8% | |
| Alamo Group (NYSE: ALG) | 26-Nov-14 | \$48.83 | \$52.71 | 7.9% | 0.4% | 7.5% | |
| PGT, Inc. (NASDAQ:PGTI) | 12-Dec-14 | \$9.00 | \$15.57 | 73.0% | 3.9% | 69.1% | |
| Unilife Corporation (NASDAQ:UNIS) | 15-Dec-14 | \$2.72 | \$1.85 | -32.0% | 4.5% | -36.5% | |
| The Dixie Group, Inc. (NASDAQ:DXYN) | 19-Dec-14 | \$9.21 | \$10.36 | 12.5% | 0.5% | 11.9% | |
| Points International Ltd. (NASDAQ:PCOM) | 20-Dec-14 | \$12.86 | \$10.70 | -16.8% | 0.5% | -17.3% | |
| Cascade Microtech Inc. (NASDAQ:CSCD) | 19-Jan-15 | \$14.02 | \$14.59 | 4.1% | 2.7% | 1.4% | |
| Quanex Building Products Corporation (NYSE:NX) | 20-Jan-15 | \$18.53 | \$20.02 | 8.0% | 2.6% | 5.4% | |
| Ballantyne Strong, Inc. (NYSE:BTN) | 27-Jan-15 | \$4.15 | \$4.59 | 10.6% | 2.9% | 7.7% | |
| InfuSystem Holdings, Inc. (NYSE:INFU) | 29-Jan-15 | \$2.71 | \$3.12 | 15.1% | 2.6% | 12.5% | |
| EXO U Inc. (EXO.V) | 23-Feb-15 | \$1.65 | \$0.81 | -50.9% | 0.0% | -50.9% | |
| Liquidity Services, Inc. (LQDT) | 24-Feb-15 | \$9.79 | \$9.38 | -4.2% | -1.7% | -2.5% | |
| Smith & Wesson Holding Corporation (NASDAQ:SWHC) | 25-Feb-15 | \$12.89 | \$16.08 | 24.7% | -1.8% | 26.5% | |
| Actua Corporation (NASDAQ:ACTA) | 26-Feb-15 | \$16.47 | \$14.53 | -11.8% | -1.7% | -10.1% | |
| M/A-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI) | 28-Mar-15 | \$35.81 | \$33.26 | -7.1% | 0.7% | -7.8% | |
| Kimball International, Inc. (NASDAQ:KBAL) | 30-Apr-15 | \$10.38 | \$12.38 | 19.3% | -0.2% | 19.5% | |
| Ironclad Performance Wear Corp. (OTC:ICPW) | 30-May-15 | \$0.27 | \$0.28 | 3.7% | -1.2% | 4.9% | |
| Customers Bancorp, Inc. (NYSE: CUBI) | 30-Jun-15 | \$26.87 | \$25.39 | -5.5% | 0.8% | -6.3% | |
| | | | | Average | 3.4% | 1.0% | 2.4% |

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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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