Mossberg's Investor Digest

February 2016

From the Editor…

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

Headquartered in San Antonio, Texas**; Rackspace Hosting (NYSE: RAX)** helps small to large business customers in 120 countries migrate, host and manager their IT computing, storage, and applications assets in the Cloud.

In the 17 years since its founding, the Company has become a significant player in Cloud infrastructure market. Gartner consistently rates Rackspace in the leader quadrant for cloud-enabled managed hosting in North America. The Company differentiates it service offering form other larger providers of unmanaged cloud hosting such as Amazon Web Services (AWS) and Microsoft's Azure, by focusing on its managed cloud service offering, which includes support for migrating, hosting, and managing cloud infrastructure and the complex tools and application that run on top of it. Others offer more commoditized unmanaged cloud computing with access to raw cloud infrastructure, but then require customers to operate and managed that infrastructure themselves.

With a 4.5x EV/ EBITDA multiple it appears that investors have over-reacted to slower revenue growth rates. Based on our modest revenue and earnings assumptions along with multiple expansion to 7x, we believe the valuation could improve 2x to 3x over the next three and five years, respectively.

As always, I appreciate your feedback.

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February 2016 Issue

Issue #92

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

Meta Financial Group, Inc. (Nasdaq: CASH) - Meta Financial Group, Inc., is the holding company for federally chartered savings bank MetaBank. MetaBank operates in both the Banking and Payments industries. MetaBank's vision is to promote financial inclusion for everyone. In 2014, MetaBank was recognized as one of the top 100 performing banks in the United States compared to other banks its size. Meta Payment Systems consistently ranks as one of the top two prepaid card issuers in the United States and has the largest "white label" ATM network in the nation.

Hooker Furniture Corp. (Nasdaq: HOFT) - Hooker Furniture Corporation operates as a home furnishings marketing, design, and logistics company primarily in North America. It designs, imports, manufactures, and markets residential household furniture products. Incorporated in 1924 and ranked among the top ten largest publicly traded furniture producers based on shipments to U.S. retailers, Hooker Furniture is an importer of residential wood and metal furniture and a manufacturer and importer of upholstered furniture.

Clearfield, Inc. (Nasdaq: CLFD) – Clearfield is a leading provider of fiber optic management and connectivity solutions. Their patented technology significantly reduces the traditional costs associated with deploying, managing and scaling a fiber optic network. Their products connect homes and businesses in more than 500 communities around the world. Clearfield offers the industry's only fiber management and delivery platform offering scalability to align capital equipment expenditure alongside subscriber revenue through a single architecture.

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Best Idea Profile: **Rackspace Hosting, Inc. (NYSE: RAX)**

DESCRIPTION:

Headquartered in San Antonio, Texas; **Rackspace Hosting (NYSE: RAX)** helps small to large business customers in 120 countries migrate, host and manager their IT computing, storage, and applications assets in the Cloud. Among its 300,000+ customers, 69 are in the Fortune 100, 68% are US-based, and no single customer accounted for more than 2% of revenue. The Company employs 6,000 people, over half of which are Cloud Engineers.

In the 17 years since its founding, the Company has become a significant player in Cloud infrastructure market. Gartner consistently rates Rackspace in the leader quadrant for cloud-enabled managed hosting in North America. The Company differentiates it service offering form other larger providers of unmanaged cloud hosting providers such as Amazon Web Services (AWS) and Microsoft's Azure, by focusing on its managed cloud service offering, which includes support for migrating, hosting, and managing the cloud infrastructure and the complex tools and application that run on top of it. Others offer more commoditized unmanaged cloud computing with access to raw cloud infrastructure, but then require customers to operate and manage that infrastructure themselves.

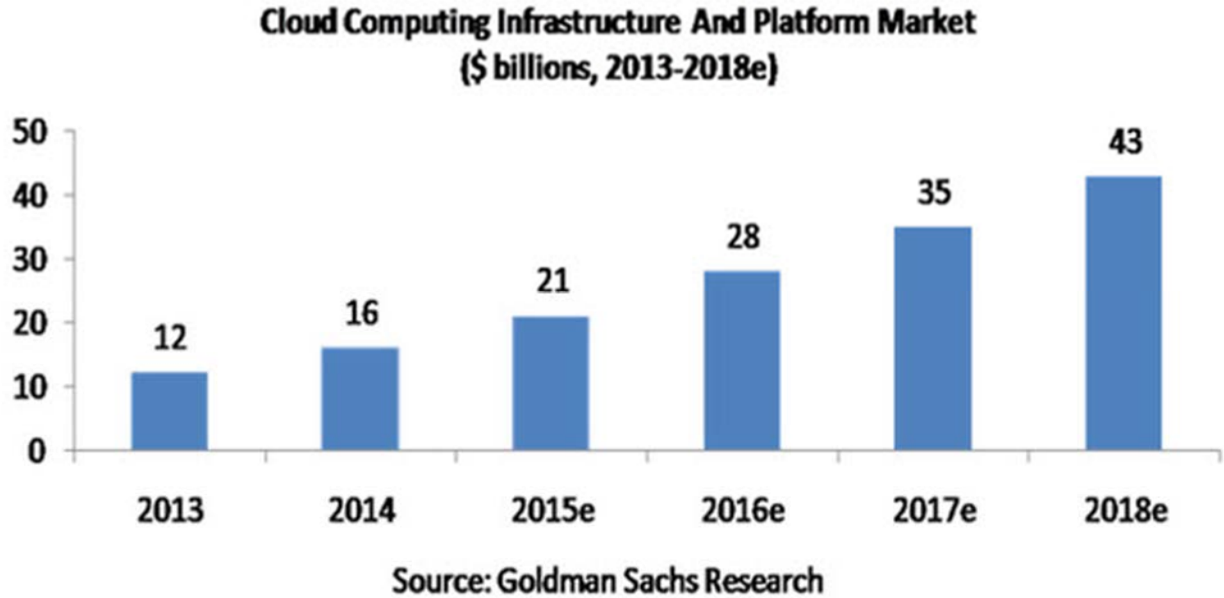
In addition to offering dedicated hosting and private clouds, the company has recently added support for managing public clouds using AWS and Azure. In addition, the company offers several data and applications services for managing email, ecommerce, collaboration, Data Storage, and managed security.

Rackspace Hosting, Inc. (NYSE: RAX)
Investment Data (as of 2/29/15)

Recent Price	**$21.54**
52-Week Range	$15.05 - $56.20
Fiscal Year End	December
Dividend	N/A
Yield	N/A
Shares Outstanding	131 M
Average Trading Volume (3 mos)	2.6 M
Market Capitalization	$2.8 B
Cash	$485 M
Long-term Debt	$656 M
Enterprise Value (EV)	$3.1 B
Book Value	$7.33
P/ Book	2.1 x
TTM Revenue	$1.8 B
EV/ Revenue	1.7 x
FY16 EPS (consensus)	$1.22
P/ EPS	17.7
TTM EBITDA	$684 M
EV/ EBITDA	4.5x

KEY INVESTMENT CONSIDERATIONS:

Attractive Secular Growth



According to Goldman Sachs the market for cloud computing infrastructure is expected to grow nearly 20% for the next three years and reach $43 Billion by 2018. According to Google's CEO Satya Pichai "Every business in the world is going to run on cloud eventually". According to Mark Hurd, the CEO of Oracle, "Virtually all Enterprise data will be in the Cloud by 2025."

This is a market that is moving past early adoption phase and into mainstream acceptance by corporate users. With just 80% of IT infrastructure still running in the corporate data center, there is a long runway for growth. Beside increasing comfort with using cloud infrastructure, there are several other factors driving adoption of outsourcing.

1) It offers a cost effective and capital efficient way to scale IT infrastructure of new business.
2) It makes sense to outsource less strategic areas, such as running the website and let in-house IT focus on strategic areas that differentiate the business.
3) Even if company wanted to do this internally, it is very difficult to find and retain people with expertise in cloud infrastructure.

Company Specific Growth Drivers

So if the market is growing at 20%, why isn't RAX keeping pace?
Revenue growth in the past year has slowed from the high teens to 11% during 2015 and is expected to be in the range of 6%-10% for 2016, which is likely the reason for the recent 60% decrease in RAX shares. The deceleration in growth is mostly due to an increase in competition from AWS, Microsoft Azure, IBM, HP and others. In the battle to be a leader in the cloud infrastructure market, larger players have cut pricing and accelerated competitive pressures in Rackspace's, more commoditized unmanaged cloud hosting service. Instead of competing directly, Rackspace management has looked for ways to differentiate and has implemented several new strategies that should allow growth to accelerate. These strategies have shown positive results so far, but it will likely be 2017, before new strategies contribute to a meaningful acceleration in growth.

Growth Drivers

- **Retain and grow existing business –** While increased competitive pressure may make it difficult for Rackspace to add new customers for its unmanaged cloud hosting service, it is less likely to increase the risk of losing existing customers. RAX enjoys a 99% retention rate, partially because of its outstanding customer service levels, but also because of the "Hotel California" effect of cloud infrastructure hosting. While it certainly is not impossible to change cloud hosting providers, the cost, effort and risk of disruption from moving from one vendor to another makes it very challenging.

- **If you can't beat them, join them –** Given the larger scale and financial resources of its larger competitors, it is unlikely that Rackspace would be able to effectively compete in the market for commoditized unmanaged cloud hosting service. To gain the efficiencies of scale in this market segment would require significant incremental capital investment, and given increasing pricing pressure, it is unlikely this new capital would be able to earn and attractive return. Instead management has implemented a strategy to partner with larger unmanaged cloud hosting providers such as AWS and Microsoft's Azure as a value added reseller. This strategy has several benefits.

    - ***Giving customer's choice of Best of breed –*** There are benefits and weaknesses of each of the cloud infrastructure providers, as well as Rackspace's hosting services. RAX strategy is to help customers choose, implement and maintain IT applications on the right cloud infrastructure to meet the specific needs of their customers' applications. This is a significant differentiator for customers who are increasingly looking to adopt a hybrid cloud model.

    - ***Expands Total Addressable Market –*** By partnering with AWS and AZURE, RAX now has the opportunity to provide incremental services to new customers who have already chosen to use alternative cloud hosting platforms. In addition, Rackspace now can resell cloud hosting platforms that might be a better fit for certain applications of its existing customers.

Company Specific Growth Drivers (continued) OpenStack

- ***Initial Success –*** In the first months of becoming an AWS reseller, RAX has signed up 100 customers, the majority of which were new to RAX. RAX has also had initial success in selling AWS to its current customers who previously were choosing AWS to provide support for incremental workloads. Previously these incremental sales were not being won by RAX.

- ***OpenStack -*** Rackspace was one of the early founders of OpenStack, which is an open-source software platform for cloud hosting. AWS and the Azure clouds are built on proprietary software code, but have more quickly reached scale and have more feature breadth than OpenStack. However, OpenStack open-source nature make it very appealing to certain users. OpenStack is transitioning from being a pure public cloud story to a platform for enterprise private clouds. According to Rackspace's CEO, "OpenStack is the most mature, and really the only viable private cloud". Given Rackspace experience with OpenStack, it is well positioned to benefit from growth as enterprises increasingly adopt private clouds.

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Focus on Driving Greater Returns

Pulling all of the levers to drive greater returns to shareholders – Based on investor messaging, clearly driving greater returns is a focus of management. To evaluate how management improves returns, I am a big fan of using the Du Pont Identity Method, or Decomposition Method. For those readers a little less familiar with the formula, here is a brief overview….

- **Measuring management effectiveness by decomposing returns –** No one should use any single financial metric to measure the value of a company, but understanding return on equity and how it is generated, is perhaps one of the most important factors to consider before making an investment. Essentially the Du Pont method breaks down the simple Return on Equity formula (net income divided by shareholders equity) into three parts. 1) Net Margin 2) Asset Turnover, and 3) equity multiplier.

$\frac{\text{Net Income}}{\text{Sales}}$ **(Net Margin)**	X	$\frac{\text{Sales}}{\text{Assets}}$ **(Asset Turnover)**	X	$\frac{\text{Assets}}{\text{Equity}}$ **(Equity Multiplier)**	=	$\frac{\text{Net Income}}{\text{Equity}}$ **(Return on Equity)**

By canceling out Sales and Assets the basic formula returns to net income divided by equity.

$\frac{\text{Net Income}}{\cancel{\text{Sales}}}$ **(Net Margin)**	X	$\frac{\cancel{\text{Sales}}}{\cancel{\text{Assets}}}$ **(Asset Turnover)**	X	$\frac{\cancel{\text{Assets}}}{\text{Equity}}$ **(Equity Multiplier)**	=	$\frac{\text{Net Income}}{\text{Equity}}$ **(Return on Equity)**

- Imagine that each of these parts is a lever that management can pull to maximize the returns to equity shareholders and the value of the business.

  Lever 1: Net Margin - Net Margin is the common metric that management teams focus on. Self-explanatory.

  Lever 2: Asset Turnover - This is an important metric that more management teams should focus on. Essentially it gives us how much sales a company can produce with a given amount of assets. Even though a company may have a low net margin, if they can turn their assets several times a year, then they can drive good returns. Think of a car dealer....A dealer sells cars on thin margin, let's say it's 5%. After he pays for variable, fixed and borrowing costs, a dealer clears 1%. However, if the average car sits on his lot for less than 30 days, he can make 1% 12 times per year, which can be an attractive return.

  Lever 3: Equity Multiplier - This is a measure of how much leverage management is using to drive returns. Getting terms from suppliers (accounts payable) is a good thing. Putting on too much bank debt can add more risk.

Focus on Driving Greater Returns (continued)

Let's review how Rackspace management is pulling each of these levers to improve returns.

Lever 1: Net margin – In an increasingly competitive environment it to maintain profit levels requires a mix shift to differentiated value added services and/or a strong control over costs. Despite recent competitive pressures and slower growth rates, management has successfully maintained net margins at 6% of sales for the last three years.

Lever 2: Asset Turnover

- **Reduce capital intensity** – Given its strategy to become a reseller of AWS and Azure, Rackspace has less pressure to keep pace with the required investment to achieve scale. As such, capital expenditures as a percentage of revenue have decreased to 23% of sales in 2015 down from 24% in 2014 and an average in the high-20's for the three years before that.

Lever 3: Equity Multiplier

- **Bring on a moderate level of leverage –** Historically the company has maintained what has been called a "lazy balance sheet", which implies that the company did not use even a moderate level of leverage to enhance returns. Given the strong level of recurring revenues and 99% customer retention rates, management decision to issue $500 million in corporate debt during late 2015 is a prudent one, which lowered the company's cost of capital and improve returns without adding significant amount of risk. Debt to EBITDA is now at a very conservative level of below 1X

- **Share repurchases –** The Company has actively been repurchasing shares. In 2014 and 2015, RAX repurchased 16.4 million shares (≈11%) of stock for $567 million at an average price of $34.57 per share. The company has an additional authorization to repurchase $633 million worth of commons stock, representing about 20% of its current market cap.

Valuation:

	2015	Growth Rate	2018		2020
Revenue (In $ millions)	2,000	10%	2,662		3,221
EBITDA Margin	34.2%		34.2%		34.2%
EBITDA (In $millions)	684		910		1,102
Valuation Multiple	4.4		7		7
Enterprise Value (In $ millions)	3,000		6,373		7,711
Cash	485		300		600
Debt	656		656		656
Market Cap	2,829		6,017		7,655
Shares Outstanding	131		111		113
Valuation Per Share	$ 21.57		$ 54.04		$ 67.54

The Table above shows our back of the envelop calculation for a blended revenue growth rate of approximately 10% and EBITDA margin remaining at current levels over the next three and five years. We also assume incremental cash and cash flow generation are used to reduce the outstanding share balance by 10% during the next three years and debt levels remain unchanged.

With a 4.5x EV/ EBITDA multiple it appears that investors have over-reacted to slower revenue growth rates. Our assumption of multiple expansion to 7x EV/ EBITA is reasonable given the company's opportunity for improving growth and returns. Given our assumptions, the valuation could improve 2x to 3x over the next three and five years respectively.

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)	28-Mar-15	$35.81	$37.67	5.2%	-16.4%	21.6%
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	$9.97	$10.65	6.8%	-15.0%	21.8%
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	$0.27	$0.25	-7.4%	-16.8%	9.4%
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	$26.87	$22.86	-14.9%	-17.3%	2.4%
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	$13.43	$12.61	-6.1%	-15.8%	9.7%
Cosi Inc. (NASDAQ:COSI)	31-Aug-15	$1.17	$0.65	-44.4%	-10.5%	-33.9%
Calloway Golf Company (NYSE: ELY).	30-Sep-15	$8.39	$8.97	6.9%	-5.8%	12.7%
New Gold (NYSE: NGD).	31-Oct-15	$2.47	$3.37	36.4%	-10.7%	47.2%
Townsquare Media (NYSE: TSQ)	30-Nov-15	$11.43	$9.80	-14.3%	-13.4%	-0.8%
Build-A-Bear Workshop (NYSE: BBW)	31-Dec-15	$11.72	$14.26	21.7%	-8.7%	30.4%
Dycom Industries, Inc (NYSE: DY)	31-Jan-16	$62.18	$57.00	-8.3%	0.2%	-8.5%
			Average	**-1.7%**	**-11.8%**	**10.2%**

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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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