

# Mossberg's Investor Digest

## From the Editor...

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

Headquartered in Minneapolis, **Select Comfort Corporation (Nasdaq: SCSS)** has a vertically integrated business model, in which it is the exclusive designer, manufacturer, marketer, retailer and servicer of Sleep Number® branded beds and accessories.

Differentiated from other manufacturers, the Company's beds allow consumers to program each side of the bed for individualized firmness and positioning. In the same way that wearable devices can monitor your heart rate and/or the number of steps you have taken, the Company has also incorporated biometric sensors and software applications that monitor sleep patterns and can make suggestions on adjusting the bed.

Financially, the Company is well positioned to produce above average returns for shareholders. The model generates high margins (60% gross margin) by selling a differentiated premium product and capturing the retailer margin. The investment in stores is relatively small and inventory is effectively 100% financed by getting attractive terms from vendors. As such, the Company requires limited investment to grow and generates significant cash flow. Only a third of operating cash flow is required to finance disciplined store growth (6%/year), leaving considerable excess cash generation. After meeting capex needs, the Company expects to generate \$500 million (40% of the current valuation) in excess cash flow from now until 2019, the majority of which will be used to repurchase shares and/or make acquisitions.

Shares have come under pressure in the past several days, falling 14% since Tempur Sealy (NYSE: TPX) announced that their 3rd quarter sales would decline 1% to 3%. TPX had previously expected growth in the mid-single digits and blamed weak consumer spending for the lower expectations. Regardless of near term weakness, we believe the SCSS is an exceptional long-term investment and the share price already reflects expected weakness.

Based on our back of the envelope calculations and an 11x EV/EBITDA multiple, we believe shares could be worth more than \$60 by 2019.

As always, I appreciate your feedback.

Dave Mossberg  
[Dave@mossbergid.com](mailto:Dave@mossbergid.com)

## September 2016 Issue

Issue #99

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...

### **Spring Bank Pharmaceuticals, Inc. (Nasdaq: SBPH)**

- Spring Bank is a clinical-stage biopharmaceutical company engaged in the discovery and development of a novel class of therapeutics using its proprietary small molecule nucleic acid hybrid, or SMNH, chemistry platform. SMNH compounds are small segments of nucleic acids that are designed to selectively target and modulate the activity of specific proteins implicated in various disease states. The Company is developing its most advanced SMNH product candidate, SB 9200, for the treatment of viral diseases, including hepatitis B virus, or HBV.

### **Pure Cycle Corporation (Nasdaq: PCYO)**

- Is a vertically integrated wholesale water and wastewater service provider that contracts with landowners, land developers, home builders, cities and municipalities to design, construct, operate and maintain water and wastewater systems. As a vertically integrated wholesale service provider, they own all assets necessary to provide water and wastewater services to customers. They operate in three segments. Wholesale water business, Service business and Farming.

### **Park-Ohio Holdings Corp. (Nasdaq: PKOH)**

- ParkOhio provides the strategic services and products that allow the world's leading manufacturers to streamline their manufacturing processes and focus their core competencies on the production of more efficient and high quality products. ParkOhio is an industrial supply chain logistics and diversified manufacturing business operating in three segments: Supply Technologies, Assembly Components, and Engineered Products. Their businesses operate approximately 90 manufacturing, distribution, and service facilities, and employ approximately 6,000 people worldwide. Revenues totaled approximately \$1.46 billion in 2015. With a customer base consisting of many of the Global 2000 infrastructure and business/personal/household products companies, the opportunities for growth are increasing for them every day.

# Mossberg's Investor Digest

## Best Idea Profile:

## Select Comfort Corporation (Nasdaq: SCSS)

### DESCRIPTION:

Headquartered in Minneapolis, **Select Comfort Corporation (Nasdaq: SCSS)** has a vertically integrated business model, in which it is the exclusive designer, manufacturer, marketer, retailer and servicer of Sleep Number® branded beds and accessories.

Differentiated from other manufacturers, the Company's beds allow consumers to program each side of the bed for individualized firmness and positioning. In the same way that wearable devices can monitor your heart rate and/or the number of steps you have taken, the Company has also incorporated biometric sensors and software applications that monitor sleep patterns and can make suggestions on adjusting the bed. Beds are in the premium category and offered in good, better best price ranges starting at \$799. The average revenue per bed is just over \$4,000.

The Company sells its products exclusively through its 500+ Sleep Number stores, or through its website at [www.sleepnumber.com](http://www.sleepnumber.com).

Financially, the Company is well positioned to produce above average returns for shareholders. The model generates high margins (60% gross margin) by selling a differentiated premium product and capturing the retailer margin. The investment in stores is relatively small and inventory is effectively 100% financed by getting attractive terms from vendors. As such, the Company requires limited investment to grow and generates significant cash flow. Only a third of operating cash flow is required to finance disciplined store growth (6%/year), leaving considerable excess cash generation. After meeting capex needs, the Company expects to generate \$500 million (40% of the current valuation) in excess cash flow from now until 2019, the majority of which will be used to repurchase shares and/or make acquisitions.

The Company employs approximately 3,500 people.

### Select Comfort Corporation (Nasdaq: SCSS)

Investment Data (as of 9/30/16)

<b>Recent Price</b>	<b>\$22.51</b>
52-Week Range	\$14.28 - \$28.34
Fiscal Year End	December
Dividend	N/A
Yield	N/A
Shares Outstanding	45.9 M
Average Trading Volume (3 mos)	540,000
Market Capitalization	\$988M
Cash	\$2.4M
Long-term Debt	\$16M
Enterprise Value (EV)	\$1.0B
TTM Revenue	\$1.2B
EV/ Revenue	0.8x
TTM Adjusted EBITDA	\$94 M
EV/ EBITDA	10.6x
2016 EPS Consensus Est.	\$1.24
P/2016E	18.2x

Shares have come under pressure in the past several days, falling 14% since Tempur Sealy (NYSE: TPX) announced that their 3<sup>rd</sup> quarter sales would decline 1% to 3%. TPX had previously expected growth in the mid-single digits and blamed weak consumer spending for the lower expectations. Regardless of near term weakness, we believe the SCSS is an exceptional long-term investment and the share price already reflects expected weakness.

# Mossberg's Investor Digest

## KEY INVESTMENT CONSIDERATIONS:

### Attractive Returns

**Select Comfort has attractive unit level economics.** On average, each store generates approximately \$2.4 million in annual sales each, or about \$1,000 per square foot. In comparison, according to Furniture Today, the median sales per square foot for the top 100 furniture stores was \$270. At 60% gross margin, the Company is generating \$600 per square foot in gross profit, more than 2x the sales of a typical furniture store.

While revenue production is impressive, the limited amount of investment required is even more impressive. While specifics were not available, if we assume 2/3 of capex spending is directed at new store growth, the average store buildout requires an investment of less than \$1.5 million, and inventory investment per store is less than \$175,000. To put that into in perspective, they are generating more than \$1,000 per square foot of sales and \$600 in gross profit, with an inventory investment of \$80 per square foot and store build-out cost of about \$600.

**Why negative working capital is a good thing** - As of the end of the second quarter, SCSS had \$145 million in current assets (excluding cash) and \$190 million in current liabilities (excluding borrowings), which equates to a negative working capital balance of (\$45 million). In effect, SCSS is being paid for the sale of its products before it has to pay for the production of its products, which means there is less investment in working capital required. This is a good thing for two reasons. 1) Significant growth can be supported without a need to raise potentially dilutive capital. 2) Every incremental dollar of profit can be supported by less investment, creating greater returns for equity holders.

- **Inventory** – Inventory turns at 10x per year. Even though the average store is selling less than 2 beds per day, there is very limited amount of inventory required per store, essentially display units. The rest of inventory is located in distribution centers, which allows for delivery times to customers of 5 to 14 days.
- **Receivables** – AR DSOs are about 10 days, which represents the time it takes to clear transactions through private-label financing companies and or credit cards. Just under 50% of sales are financed through a private-label consumer credit facility from Synchrony bank. The remaining sales are financed through a secondary private label program, or paid for via cash or credit card.
- **Customer prepayments finance ≈30% of inventory** – The Company receives pre-payments from customers that equate to approximately 10% of sales for each quarter. At \$25 million, prepayments equal about 30% of inventory investment.
- **Accounts Payable** – AP Days are 70+, which essentially means that SCSS has more than 70 days to pay its vendors. Combined with prepayments, the company is able to finance 100% of inventory receivables.

# Mossberg's Investor Digest

## New ERP system

**Unanticipated difficulties** – As the old adage says, ERP systems usually ‘cost twice as much and take twice as long to implement as originally anticipated’. Last year, the Company implemented a new ERP system and ran into typical implantation issues, which caused delivery delays, lost sales and higher costs from cancellations, appeasements and returns. As a result, financial results suffered in 2015 and the first half of 2016. The implantation was completed at the end of the first quarter and is now behind them.

### Expected Benefits

Despite the pain of transitioning from their 20-year-old system, the new ERP system is expected to provide significant benefits to the Company.

- **Improve profitability** - 50 to 100 basis point margin improvement during 2016 and 2017
- **Improve customer service, while maintaining low levels of working capital investment** – In the past 2 years, the Company has migrated from manufacturing beds on a “just-in-time” basis to hybrid “make-to-stock” model, in which the bestselling products are forward stocked in distribution centers. The new ERP system will enable this hybrid model to deliver products to customers in less than 7 days, without significantly impacting required levels of inventory investment.

## Aggressive Store Growth

**Only vertically integrated player** – Sleep Number is the only major bed manufacturer that has a vertically integrated retail system.

**Plenty of room for growth** – Among Bed manufacturers, Sleep Number is a distant third with 5% market share compared to the top two players Tempur Sealy (NYSE: TPX) and Advent International (Private equity firm that owns Serta and Simmons) that command a combined 70% share. On the retailer side, the market is much more fragmented, with the top two players only controlling 19% of the market and Sleep number coming in at 7% market share.

**5% to 7% store count growth without cannibalizing sales per store** – With approximately 500 stores in the U.S., the Company has plans to expand its store base by 5% to 7% per year, which should result in about 650 stores over the next four years. As shown in the chart below from the Company's investor presentation, through advertising efficiencies and new store designs/ formats, SCSS is able to increase penetration in certain markets while increasing the sales/ profit contribution from each store.



We attempt to provide subscribers with reasoned opinions based on our analysis of publicly available information from sources believed to be reliable, but make no representations as to its accuracy or completeness. Best Idea profiles are not based upon individual needs of subscribers nor are they an offer to buy or sell securities. Additional disclosures can be found under the Disclosures portion of the Mossberg's Investor Digest website.

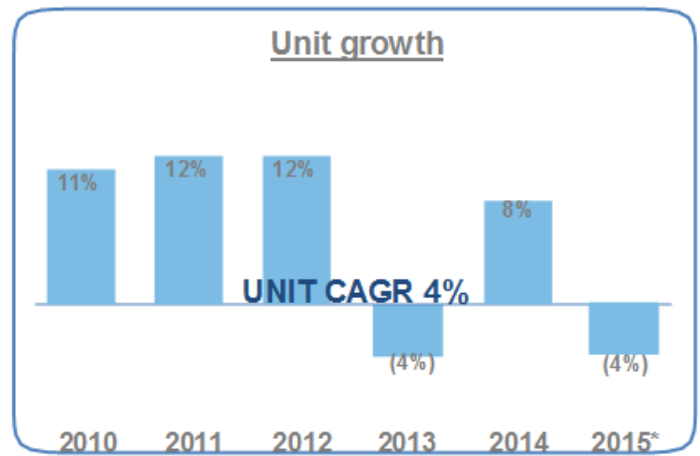
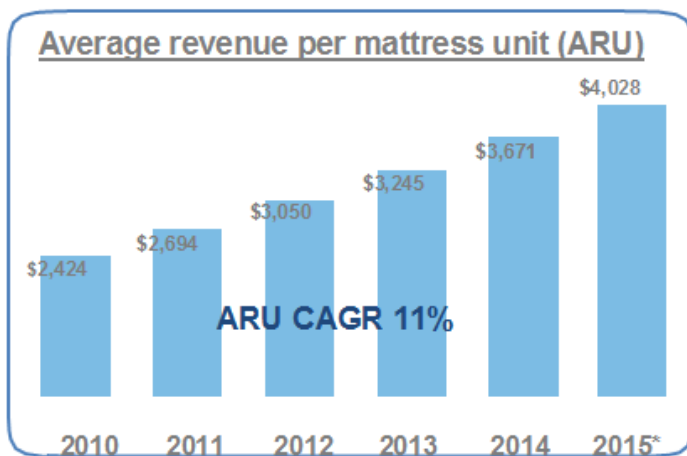
# Mossberg's Investor Digest

## Differentiation and innovation is key in a commodity market

**Differentiating in a commodity market** – As in most commodity markets, bed manufacturers have a limited number of inputs that can be changed to provide truly differentiated products. The basic inputs... springs, fabric, padding, and polyurethane, or latex foam have not changed much in the past 50 years. To differentiate, manufacturers have relied more on marketing to provide differentiation. In contrast, Select Comfort has differentiated its products by providing individualized adjustment for each side of the bed and using smart technology that can monitor, track and make recommendations to improve sleep.

- **Adjustability** – Differentiated from a “one-size-fits-all” mattresses, Sleep Number beds use two independent air chambers that allow couples to adjust the firmness of each side of the bed. According to the Company’s presentation, 58% of customers who adjust their settings are more likely to have improved sleep quality as measured by having restful time in bed.
- **Smart Technology** – The Company’s SleepIQ gathers biometric data from sensors in the bed to quantify the duration of sleep and makes suggestions on making adjustments to the bed. The Company is introducing APIs that will allow users to connect this data to other wellness applications that track exercise, nutrition, etc.

These differentiated areas should allow the Company several benefits including taking market share, commanding premium pricing and higher margins, as well as increasing customer engagement, which should drive multiple purchases (for each bedroom) and repeat business from customers. As shown in the image below from the Company’s investor presentation, this differentiation is helping drive average revenue per unit.



# Mossberg's Investor Digest

## Valuation

	2015	2016	2017	2018	2019
	(in \$millions)				
Store Count	488	535	567	601	637
Growth Rate		6%	6%	6%	6%
Revenue	1,214	1,372	1,488	1,615	1,752
Sales per Store	2.5	2.6	2.6	2.7	2.7
EBITDA	133	159	181	206	234
EBITDA Margin	11.0%	11.6%	12.2%	12.8%	13.4%
Net Income	51	62.04	78	96	116
Net Income Margin	4.2%	4.5%	5.2%	5.9%	6.6%
Share Count	52	47	46	44	43
EPS	\$0.97	\$1.32	\$1.70	\$2.16	\$2.69
Operating Cash Flow		120	149	178	193
Capex		70	60	60	60
Excess Cash Flow Generation		50	89	118	133
50% allocation to stock repurchases		85	44	59	66
Average Stock Price		\$21	\$34	\$43	\$54
# of shares repurchased		4.0	1.3	1.4	1.2

In our back of the envelop calculation above, we make the following assumptions for growth and improvement in profitability:

- **Revenue Growth** – Over the next four years, we assume revenue will grow at approximately 8%, through a combination of 6% store growth and 2% same store sales growth.
- **EBITDA & Net Margin** – We assume 70 basis points of improvement in EBITDA and net income margins each year through 2019. EBITDA reaches 13.4% and net margin reaches 6.6%, which is in line with historical performance. Margin improvement will come from operating leverage and greater efficiencies.
- **Operating Cash Flow Generation** – We assume operating cash flow generation of 10% to 11% of sales, generating \$640 million from 2016 to 2019.
- **CAPEX** – We assume \$60 million in annual capex, which is in line with Company guidance.
- **Share repurchases** – We assume that 50% of the cash flow left over after capital spending will be used to repurchase shares. We use a 25 multiple of EPS in each year to determine an average price for repurchased shares.
- **EBITDA Multiple** – We believe the Company should conservatively command an EV/EBITDA multiple of 11x. If the Company is able to consistently deliver on its growth plans, we believe investors could assign an even higher multiple in the mid-teens.
- **Valuation** – Based on 11x EV/EBITDA and a substantial remaining cash balance of \$170 million, we believe shares could be worth more than \$60 by 2019.

Excess Cash Generation - post share repurchase	135
Cash	170
EV	2,574
EV/ EBITDA	11
Market Cap	2,744
Price/ Share	\$63.71

We attempt to provide subscribers with reasoned opinions based on our analysis of publicly available information from sources believed to be reliable, but make no representations as to its accuracy or completeness. Best Idea profiles are not based upon individual needs of subscribers nor are they an offer to buy or sell securities. Additional disclosures can be found under the Disclosures portion of the Mossberg's Investor Digest website.

# Mossberg's Investor Digest

## 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. Date	Relative Perf. vs. Russell 2000	
M/A-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI)	28-Mar-15	\$35.81	\$41.85	16.9%	-0.2%	17.1%	
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	\$9.97	\$12.99	30.3%	1.4%	28.8%	
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	\$0.27	\$0.26	-4.3%	-0.7%	-3.6%	
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	\$26.87	\$24.97	-7.1%	-1.3%	-5.8%	
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	\$13.43	\$12.27	-8.6%	0.5%	-9.1%	
Cosi Inc. (NASDAQ:COSI)	31-Aug-15	\$1.17	\$0.08	-93.3%	6.8%	-100.1%	
Calloway Golf Company (NYSE: ELY)	30-Sep-15	\$8.39	\$11.55	37.7%	12.5%	25.2%	
New Gold (NYSE: NGD)	31-Oct-15	\$2.47	\$4.44	79.8%	6.5%	73.2%	
Townsquare Media (NYSE: TSQ)	30-Nov-15	\$11.43	\$9.28	-18.8%	3.3%	-22.1%	
Build-A-Bear Workshop (NYSE: BBW)	31-Dec-15	\$11.72	\$10.65	-9.1%	9.0%	-18.1%	
Dycom Industries, Inc (NYSE: DY)	31-Jan-16	\$62.18	\$81.53	31.1%	19.5%	11.6%	
Rackspace Hosting, Inc. (NYSE: RAX)	29-Feb-16	\$21.54	\$31.66	47.0%	19.7%	27.3%	
Kopin Corporation (Nasdaq:KOPN)	31-Mar-16	\$1.66	\$2.18	31.3%	11.1%	20.2%	
PAR Technology Group (NYSE: PAR)	30-Apr-16	\$6.39	\$5.30	-17.1%	9.5%	-26.5%	
Full House Resorts Inc. (Nasdaq: FLL)	30-May-16	\$1.60	\$1.76	10.0%	7.6%	2.4%	
Control4 Corporation (Nasdaq: CTRL)	30-Jun-16	\$7.99	\$12.26	53.4%	7.5%	46.0%	
KapStone Paper and Packaging Corporation (NYSE: KS)	31-Jul-16	\$14.28	\$18.99	33.0%	1.5%	31.5%	
Ampco-Pittsburgh Corp. (NYSE: AP)	31-Aug-16	\$11.12	\$11.27	1.3%	-0.2%	1.5%	
				<b>Average</b>	<b>11.9%</b>	<b>6.3%</b>	<b>5.5%</b>

We attempt to provide subscribers with reasoned opinions based on our analysis of publicly available information from sources believed to be reliable, but make no representations as to its accuracy or completeness. Best Idea profiles are not based upon individual needs of subscribers nor are they an offer to buy or sell securities. Additional disclosures can be found under the Disclosures portion of the Mossberg's Investor Digest website.

# Mossberg's Investor Digest

## **Subscription Information**

Subscribe to Mossberg's Investor Digest at <http://midresearch.com/subscribe/>

### **12 New IDEAS per year**

### **Immediate Access Annual Subscription: \$295/ year**

Immediate Access Annual subscribers will receive that month's issue during or before the end of each month.

### **Annual Subscription: \$245/ year**

Annual subscribers will receive that month's issue two weeks later than Immediate Access Subscribers

## **About Mossberg's Investor Digest**

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.

## **Disclosures**

**Not Investment Advice:** Investors should consult a financial advisor before investing in any securities highlighted in the Digest or subscribing to any newsletter service. We attempt to provide subscribers with reasoned opinions based on our analysis of publicly available information from sources believed to be reliable, but make no representations as to its accuracy or completeness. Best Idea Profiles highlighted in Mossberg's Investor Digest are not based upon individual needs of subscribers nor are they an offer to buy or sell securities. Mossberg's Investor Digest is not suitable for people seeking low to moderate risk investments.

It is the policy of the publisher to follow the CFA Institute's "Standards of Practice" regarding disclosure of potential conflicts of interest. The publisher's policy is to avoid conflicts of interest when possible. However, when potential conflicts are unavoidable, the publisher's policy is to disclose material business relationships between it and issuers of securities highlighted in the letter. In addition, the publisher's ownership in securities highlighted in the letter is disclosed. By disclosing potential conflicts of interest, subscribers and prospective subscribers will have additional information to evaluate the objectivity of ideas highlighted in the newsletter.

\*There are no material business relationships between the publisher and the securities highlighted in this issue.

\*As of September 2016, the publisher owns shares in COSI, CUBI, KOPN, FLL and DSNY.

---

We attempt to provide subscribers with reasoned opinions based on our analysis of publicly available information from sources believed to be reliable, but make no representations as to its accuracy or completeness. Best Idea profiles are not based upon individual needs of subscribers nor are they an offer to buy or sell securities. Additional disclosures can be found under the Disclosures portion of the Mossberg's Investor Digest website.

[www.midresearch.com](http://www.midresearch.com)