IMC INVESTORS MANAGEMENT CORPORATION

Reinvestment Moats

zooplus

ValueX Vail 2017

Connor Leonard

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The "IMC Story"

- Investors Management Corporation ("IMC") was founded by James Maynard and Bill Carl in 1971
  - Entity formed with the plan to create a casual dining restaurant chain (Golden Corral)
  - Initial $50,000 investment remains the only equity capital invested in IMC
- Golden Corral grew from one location in Fayetteville, NC to America's #1 buffet and grill
  - 485 locations in 40 states today
  - $1.7Bn in system sales, 85% franchised

IMC Today

- Privately-held holding company located in Raleigh, NC run by CEO/Chairman Quinton Maynard
  - 8 subsidiary companies today, including Golden Corral
- Goal is to be a responsible long-term owner of a collection of good businesses
  - Inspired by the principles of Berkshire Hathaway
- Actively seeking majority acquisitions of companies with:
  - Proven business models with above average returns on invested capital
  - Talented management teams with a strong desire to continue running the business
  - Earnings between $5mm and $25mm

IMC Today

IMC

IDOC
independent. together.™

Right at Home®
In Home Care & Assistance

CORNERSTONE
BUILDING ALLIANCE

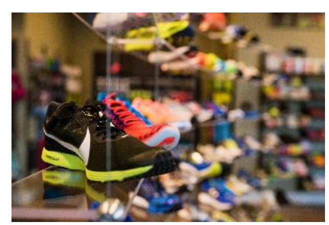
ARCADIA
FARMS™

golden corral
Buffet & Grill

back pack
PARTNERS

KDI
CAPITAL PARTNERS
KNOWLEDGE • DISCIPLINE • INTEGRITY

FLEET FEET
Sports



Public Market Investing

- IMC invests in both privately-held and publicly-traded businesses out of the holding company structure
  - Connor Leonard is in charge of public securities investing for IMC, including 100% autonomy over a stand-alone portfolio
- The IMC Public Portfolio aims to *connect public market investing to the private acquisition mentality at IMC*:
  - 5 - 10 holdings, with the top position potentially being 25%+ of assets if high conviction
  - Extensive fundamental research coupled with infrequent, but concentrated investment actions
  - Preference for businesses that are increasing intrinsic value at high rates over multiple years
- The goal is to build a <u>"conglomerate" of minority interests</u> in exceptional subsidiaries that happen to be publicly-listed

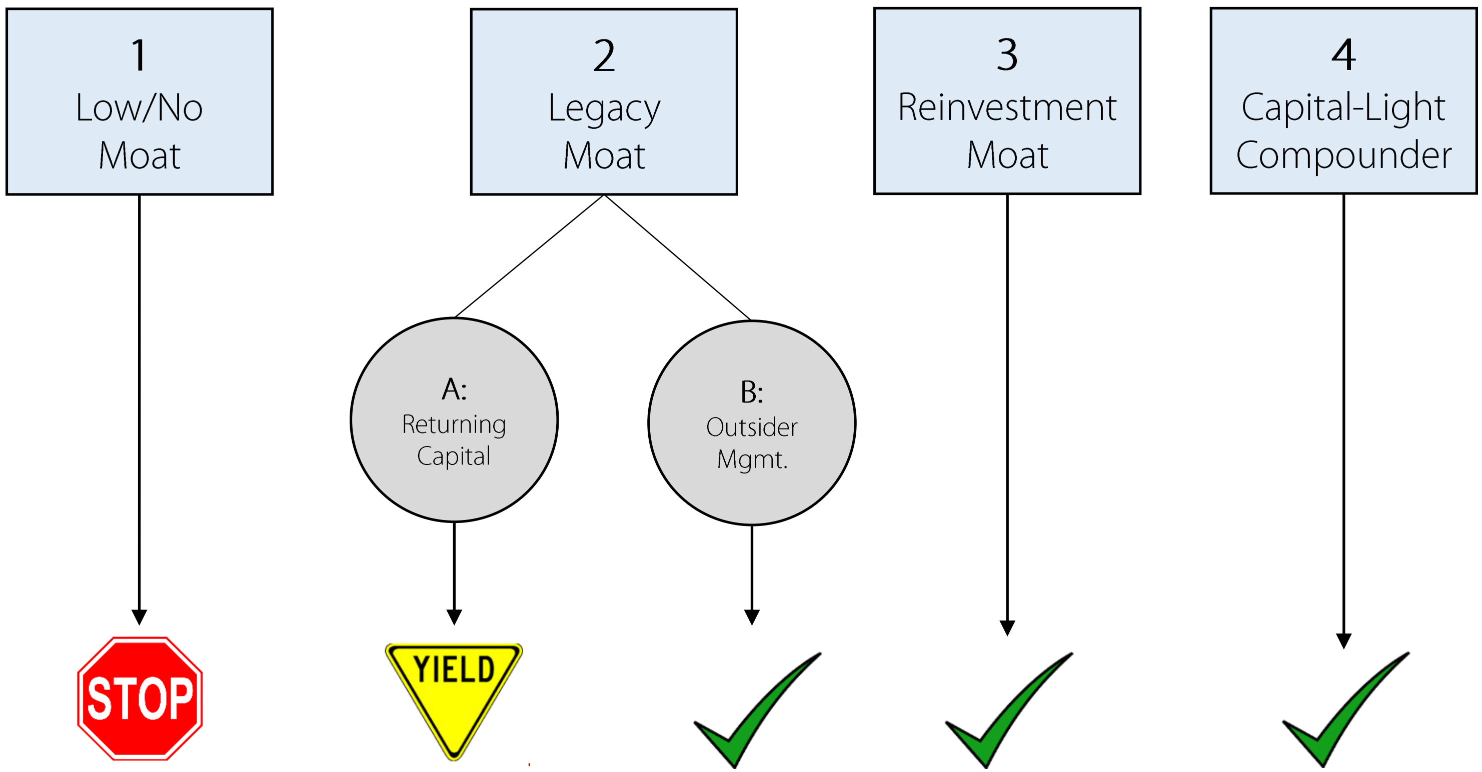
Structural Advantages

- Long-term orientation
  - Permanent capital enables a public market investment time horizon of 5+ years vs. 3-6 months for peers
- Investment free from typical institutional constraints
  - No formal mandate other than *"invest as if it's your own money"*
- Focused solely on compounding capital at high rates over long stretches
  - Incentives reward performance over asset gathering
  - Reduced administrative and fundraising burdens frees up more time for analyzing companies

How I Categorize Moats

- Most companies are "Legacy Moats"
  - Earning strong returns on **prior invested capital**, but do not have opportunities to deploy incremental capital at similar rates
  - Cash earned today is either distributed to owners, or utilized in a focused M&A program ("Outsider" option)
- Few companies are "Reinvestment Moats"
  - These companies posses all the advantages of a Legacy Moat, plus opportunities to **deploy incremental capital at high rates**
  - Current profits are protected by Legacy Moat, plus ability to retain capital and deploy internally in high return opportunities

Investment Filter



Examples [1]	Coca-Cola, Hershey's	Danaher, TCI, Transdigm	Wal-Mart in 1972, GEICO in 1951	Visa, Moody's, Verisign

For more detail, please refer to: Reinvestment Moats vs. Legacy Moats | Capital-Light Compounders

[1] Examples are for illustrative purposes and are not holdings of the IMC Public Portfolio

The Power of Compounding

- The longer your investment horizon, the closer your return matches up with the returns of the underlying business
- Price paid matters, but it doesn't have to be a "Ben Graham" valuation for the investment to work
  - See example
- Finding these companies early on is challenging…
  - But I'm only looking for a handful and
- **The power of compounding makes it worth the hunt**

	Reinvestment Corp.	Undervalued Corp.
Current Earnings Power	$100	$100
Beginning Multiple	20x	10x
Current Valuation	$2,000	$1,000
% of Earnings Reinvested	100%	50%
Returns on Retained Earnings	25%	10%
Cumulative Dividends	$0	$629
Year 10 Earnings Power	$931	$163
Year 10 Multiple	15x	15x
Year 10 Valuation	$13,965	$2,445
Total IRR	21.5%	13.6%
Multiple on Original Investment	7.0x	3.0x

My Criteria

	Reinvestment Moat Checklist
☐	Understandable Business Model
☐	Product/Service Benefits the Entire Ecosystem
☐	Sustainable Competitive Advantage
☐	Long Runway for Growth
☐	Moat Widens as the Company Grows
☐	Long-Term Oriented Management Team
☐	Clearly Articulated Variant Perception
☐	Under Followed
☐	Reasonable Valuation
☐	Act With Conviction

Actionable Idea: zooplus AG

- Ticker: (DB: ZO1)
- HQ: Munich, Germany
- Founded: 1999
- Market Cap (EUR): €1,270mm
- Ent. Value (EUR): €1,200mm
- Description: Europe's leading online retailer for pet products

(Euros MM)	2011	2012	2013	2014	2015	2016
Revenue	257.1	335.6	426.9	570.9	742.7	952.0
Growth Rate	*32.8%*	*30.5%*	*27.2%*	*33.7%*	*30.1%*	*28.2%*
EBIT	(7.6)	(2.6)	4.2	9.2	12.8	18.1
% Margin	*(2.9%)*	*(0.8%)*	*1.0%*	*1.6%*	*1.7%*	*1.9%*

Investment Highlights

- zooplus has 50% market share of online pet food sales in Europe, vastly ahead of peers
- zooplus is one of the few companies that competes effectively against Amazon
- Online is only 7% - 8% of total European pet sales and is structurally taking share from Brick and Mortar (B&M)
- Aligned management team is focused on long-term value creation over maximizing short-term earnings
- Valuation is very reasonable compared to peers and potential earnings power

Now let's run it through the Reinvestment Moat Checklist

(1): zooplus Q1 2017 investor presentation
(2): zooplus 2016 Annual Report

Business model

Checklist: *can I explain how the company makes money in my own words?*

- Zooplus buys pet products directly from manufacturers, stores it in distribution centers, and sells it to consumers through country-specific websites
  - 8,000+ SKUs offered across 30 European countries
  - Zero brick & mortar locations, all sales online
    - **84% food | 16% non-food**
    - 47% dog focused | 48% cat focused | 5% other pets
    - 10% private-label brands
- Packages are delivered to consumers throughout Europe by 3rd party couriers
  - Free shipping on orders over €19 - €39
  - Delivery within 1 – 2 days

Source: company filings and presentations

Benefits All Stakeholders

Checklist: *Is the business providing a product/service that benefits the entire ecosystem?*

Purchasing pet food online is ***great*** for all stakeholders

- Very convenient for customers:
  - Massive selection online with lower prices
  - Not an item you need to "try on"
  - No longer requires carrying a bulky bag to the car
- Recurring, predictable sales for zooplus:
  - 94% customer retention rate in constant currency [(1)]
  - <2% of all orders are returned
- Pan-European exposure for manufacturers:
  - zooplus provides access to a loyal customer base across 30 countries

(1): zooplus Q1 2017 investor presentation

Competitive Advantage

Checklist: *does the business have a sustainable competitive advantage/moat?*
- *Consumer side: brand, franchise, share of mind*
- *Production side: market position, low cost provider*

- zooplus has dominant 50% European online pet supplies market share [1]
  - zooplus European online market share has been at least 40% every year since 2009 [2]
  - zooplus is 10x bigger than the #2 online specialist in Europe [3]

- Amazon has ~11% online share despite selling pet products in Europe since 2005 [1]
  - Zooplus growing 18% - 29% YoY in DE, GB, FR - Amazon's strongest European markets [3]

- Brick & Mortar incumbents have limited online presence and structurally higher gross margins
  - 97%+ of Pets at Home (GB) and Fressnapf (DE) sales are offline [1]
  - Pets at Home sells at 54% gross margin compared to zooplus at 28% [2]

(1): zooplus Q1 investor presentation
(2): Company filings
(3): medicanimal – UK based online pet retailer

zooplus crushes B&M

- *zooplus averages 17% lower prices than Pets at Home (PaH)*
  - Fressnapf is undercut by zooplus on 1/3rd of SKUs by an average of 14%
- zooplus has superior selection and shipping:
  - 26% - 34% of SKUs in my basket not carried at B&M, but in stock at zooplus
  - zooplus offering free delivery over €19
- <u>Brick & Mortar remains 90%+ of pet supplies market, representing a great opportunity for zooplus</u>
- The question becomes: can zooplus fend off Amazon along the way….

	Zooplus	Pets at Home	Δ
	£9.99	£14.49	(31%)
	£26.99	£39.49	(32%)
	£37.99	£87.56	(57%)
	£26.99	£42.99	(37%)

Sample SKU comparison

Source: IMC proprietary research based on using Google Translate to "shop" a basket of 50 SKUs comparing zooplus vs. leading B&M vs. Amazon websites item by item in top 5 European countries. Basket roughly matches zooplus sales mix: 80% food, 45% dogs, mix of generic and niche brands, etc. Top 5 markets represent 67% of zooplus overall sales. Prices and shipping terms subject to change.

zooplus bests Amazon

- **zooplus averages 8% - 17% lower prices compared to Amazon**
- ~40% of Amazon SKUs are only offered by 3rd party marketplace sellers
  - Typically specialty/premium SKUs
- **Within these niche SKUs zooplus dominates with 10% - 30% lower prices**
- **zooplus started earlier, stayed focused, and now has ~5x the scale of Amazon in this niche market**

Zooplus averages lower prices than Amazon, but it's more pronounced vs. 3rd party sellers

Zooplus versus

	Amazon Overall	Amazon Direct	Amazon 3rd Party	% 3rd Party
Germany	8% less	5% less	10% less	34%
UK	17% less	8% less	28% less	42%
France	15% less	3% less	29% less	42%

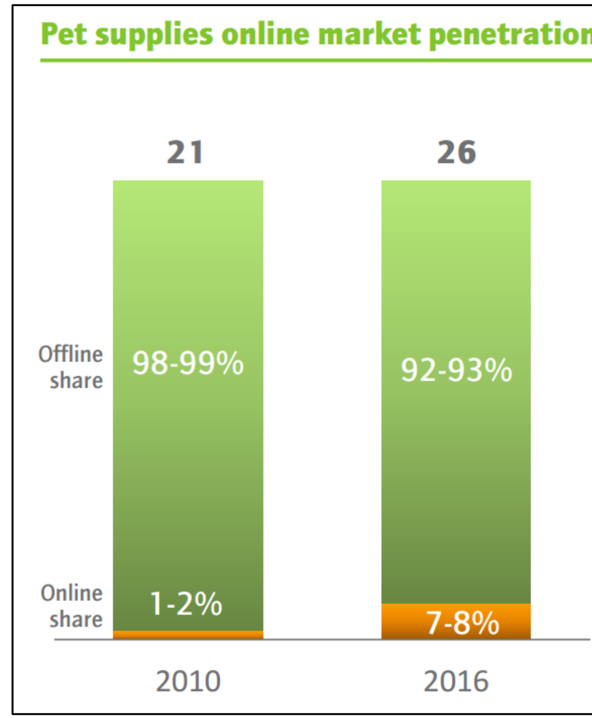
I now think select "verticals" like zooplus can compete effectively against Amazon

Source: IMC proprietary research based on using Google Translate to "shop" a basket of 50 SKUs comparing zooplus vs. leading B&M vs. Amazon websites item by item in top 5 European countries. Basket roughly matches zooplus sales mix: 80% food, 45% dogs, mix of generic and niche brands, etc. Top 5 markets represent 67% of zooplus overall sales. Prices and shipping terms subject to change.

Long Runway

Checklist: *does the company have a long growth runway supported by structural tailwinds?*

- **zooplus benefits from two structural tailwinds:**
  - Humanization of pets
  - Shift from offline to online purchases
- **Result: overall pet market is growing, and online is rapidly taking share**
- European Pet Supplies market: €26Bn and growing 3% p.a. [1]
- Online Pet Supplies market penetration trails comparable categories….for now:
  - China/Korea online penetration of pet food: ~30% [2]
  - European online penetration for electronics: >25% [2]



Source: zooplus 2017 capital markets day

[1] zooplus 2017 investor presentation
[2] JP Morgan research

Widening Moat

Checklist: *does the moat widen as the company grows?*

- *Network Effects or Scale Economics*

- **Scale Economies Shared** is a powerful concept first outlined by Nick Sleep of Nomad Investment Partnership[1]:
  - When a business gains purchasing scale, rather than selling goods at a higher margin, companies can chose to lower prices – **effectively sharing scale economies with customers**
  - By sharing efficiency gains with customers in the form of lower prices, the company can increase demand, leading to further scale advantages
- Once this virtuous cycle is in motion, it becomes exceptionally difficult for competitors to catch up
- Very few companies opt for this strategy because it requires long-term commitment and patient investors

[1] Also referred to as Sleep, Zakaria and Company

Costco Is The Best Example

"Most companies pursue scale efficiencies, but few share them. *It's the sharing that makes the model so powerful.* But in the center of the model is a paradox: the company grows through giving more back. We often ask companies what they would do with windfall profits, and most spend it on something or other, or return the cash to shareholders. Almost no one replies give it back to customers – how would that go down with Wall Street? *That is why competing with Costco is so hard to do*. The firm is not interested in today's static assessment of performance. It is managing the business as if to raise the probability of long term success" - Nick Sleep [1]

[1] *Nomad Investment Partnership December 2004 Investor Letter, excerpt used with permission of Nick Sleep*

Interesting note: Nomad was one of the largest investors in zooplus from 2009 until 2014, when Sleep decided to retire and wind down Nomad after an incredible stretch of results. Sleep was recently nominated as a candidate for zooplus' Board of Directors.

Following The Playbook

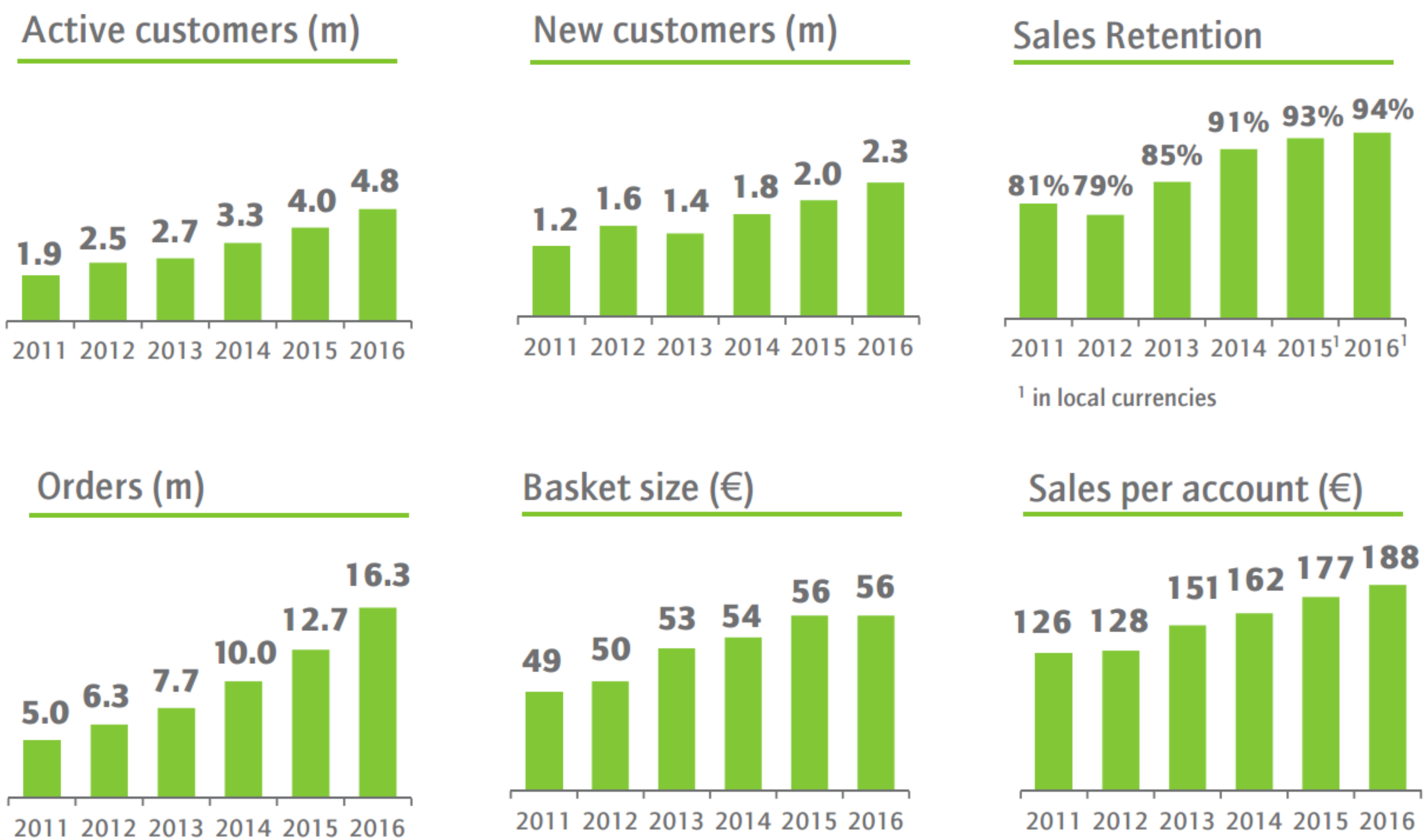
zooplus Scale Economies Shared in action:

zooplus AG	2011	2012	2013	2014	2015	2016
Gross Margin %	38.9%	36.2%	34.5%	31.2%	30.2%	28.4%
General & Admin %	41.8%	36.9%	33.5%	29.6%	28.5%	26.5%
EBIT Margin %	**(2.9%)**	**(0.8%)**	**1.0%**	**1.6%**	**1.7%**	**1.9%**

- EBIT margins at all-time highs despite gross margin decreases of 1,000 basis points over five years
  - Optimal strategy for maintaining the lead in a long-term game

Industry Source: *"zooplus is the only company currently able to sell pet food online profitably"*

KPIs Are Following Suit



Customers are returning more, shopping more, with bigger baskets

Source: zooplus 2017 Capital Markets Day

Management Team

Checklist: *Is the company run by a long-term oriented management team?*

- *Preferably founders who are invested alongside me?*

- Founder/CEO: Dr. Cornelius Patt
- Management team collectively owns 5% of shares [(1)]
- Strategy is to prioritize growth, but self-finance along the way by remaining free cash flow positive
  - *"We will consciously decide in favor of growth over short-term profit maximization when given a choice"* [(2)]
- This is not a VC-backed land grab, this is a company executing a simple plan with extraordinary focus

[(1)]: zooplus 2016 Annual Report
[(2)]: 2010 Annual Report
Note: Another zooplus co-founder left in 2013 to start an investing firm, Maxburg Capital. zooplus is currently the firm's largest position.

Variant Perception

Checklist: *Do I have a clearly articulated variant perception on the company?*

- LTM EBIT margins are 1.9%, ***but that doesn't tell the full story***
- In mature markets zooplus has significantly higher margins
  - Logistics costs are 13% - 15% of sales vs. 20% - 22% in newer markets [1]
- Customer Acquisition Costs are strong long-term investments, but put pressure on current margins
  - Repeat customers have margins 600–700 bps higher [1]
- As the company continues to mature and scale fixed costs, **EBIT margin should trend towards ≥ 5%**
- Return on Capital Employed is 37% today due to zooplus turning over capital 20x a year[2]
  - **At 5% EBIT margin with 20x turnover = ~100% ROCE**

[1] 2017 zooplus Capital Markets day
[2] LTM as of 3/31/2017, reflects EBIT / (Current Assets – Cash – Current Liabilities + PP&E + Intangible Assets)

Under Followed

Checklist: *Do I understand why the business is currently undervalued, out of favor, or being sold?*

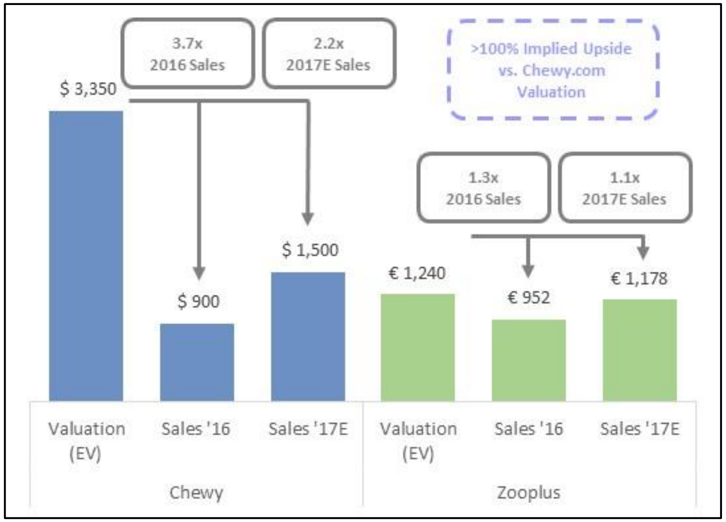
- zooplus is essentially unknown in the U.S. public markets:
  - Not on Value Investors Club or SumZero
  - Never discussed in the Wall Street Journal or on CNBC
- Only one U.S. investment bank covers zooplus, and they only initiated last month [1]
- Limited liquidity: trades roughly €1mm - €4mm per day
- Investor calls/presentations are in English, but often ≤ 5am EST, with inconsistent transcripts
  - *Hope you are a morning person!*
- <u>zooplus has little coverage, low liquidity, and is difficult to follow</u>
  - This company is in the "minor leagues", <u>*which is exactly what I want*</u>

[1] 2017 J.P. Morgan "Zooplus: Pure Pedigree; initiate coverage with OW rating" 5/24/2017

Reasonable Valuation

Checklist: *Can I make a compelling case for valuation on a yellow legal pad?*

- Chewy.com is an almost identical business model to zooplus, but U.S. focused
  - Similar online market share
  - Competes well against Amazon
  - Not currently profitable [(1)]
- Recently acquired by PetSmart owners for $3.35Bn - a **massive valuation premium** to zooplus
- Apply Chewy's forward revenue multiple to zooplus 2017E revenue = <u>+100% upside</u>



Source: Hayden Capital, Recode.net, Forbes.com

(1) zooplus has higher 2016 sales than Chewy.com with roughly 1/10th the employees

Reasonable Valuation

Checklist: *Can I make a compelling case for valuation on a yellow legal pad?*

- Longer-term: zooplus sales of ≥€2bn by 2020
  - At a 5% EBIT margin: 8% yield on today's Ent. Value
  - At a 10% EBIT margin: 17% yield on today's Ent. Value

- Both very reasonable for a dominant eCommerce business growing ~20%

Act With Conviction

Checklist: *do I feel comfortable putting at least 5% of AUM into this idea?*

- **Result:** IMC purchased zooplus shares in February 2017
  - 15% of the IMC Public Portfolio at cost

- Only new publicly-traded company purchased in the last 12 months
  - No plan to sell or trim
  - Will continue to follow the company and industry like an owner

"The wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time they don't. It's just that simple." – Charlie Munger

Questions

Contact Information:

Email: cleonard@investorsmanagement.com

Twitter: @Connor_Leonard

Investors Management Corporation (IMC)

www.investorsmanagement.com

For private acquisitions please contact: gmaynard@investorsmanagement.com

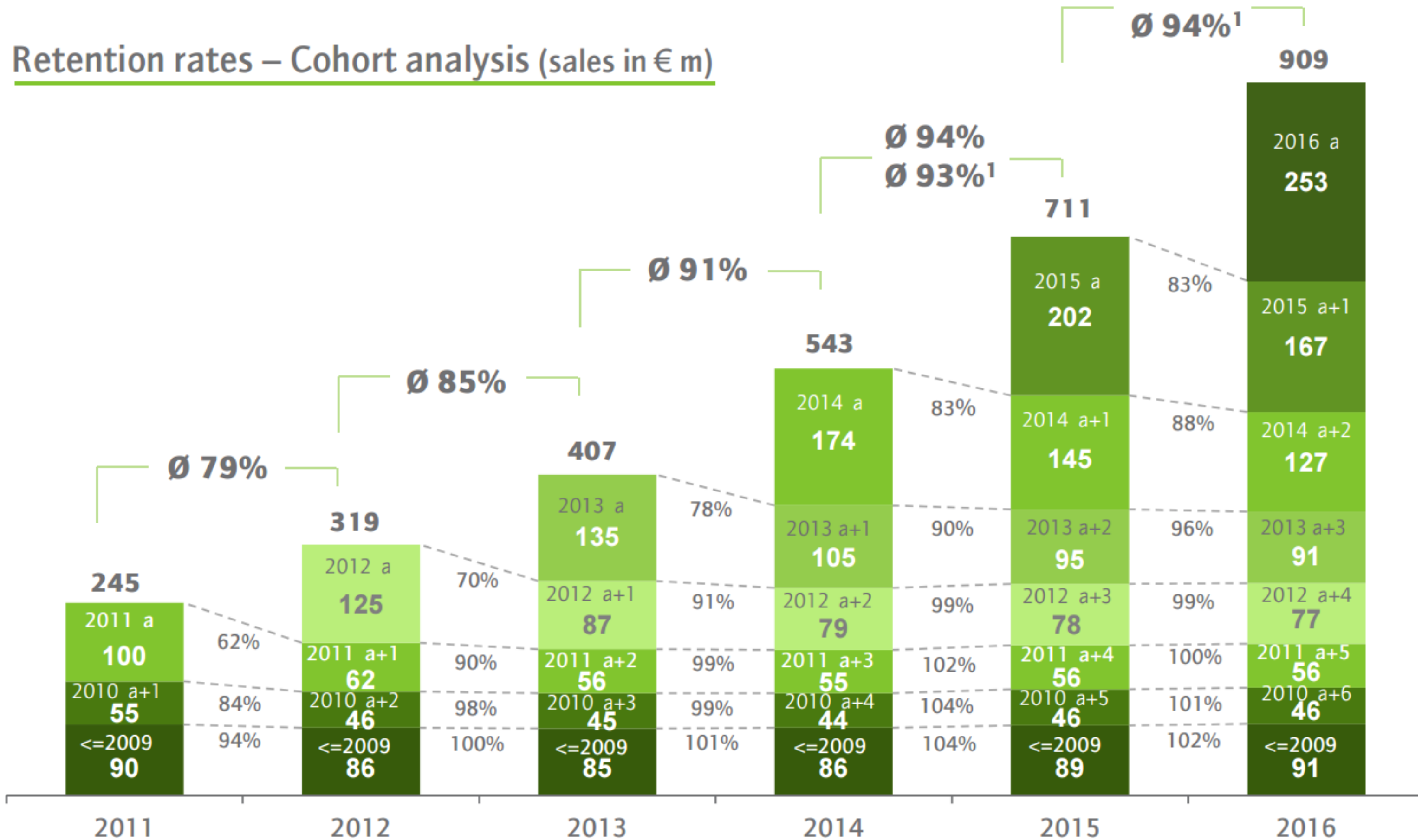
Thanks to Fred Liu

- Friend and fellow ValueX Vail attendee Fred Liu (Hayden Capital) first told me about zooplus
    - For Hayden's full write up, follow this link: Hayden Capital – zooplus
- For more information visit: www.haydencapital.com
    - fred.liu@haydencapital.com | @HaydenCapital

Appendix – Company Metrics

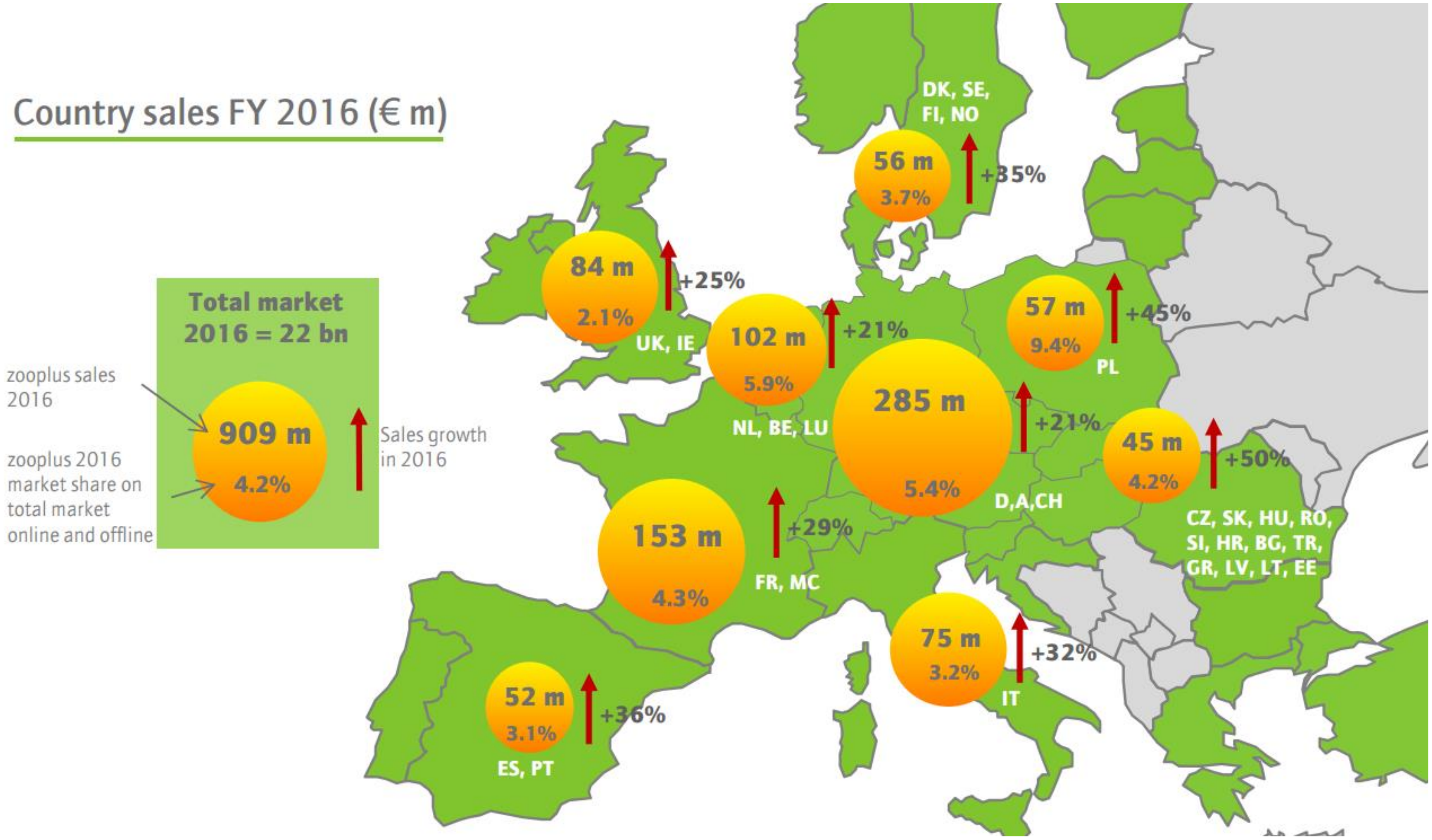
- Customer Retention
- European Online Market Share
- Country Sales
- G&A Leverage

Customer Retention



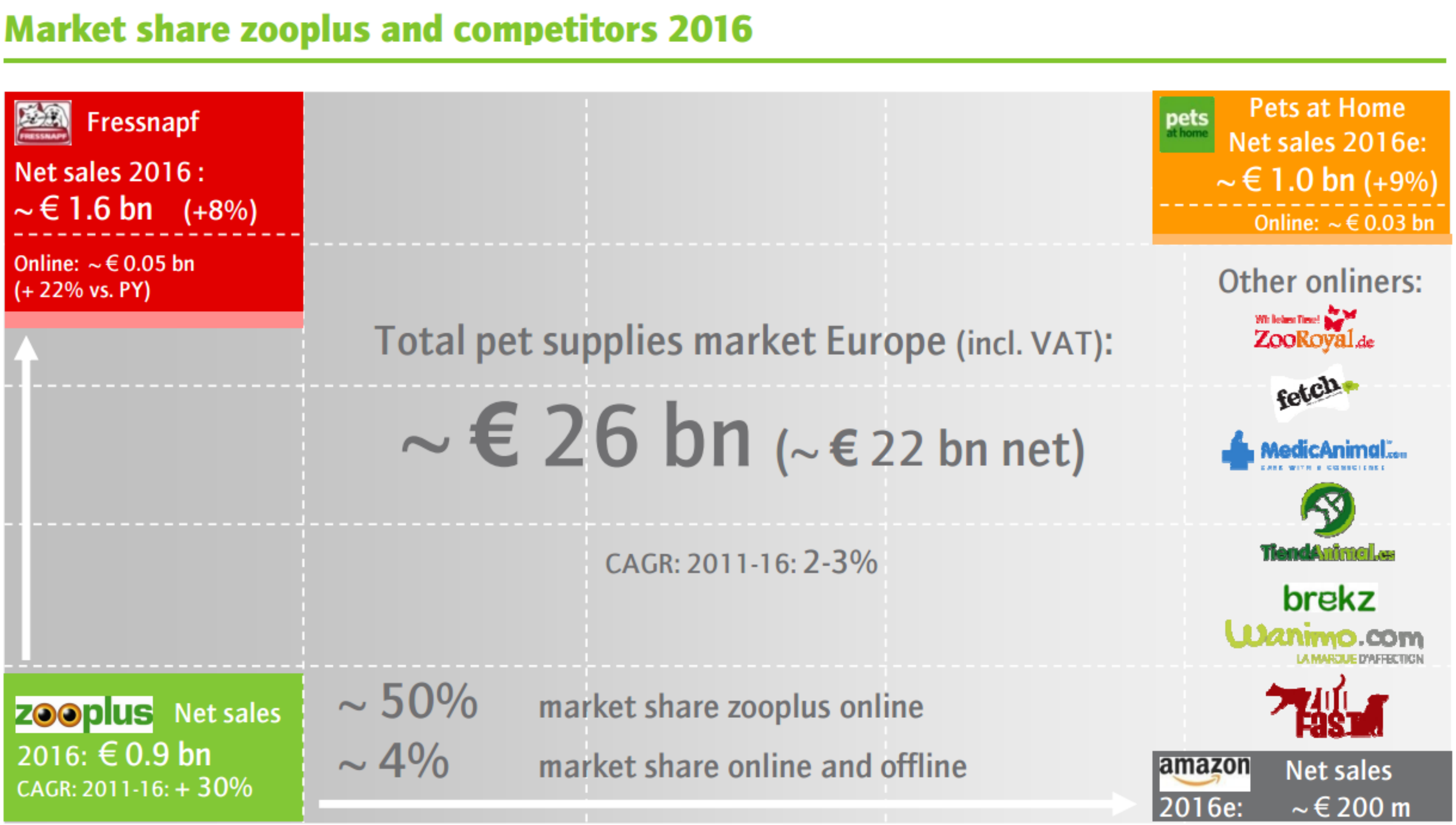
Source: zooplus 2017 Capital Markets Day

Country Sales



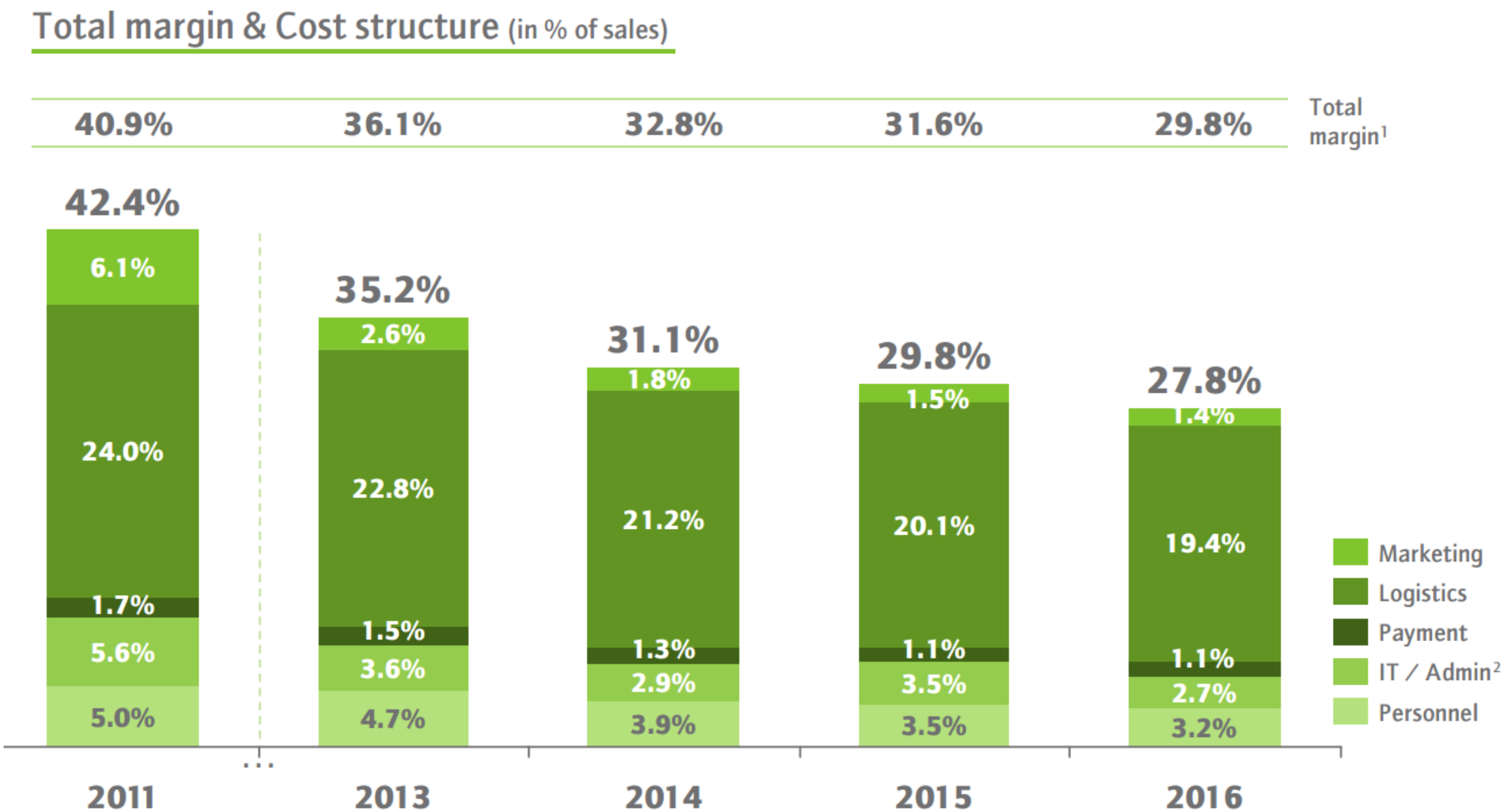
Source: zooplus 2017 Capital Markets Day

Market Share



Source: zooplus 2017 Capital Markets Day

G&A Leverage



Source: zooplus 2017 Capital Markets Day

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