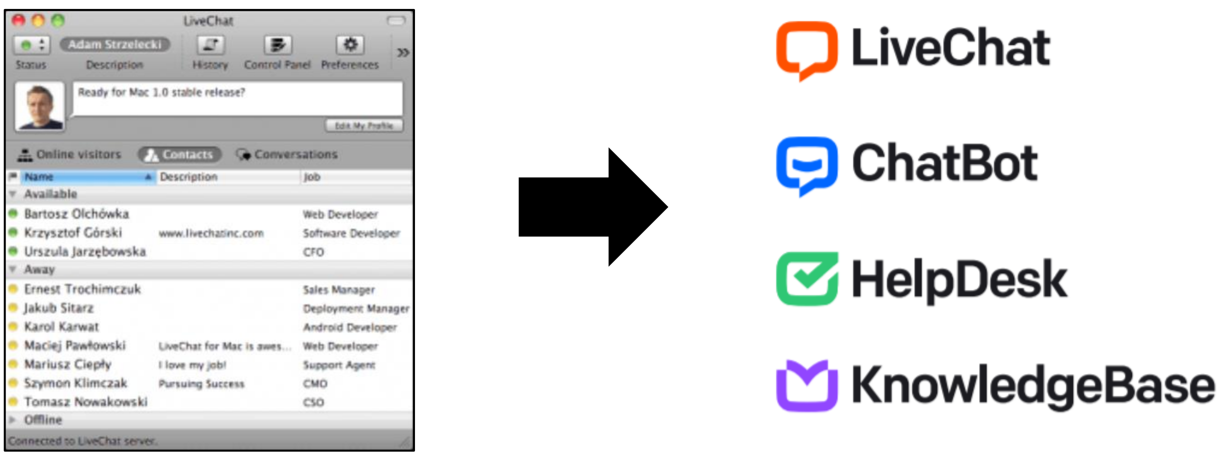
8/31/2020

<u>LiveChat Software Investment Thesis</u>

Preface: Note that the company discussed below is a small cap that only trades on a foreign exchange. However, the ~$250 M USD free float and trading volumes ($925k USD/day) are still sufficient for most individuals and small funds to take a position. We also want to mention that LVC is scheduled to report earnings on Aug. 28th, which coincides with the completion of this piece. We don't have any particular view on how the stock will react, and it's not crucial to the long-term thesis; however, if there were to be a sizable move, please adjust upside projections accordingly.

Company Introduction

LiveChat Software (WSE: LVC) is a software-as-a-service (SaaS) company with offices in Wroclaw, Poland, and Boston, MA, USA, and a current market capitalization of around $600 M USD. The firm was launched in 2002 by founders (and current executives) Marius Cieply, Maciej Jarzabowski, and Jakub Sitarz with the idea of introducing a new channel of communication that could fill the void between time-consuming phone calls and slow emails. The company's first product was a simple desktop web chat tool (see screenshot below left), but from there it has grown into a formidable business communications platform.



LVC's road to success was not without twists and turns, however. In 2006, the company sold a 50% stake to investment and consultancy firm Capital Partners, who in turn sold to a Naspers-backed public company called Gadu-Gadu SA in 2008. Three years later, the business came full circle – the founding management team teamed up with a private equity firm to buy back the entire stake and regain control.

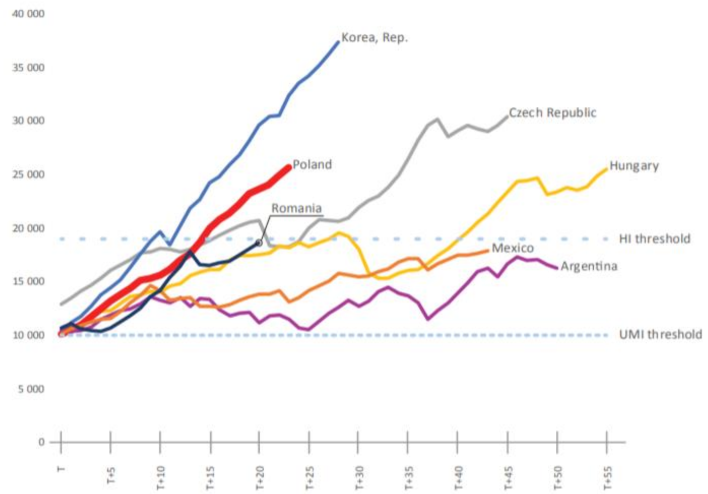
Getting its original team back in control – just in time for the emergence of SaaS as the preferred licensing and delivery model for software applications – proved to be a turning point for the company. After getting to 1,000 paying customers over its first nine years of business, LVC doubled that number in 2011 alone. After a few more years of ramping growth, LiveChat went public on the Warsaw Stock Exchange in 2014 to further accelerate its expansion. This proved successful (sales grew at a 40% CAGR over the next three years), so the PE firm decided to crystalize its sizable gains by gradually exiting the position. However, their final sale in the fall of 2017 was notable because they sold a portion of their shares back to the management team, which wanted to further increase its already huge stake. The team's confidence has paid off, as the business has continued prospering in the years since. Today LVC has over 30,000 customers using its flagship product across 41 different languages, and it has generated nearly a 500% total shareholder return to buyers on the day of its IPO.

Geographic Overview

**Note: while this section is not specifically about LiveChat, we believe it's worth including as part of the broader investment thesis. As we all know, geopolitical risks can derail otherwise promising investment opportunities, so it's important to be comfortable with the geography of a target both in terms of its business operations and its exchange and currency of denomination. Further, we would guess that most investors are currently relatively unfamiliar with the country. Even though for years I've routinely screened for new ideas across the world and have some Polish heritage myself, I had never closely looked at the market, much less purchased one of its local stocks, prior to LiveChat.*

We think Poland is underappreciated globally and relative to other Euro markets. After enduring over four decades of post-WW2 communist control as a USSR satellite state, the country had its first independent elections in 1991. Eager to rid itself of any remnants of Soviet hegemony, Poland quickly embraced a fully democratic government and a market-based economy. Joining NATO in 1999 and the EU in 2004 further confirmed its transformation away from the days of the Warsaw Pact and Eastern Bloc.

The results of this transition have become a case study on the power of the free market. Poland has now enjoyed 27 years of uninterrupted GDP growth (though COVID-19 will in all likelihood break that streak this year), which is a European record. Additionally, the country boasts the second fastest rise to World Bank "high income" status (only South Korea managed it faster).

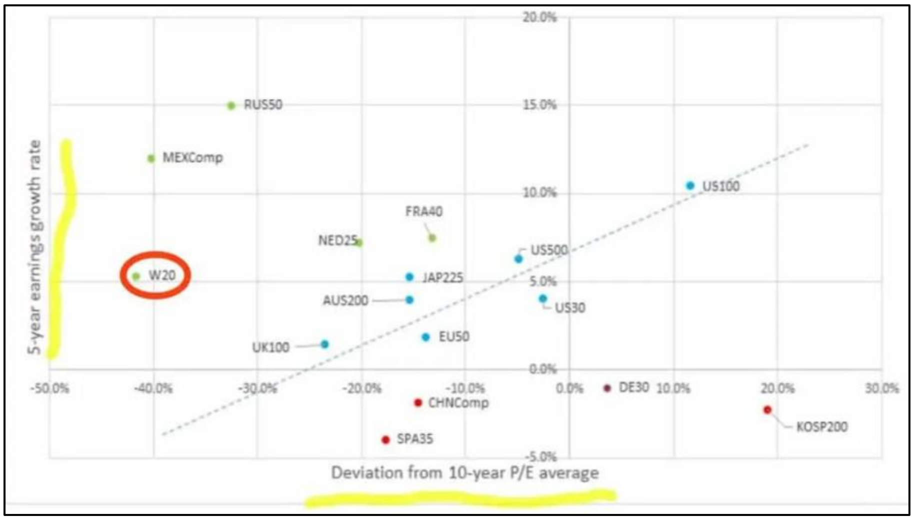


Source: WDI, Groningen Growth and Development Centre.
Note: T= period when the country crossed Upper MIC threshold for good.

In the past ten years alone, Poland has passed the likes of Greece, Portugal, and – in what must be a source of great satisfaction to the populace – even Russia. Importantly for investors, the country has a stable currency (exchange rate vs. USD is currently the same as it was five years ago), no political turmoil (the incumbent president was recently re-elected to a second five-year term), and minimal inflation (1.6% annualized since 2010).

Poland's capital markets have developed nicely alongside the broader economy. The Warsaw Exchange, the country's largest, has around 500 companies, including 27 with MC over $1 B USD. The exchange is accessible via nearly any institutional brokerage (including Interactive Brokers), and nearly all listings have robust daily liquidity. The listed companies are not just "old world economy" companies, either – successful software companies like LVC are a case in point, as is CD Projekt, a video game developer that is currently most highly-valued Polish company, with a market capitalization exceeding $10 B USD.

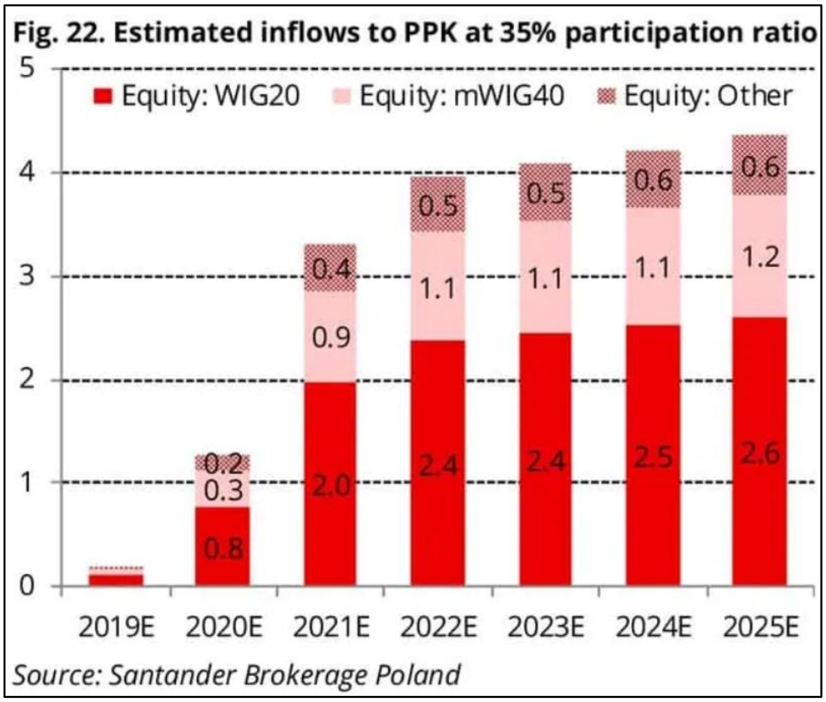
Despite consistent GDP expansion and wealth creation in recent years, the Polish stock market is currently one of the cheapest in the world. The benchmark index P/E is low on an absolute basis (currently 13x), and especially so relative to its earnings growth and long-term multiples. The charts below (taken from a quite excellent blog providing an introduction of the Polish investment landscape) show the extent to which it (along with Russia and Mexico) stand out from the rest.



This valuation discount may soon start to close, as a large tailwind is approaching in the form of pension reforms. Last November, the Polish government finalized a plan that transferred the large majority of the employed population's state-guaranteed pension funds to individual retirement accounts. This plan went into effect last month, joining an auto-enrollment scheme that launched in January for employers with 50-250 employees.

Both developments are likely to be net benefits to Polish equities. The transfer to the newly created specialized open-ended funds in which individuals can now invest stipulates a minimum percentage of assets that must be allocated to domestic equities. The current minimum is 80%, but that increases to 92% by the end of 2021 (thereafter it is gradually reduced each year until reaching 70% in 2032). In the near term, this suggests a significant amount of forced buying as the managers of these open-ended funds increase their positions to meet the minimum requirement.

The auto-enrollment plan will have a smaller but longer-lasting impact by increasing the country's aggregative savings rate (and thus investment), much of which will likely be put into stocks. Estimates published by local investment banks reflect these dynamics – significant inflows in 2021 as the minimum step-up takes effect, followed by years of further gradual gains as newly auto-enrolled accounts are opened or added to. Note the mWIG40 index, of which LiveChat is a member, is expected to see inflows nearly quadruple in the next two years (see chart below).



Company and Industry Background

LiveChat has four products, although one comprises the vast majority of the value and another remains pre-revenue. A summary of the four is as follows:

1. LiveChat – the company's flagship product that currently generates the vast majority of revenues (128.4 M PLN) and over 100% of net profits. The product is a chat application embedded in a company's website that facilitates quick contact between that company and its customer. Use cases are wide ranging but tend to be centered around either customer service or online sales. The application has over 30k paying customers in 150 countries, including such household names as PayPal, Adobe, and Best Buy. *Note: when discussing just this business line, we will refer to it as the "LiveChat segment" so as to differentiate from the overall LiveChat company.*
2. ChatBot – product allowing for the creation of conversational chatbots. Around 80% of customer service inquiries are oft-repeated ones, so automating these repeated questions can allows representatives to focus on the other 20%, thereby saving or reducing staffing requirements. Bots are created by preparing a detailed decision tree script of the conversation using a drag-and-drop interface that doesn't require computer science expertise and can be integrated with other tools such as Facebook Messenger. Launched in 2018, Chatbot is currently growing exponentially off a small base; revenues increased 3.5x in the last fiscal year to 2.3 M PLN.
3. HelpDesk – supports business communications through a digital ticketing system. The tool allows collaboration between employees on solving customer issues, as well as automated assignment of the issue to the relevant business unit. Launched just last year, HelpDesk is in its infancy and generated 23.5k PLN in revenue in FY20 from a standing start.
4. KnowledgeBase – platform that allows companies to create folders containing articles on a given topic that can be accessed by employees, clients, or both (not unlike this one). The benefit of this is the ability to organize and quickly retrieve information on evergreen questions that may require more in-depth explanations than what can be easily provided through a chat or a bot. LVC's

monetization of the product has not ramped up yet, and its financial contribution is currently *de minimis.*

Though the nature of LiveChat's four products all fall under the umbrella of text-based business communication tools, given the negligible contribution of HelpDesk and KnowledgeBase today, my writeup will focus primarily on the LiveChat and ChatBot business lines.

First, let's explore the broader market for chat-based web applications. In general, the communication medium has benefitted from both the evolution of customer relationship management tools (with demand increasing both for users and providers) and the evolution of commerce itself (as eCommerce share of retail transactions continues to grow). Starting with the consumer side, a recent survey commissioned by WhosOn spelled out several key benefits related to customer satisfaction and convenience:

- 92% of customers feel satisfied when they use live chat to deal with businesses, more than any other communication option
- Chat has become the leading online contact source, with 42% of customers using chat versus email or social media
- All demographics are comfortable with live chat; even one-third of Older Boomers and the Golden Generation use it for customer service
- 93% of consumers feel real-time help is beneficial during the online customer journey
- 87% of consumers list live help among the three most important features of a website

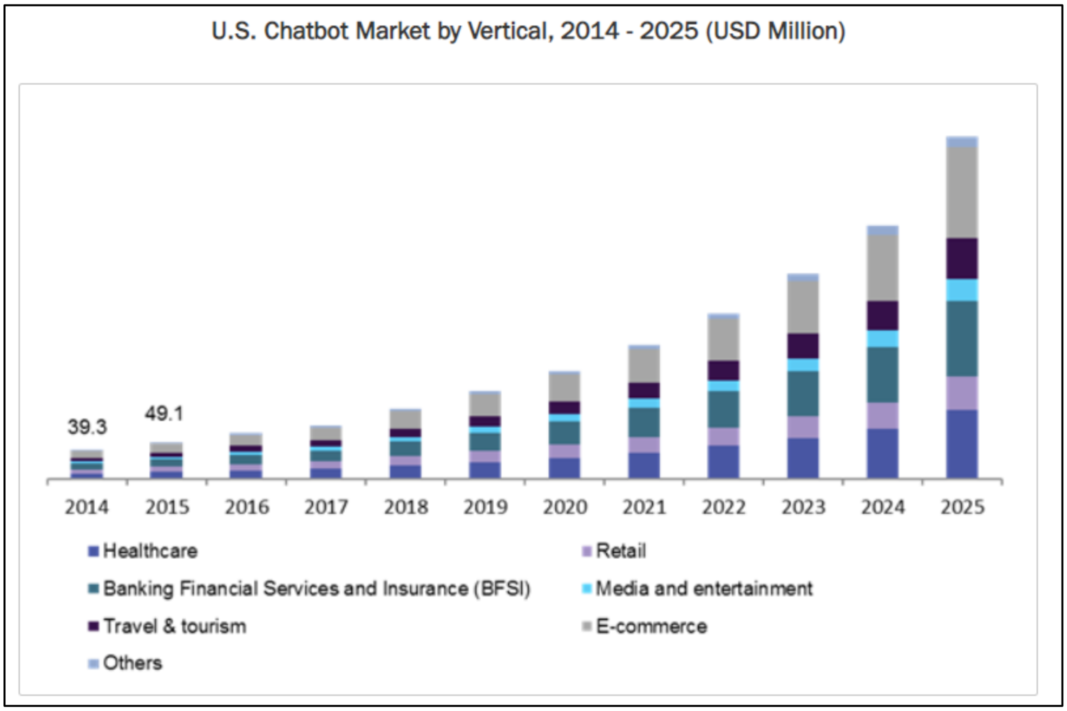
For businesses, the proposition is equally compelling, with benefits seen both in terms of revenue generation and cost control:

- Chatters are worth 4.5x as much as website visitors who don't chat
- 62% of customers are more inclined to purchase online if live support is available
- 79% of businesses say adding live chat has had a positive impact on customer loyalty, sales, and revenue
- Live chat is 17%-30% cheaper than a phone call
- Companies that use live chat have a 2.4 times greater annual increase in upsell revenue

Accordingly, despite being a relatively established market, most estimates call for the industry to continue expanding around 7% a year, which will provide a supportive environment for continued growth in LVC's flagship product in the years to come.

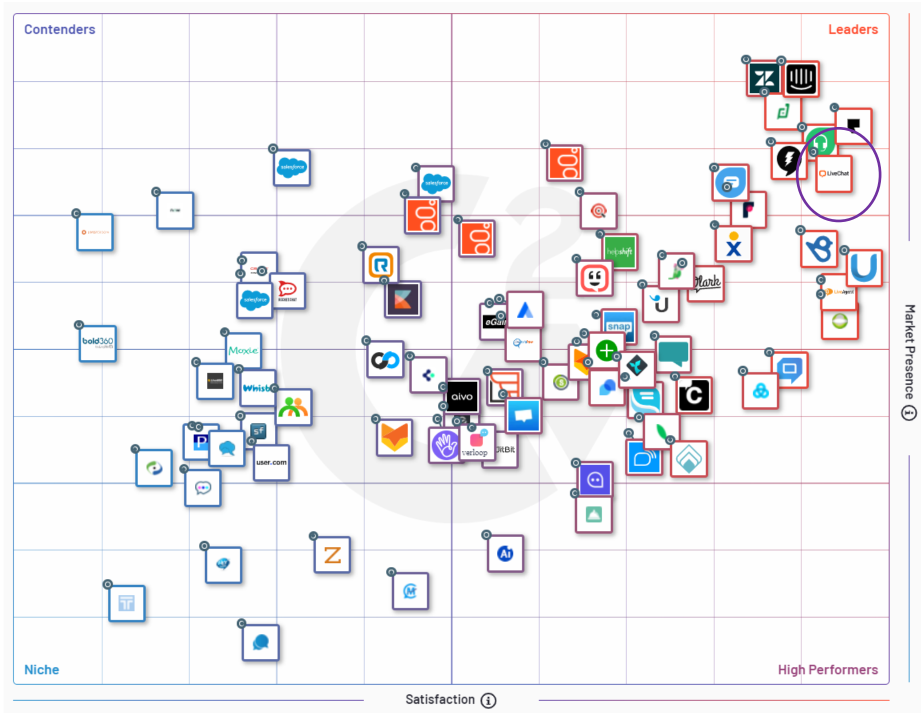
Meanwhile, the chatbot software market is smaller but growing much more quickly (thus mirroring LVC's segment-level financial development). Already found in the bottom-right corner of many popular sites, smart chatbots are in many ways the next logical step for text-based business communications; cutting out support agents from some conversations entirely obviously further increases service speed and/or reduce costs. Many companies are moving to a hybrid model in which the 80% of chats related to routine inquiries are handled by bots, with the remaining 20% of customers with a rarer question are then passed on to live agents. In addition, ongoing artificial intelligence advances will further improve the range and quality of bots' responses to queries, thus pushing up that 80% success rate over time.

As the chart below shows, the US chatbot market is expected to roughly double over the next five years, and the rapid growth is expected across a wide range of industries, particularly eCommerce:



LVC is well positioned to benefit from this trend across all market subsets. For those that need only a basic application or that lack programming sophistication, the company offers clients a wide range of pre-built templates free of charge. To those requiring a more customized or advanced solution, LVC's open APIs allow for a wide range of third-party app connections that make it a viable option across a wide range of industries and use cases. Given the popularity of the hybrid model, the ability to offer a seamless integration with LiveChat should be helpful both in winning upsells from existing clients and in competing for new customers looking to implement a holistic solution with minimal headaches. Owning prime online real estate shouldn't hurt either.

Third party analysis shows LVC in the upper echelon of chat providers, both in terms of customer satisfaction and market presence:

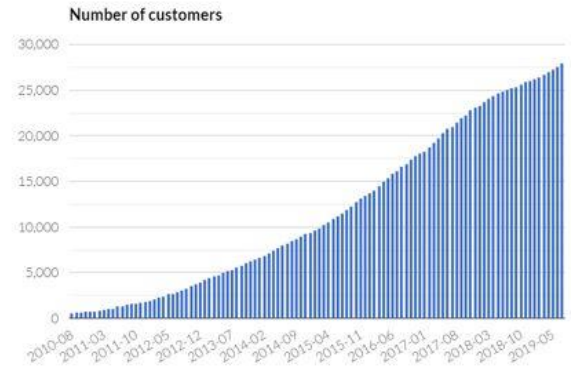


While the graphic above suggests a (very) crowded market, keep in mind that it includes on-premise providers as well as multiple products from the same provider (notice three different Salesforce.com boxes, for instance). Additionally, LVC has made it clear that it does not view “freemium” solutions (which comprise the great majority of options) as competitors, since it does not offer any free plans. Its stated rationale, and the factors it chooses to compete on instead, were provided in the latest annual report:

“In the assessment of the Management Board of LiveChat Software, monetisation of clients which started to use free services is a very difficult and ineffective process. The “LiveChat” solution is distinguished by, among other things, the number of available functionalities, options and integration capabilities. A matter of paramount importance is also customer service, which largely exceeds capabilities of the majority of other suppliers.”

Accordingly, management believes that ZenDesk and Intercom are its only truly direct competitors in the premium segment – a far cry from what the quadrant above might suggest.

In any case, competition has not seemed to bother the company to date. Market expansion, along with LVC's excellent value proposition and execution, have led to consistent customer and sales growth, as shown in the charts below:

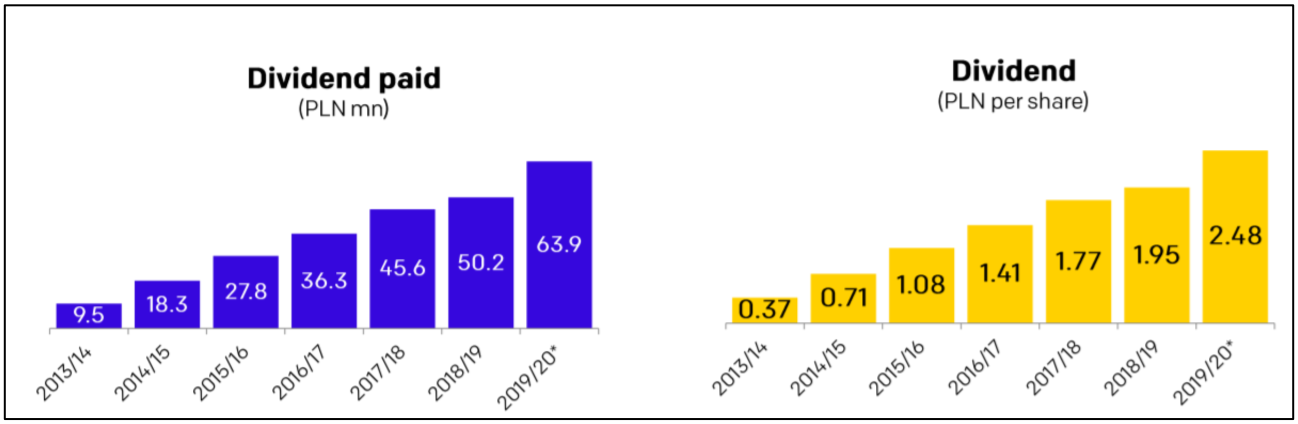


More impressive, however, is how LVC has managed to achieve this growth while maintaining very high levels of profitability (87% gross, 68% EBITDA and 58% net margins last FY). Tight expense control and a strong inbound marketing focus make for very efficient spend, with returns on assets, equity, and capital all exceeding 90% since 2015 (see table below). LVC also maintains a strong balance sheet with 39 M PLN cash and no debt. In fact, LVC could likely further accelerate sales growth by ramping S&M spend (currently running at 15% of sales vs. a 39% average for listed SaaS companies) while still maintaining best-in-class margins.

Profitability (%)

	5Y Avg	MAR '12	MAR '13 365 DAYS	MAR '14 365 DAYS	MAR '15 365 DAYS	MAR '16 366 DAYS	MAR '17 365 DAYS	MAR '18 365 DAYS	MAR '19 365 DAYS	MAR '20 366 DAYS
Gross Margin	84.5	88.8	84.5	84.3	84.6	83.8	84.6	84.0	83.6	86.7
SG&A to Sales	18.2	25.1	15.2	21.8	14.2	17.9	14.7	15.3	18.8	24.0
Operating Margin	66.4	59.1	67.0	63.6	70.4	65.9	69.9	68.6	64.8	62.6
Pretax Margin	66.2	57.4	63.8	63.9	70.0	66.1	70.1	67.1	64.9	62.6
Net Margin	54.8	43.7	50.6	51.2	56.2	52.9	56.3	54.0	52.4	58.2
Free Cash Flow Margin	49.9	42.8	55.1	59.1	54.0	53.7	56.8	48.1	46.3	44.5
Return on Assets (%)	103.9	-	96.2	91.6	108.5	105.2	107.8	100.5	103.9	102.1
Return on Equity (%)	113.3	-	115.1	109.5	121.9	114.0	115.7	107.5	115.0	114.4
Return on Common Equity	113.3	-	115.1	109.5	121.9	114.0	115.7	107.5	115.0	114.4
Return on Total Capital	136.9	-	152.3	136.0	152.9	141.8	143.8	136.5	142.2	120.4
Return on Invested Capital	112.9	-	115.1	109.5	121.9	114.0	115.7	107.5	115.0	112.5
Cash Flow Return on Invested Capital	115.0	-	125.3	126.2	117.3	115.6	116.8	107.5	123.2	112.0

Reviewing LVC's financials is refreshing for those accustomed to the cash burn and share dilution found at most public software companies. In contrast, LVC has no stock-based compensation or external capital needs (share count has remained identical since 2014 IPO), and it has returned capital to shareholders each year (the chart below could make even a conservative dividend growth investor take a look here).



Management and Culture

There has been very little turnover in LVC's management ranks, and all three founders are still involved with the company. One founder, Marius Cieply, has served as CEO since 2010 (just before LVC's founders regained full control), while the other two are on the Board of Directors. All three still retain at least a 11% stake in the company, ensuring that their interests are fully aligned with shareholders.

Shareholder	Number of shares and votes	% of shares and votes
Nationale-Nederlanden PTE	1 591 000	**6,18%**
Aviva OFE Aviva Santander	1 687 000	6,55%
Agreement of Shareholders	**12 077 522**	**46,90%**
Mariusz Ciepły	4 010 000	15,57%
Maciej Jarzębowski	3 010 000	11,69%
Jakub Sitarz	3 010 000	11,69%
Others	**10 394 478**	**40,37%**
Together	**25 750 000**	**100,00%**

The CFO, Urzsula Jarzebowska, has worked at the company since 2002 and been CFO since 2010. Compensation for both the CEO and CFO is reasonable for a company of this size at $240k USD equivalent for the CEO and $160k for the CFO.

We think LVC's culture is a key differentiator in a competitive industry. As the G2 graphic above suggested, the live chat niche of the software market has no shortage of players. However, this is a fact that is fully acknowledged by management, and in the company's "Living Constitution", Cieply lays out how they've managed to carve out a defensible niche despite that. The company's guiding principles are as follows:

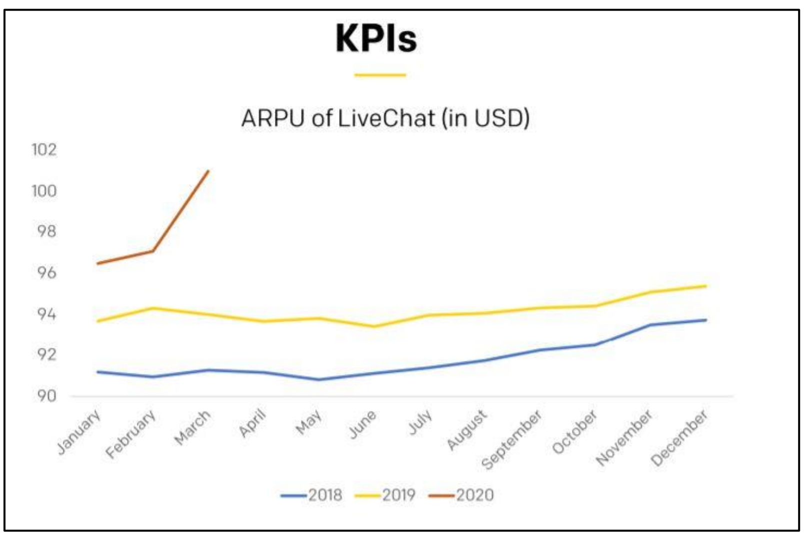
- **Customer-centricity**: Must accept that many products in the industry are nearly identical, which means the key to winning business is building "emotional capital" by taking care of the customer relations process and making end users happy.
- **Open ecosystem:** Be willing to partner with other ISVs to create the best solutions for customers, and even provide the building blocks for others to create their own customer service solutions.

- **Centralized point of customer interactions**: Make sure product is a hub for data importation and collection; this provides the insights needed for effective decision-making.
- **Differentiation through innovation**: Look for creative ways to deliver an emotional charge and avant-garde solutions.
- **Leveraging economies of scale**: Use the millions of end users and the data they create to drive insights; once you have them, prioritize the biggest projects first.

The Living Constitution also contains the company's vision, mission, and core values. Many companies have buzzwords that outline similarly grandiose ideals, but putting them in the public domain and having employees sign their name to them helps to filter and separate out those individuals who truly believe in them from the rest. We'd highly recommend any prospective investor to review the full document.

Valuation

Though LVC is expensive on an EV/S basis (about 15x NTM sales), there may be a valid argument that this is reasonable valuation for a company with an NTM Rule of 40 score of about 75% (the only SaaS company with a higher one, Zoom, trades at over 30x NTM sales). However, we don't need to resort to sales-based metrics here, as the company is already very profitable. The stock trades at 23x NTM earnings, which we think is too cheap for business that grew EPS 33% last year with almost 100% recurring revenue – and pays 2.5% dividend to boot. This is especially true given that sales and net income growth are very likely to accelerate this year due to a change in pricing models this January, leading to large ARPU increases for the flagship LiveChat product.



The pricing initiative is already paying off – sales growth of 20% last FY accelerated to 30%+ in Q1, likely at very high incremental margins.

Based on the recurring nature of the LVC's sales and its ARPU and user disclosures, it's a fairly easy process to create a basic model showing the company's likely financial results for the LiveChat segment in the near-term. Based on a press release stating 1FQ21 revenues were over $10 M USD (and another with user count disclosures), we estimate APRU expanded to about $105 in the quarter. For the rest of the year, we estimate that the company adds about 400 customers a month, in line with its recent averages, and that ARPUs continue expanding gradually for the rest of the year (based on a June disclosure that changes in LVC's pricing model "are expected to have a positive impact on ARPU in coming quarters"):

LiveChat Segment Assumptions

	FY 20			FY21													
	Jan.	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar		
ARPU	96	97	101	105	105	105	111	111	111	117	117	117	123	123	123	400	avg. customers added per month
x Users	28,000	28,400	28,784	29,184	30,000	30,400	30,800	31,200	31,600	32,000	32,400	32,800	33,200	33,600	34,000		
Sales	2,688,000	2,754,800	2,907,184	3,064,320	3,150,000	3,192,000	3,418,800	3,463,200	3,507,600	3,744,000	3,790,800	3,837,600	4,083,600	4,132,800	4,182,000		

CY 20 Total	39.52	USD	146.6	PLN	3.71	USD/PLN
FY21 Total	43.57	USD	161.6	PLN		

The exponential growth of ChatBot and HelpDesk makes estimates here much more imprecise, but the company did disclose a sharp increase in ChatBot sales prices and APRU for the first quarter of CY20. We think doubling ChatBot sales (down from a 3.45x increase the previous year at much lower ARPUs) to 4.5 M PLN and assuming HelpDesk can reach 0.5 M PLN this year (from .023 M last year) is a fair estimate, although because these two segments are so small it doesn't have a material impact on the valuation. Adding this together to our LiveChat estimates yields a revenue projection of about 166 M PLN for FY21.

Despite growing sales at a 20% clip last year, LVC's COGS spend declined in absolute terms. Given ARPU increases (which of course cost nothing to implement) are set to be double-digits this year instead of the low single digits seen previously, we think we're likely to see further moderate margin expansion on this line even if COGS grow too. Meanwhile, net margins have fluctuated slightly in recent years based on the pace and cadence of hiring and external services, but the new addition of the IP Box tax benefit[1] means that they should remain structurally higher in upcoming years. even assuming significant further operating expense growth. As shown below, this produces 102 M PLN in net income, and with the 25.75 M share count, we thus estimate the business will earn about 4 PLN/share in EPS next FY.

[1] IP Box refers to a tax exemption available in several European countries that applies to income generated from qualified intellectual property rights. The past FY was the first time LVC applied for the exemption, and it expects to continue doing so going forward. The regulations concerning corporate income tax frequently change, but for now we believe it's appropriate to estimate future net income using the lower consolidated rate.

LVC Basic Model					
			FY21		
FY21 Revenues (PLN)		Total Revenues	166.6		
LiveChat	161.6	x Gross Margin	88.6%	<-- assumes 10% COGS growth	
ChatBot	4.5	Gross Profit	147.63		
HelpDesk	0.5	- Opex	37.69	<-- 20% opex growth as external service spend moderates	
KnowledgeBase	-	EBIT	109.94	66.0%	implied margin
Total	166.6	- Net Financial Exp.	-	<-- assume no interest on cash & equivalents	
		Pre-tax Income	109.94		
		- Taxes	7.70	7%	effective rate post IP Box (in line with FY20)
		Net Income	102.24		
		/ Shares	25.75		
		EPS	3.97		

Our EPS estimate is roughly in line with consensus, so in the near term, it's fair to say that this is more of an "under the radar" idea than a 'strong variant view' idea. However, a variant view does begin to materialize after that, as our numbers begin to differ materially from consensus in outer years. Current consensus calls for 10-12% earnings growth in FY22 and FY23; we think it will be over 20%. Furthermore, there is ample reason to believe double-digit growth can continue for beyond the next few years thanks to the market expansion (particularly in the chatbot category) and eCommerce trends discussed above.

Why the discrepancies? We think the sell-side isn't paying particularly close attention here beyond the next release or two. To illustrate, one analyst reiterated a buy rating in late July, but bizarrely kept a 48 PLN price target – which would imply 50% downside. Assuming that analyst isn't purposely trying to help clients lose money, the best explanation is that his LVC coverage is a very low priority.

Broker	Rating Date	Rating*	Price on Rating Date	Tgt Price Date	Tgt Price*	Price on Tgt Price Date	Tgt Price Implied Return (%)
Mean	20 Aug '20	Overweight (1.30)	99.00	20 Aug '20	78.20	99.00	-21.0
Wood & Company	18 Aug '20	Buy	98.20	18 Aug '20	48.00	98.20	-51.5
Erste Group Research	04 Aug '20	Overweight	89.30	04 Aug '20	103.40	89.30	4.4
PKO Dom Maklerski	17 Jul '20	Buy	85.20	17 Jul '20	90.00	85.20	-9.1
Santander Brokerage Poland	16 Jul '20	Buy	85.00	16 Jul '20	68.00	85.00	-31.3
BOS Dom Maklerski	15 Jul '20	Hold	76.30	15 Jul '20	81.60	76.30	-17.6

Looking out two years, we think LVC will generate at least 5.50 PLN in EPS for FY23, based on 240 M PLN sales and a 60% net margin. Rolling forward the current NTM P/E multiple would suggest a fair value two years out of about 130 PLN, which would be a 17% IRR (including dividends). While this serves as our base price target, in our opinion it is actually very unlikely that 23.5x is the right multiple to use for this business in a near-zero interest rate world. This is especially true when the median multiple for listed SaaS companies expecting positive EPS next year is multiple times that. The chart below, including only companies whose combined sales growth and FCF margins are expected to be above 20%, shows the extent of the variance (recall LVC's Rule of 40 is about 75%):

Symbol	Name	NTM Rule of 40	Price / NTM EPS
ZM	Zoom Video Communi	150.5%	189.6
VEEV	Veeva Systems Inc Cl	46.9%	94.6
ADBE	Adobe Inc.	44.4%	43.1
SWI	SolarWinds Corp.	38.6%	20.0
SHOP	Shopify, Inc. Class A	38.4%	458.7
LRN	K12 Inc.	33.9%	39.5
CRWD	CrowdStrike Holdings,	31.2%	1,352.1
CSOD	Cornerstone Ondemar	27.6%	27.9
NOW	ServiceNow, Inc.	27.1%	85.8
ECOM	Channeladvisor Corpo	23.2%	18.9
RP	RealPage, Inc.	22.8%	30.1
DOCU	DocuSign, Inc.	22.7%	309.0
CRM	salesforce.com, inc.	22.5%	62.1
APPF	AppFolio Inc Class A	21.6%	191.9
Average		**37.1%**	**196.5**
Median		**27.3%**	**87.3**

We don’t expect LVC to ever be valued at anything like the median values above – but it doesn’t have to in order to generate an attractive return. Importantly, we are very confident that our estimates will be at least directionally correct and believe the predictability of the revenues streams and profitability mean intrinsic value will increase each year. As a result, the risk of permanent capital impairment seems low for a long-term investor, while the opportunity for significant multiple expansion from current levels creates an asymmetric risk-reward.

Looking out further than two years also suggests a 17% IRR estimate could prove quite conservative. Consider this quote from Charlie Munger to get an idea of the multi-year upside (recalling LVC has generated a 120%+ return on capital every year since going public):

“Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result.”

Modeling out the next ten years (even assuming a lower reinvestment rate of about 30%) gives us a rough idea of the upside case if LVC can maintain anything close to its current levels of profitability, even if the multiple contracts significantly:

LiveChat Software ROC Analysis			
LVC LTM NI	76.4	PLN	
Beginning Multiple	32.6		
Current Valuation	2,488	PLN	
% Earnings Reinvested	30%		<-- % of LTM NI not distributed as dividends is 35%
Returns on Retained Earnings	120%		<-- in line w/ LTM; 5 yr. avg. is 137%
Cumulative Dividends	57.9	PLN	<-- assumes continued dividend growth
Year 10 NI	1,652.8	PLN	
Year 10 Multiple	15.0		<-- at 30x multiple, equates to 35% IRR and 20x MOIC
Year 10 Valuation	24,792	PLN	
Total IRR	*25.9%*		
MOIC	10.0		

As such we think the range and skew of outcomes is attractive across a variety of contemplated holding periods.

Why Does the Opportunity Exist?

We can think of several possible reasons for why this opportunity is available to investors today, compiled in list form below:

- The most obvious is that this is a small-cap stock listed in a country that generally doesn't receive much investor attention. Many large funds are unable to take positions, and most smaller players have never heard of it.
- Sell-side coverage on LVC is limited to smaller regional players (you can see the list in the graphic above), which in turn limits the number of investors with access to their reports.
- The management team is fairly non-promotional and doesn't give guidance like most software companies. The company's inbound marketing focus also means you won't see them advertising on a billboard to get their name out anytime soon.
- LVC is not particularly cheap on EV/S, the predominant SaaS metric. Screens run solely on that basis would not cause the company to stand out.

Catalyst

We don't anticipate a hard catalyst leading to a sudden re-rating here. Instead, value will likely serve as its own catalyst as growth continues and more capital is returned to shareholders. A few other plausible ways are outlined below, though we are not banking on any of them occurring:

- Analyst estimates will likely move up and more closely convergence with ours. Though the brokers are not particularly well-known, this could positively reset expectations for some investors.
- Software is a notoriously M&A-happy industry, and LVC makes sense as a potential takeout candidate, particularly given its niche focus. There are plenty of companies with the financial

resources to make a ~$600 M USD purchase, and LVC's existing integrations with the likes of Salesforce.com and HubSpot would make for it a logical combination for many of them.
- Given their prominence, American software companies tend to be closely followed and often awarded premium valuations. To that end, LVC could pursue an ADR listing to help close the valuation gap, particularly since a large portion of its customer base is in North America. However, there is no indication that management is pursuing such a course, so nothing is imminent on this front.

Risks

Despite the quality of the business, this investment is not without risks. We are very comfortable with the risk-reward profile here, but valid concerns are as follows:

- LVC's revenues are 95% USD-denominated, while its financial statements and almost all of its costs are in PLN. This currency mismatch could potentially be a headwind if the Zloty were to significantly strengthen against the greenback.
- As the G2 graphic depicted, there are a wide range of firms with chat software offerings. Staying ahead of the pack will require keeping up the same level of innovation and execution that LVC has shown in recent year.
- Price increases this past January combined with COVID-related business problems for clients did lead to a slight uptick in churn rate; however, management has commented that it has steadily glided toward its long-term average of 3% since the second half of April.
- LVC stock has run up in recent months, so it's possible there could be a pullback to a better entry price in the future. Of course, this is irrelevant if you take a long-term view on the opportunity.

Conclusion

In summary, we think LiveChat Software is an excellent buy and hold investment that possesses many of the hallmarks of a great business. The company operates in an attractive industry niche, with a rare combination of growth and profitability, as well as a track record of execution and aligned insiders. Furthermore, there are tailwinds for increased demand from investors both on a macro (Polish pension reform) and micro level (increased awareness/recent market value increases making position feasible for more funds). It's hard to suggest a firm target price here – but we'd rather be approximately right than exactly wrong, and in our view, buying businesses generating 100%+ returns on capital at roughly market multiples makes it very likely we will be directionally correct. As such, we think the risk-reward is very attractive at current levels and have been accumulating shares in our fund.

Disclaimer:

The enclosed material is confidential and not to be reproduced or redistributed in whole or in part without the prior written consent of Adestella Investment Management, LLC. The information in this material is only current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Any statements of opinion constitute only current opinions of Adestella Investment Management, LLC, which are subject to change and which Adestella Investment Management, LLC does not undertake to update. Due to, among other things, the volatile nature of the markets, an investment in the fund may only be suitable for certain investors. Parties should independently investigate any investment strategy or manager, and should consult with qualified investment, legal and tax professionals before making any investment.

The fund is not registered under the investment company act of 1940, as amended, in reliance on an exemption there under. Interests in the fund have not been registered under the securities act of 1933, as amended, or the securities laws of any state and are being offered and sold in reliance on exemptions from the registration requirements of said act and laws.