THE MANUAL OF IDEAS ™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

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When asked how he became so successful, Buffett answered: "We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

Also Inside

About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

THE SUPER-INVESTOR ISSUE

- ► MOI Signal Rank and top holdings of 50+ superinvestors
- ► Screening 800+ superinvestor holdings
- ► 20 companies profiled by The Manual of Ideas research team
- ► Proprietary selection of Top Three candidates for investment
- ► Plus: Exclusive interview with Alan Zafran of Luminous Capital
- ► Plus: Exclusive interview with Brian Boyle of Boyle Capital
- ► Plus: Exclusive write-up by Robert Leitz on Digital River

Superinvestor holdings profiled include Aeropostale (ARO), Apache (APA), Brookfield Asset (BAM), Colfax (CFX), Cooper (COO), FLIR Systems (FLIR), General Motors (GM), Heineken (HINKY), Humana (HUM), Lazard (LAZ), Marriott Vacations (VAC), Marvell Technology (MRVL), Phillip... ...ble (PG), Range Resources (RRC), Ro... Thermo Fisher (TMO)...

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Inside:

Exclusive Write-up on Digital River (DRIV) by Robert Leitz

With compliments of The Manual of Ideas

Robert Leitz on Digital River

The following investment thesis is authored by Zurich-based value investor Robert Leitz, founder and portfolio manager at iolite Partners. He has previously worked at TPG Credit, Goldman Sachs, and KPMG.

> *"Over the last five years, the company has averaged sales of $380 million and owner earnings of $80 million (20% margin) on tangible assets of $50 million."*
> *[market value: $540 million]*

Investment Thesis

Digital River is a solid company in a competitive but growing industry and benefits from high scalability. It provides end-to-end global e-commerce solutions, such as online shops with integrated payment systems, and generates a substantial majority of its revenue on a client revenue-share basis. Despite a concentrated customer base and short-term contracts, the company is in a good position to benefit from the growth of online retail and some customer stickiness. Over the last five years, the company has averaged sales of $380 million and owner earnings (OCF less capex) of $80 million (a 20% margin) on tangible assets of $50 million.

With a recent market cap of $540 million, the company trades at 80% cash to market cap, 130% cash and investments to market cap, 2.0x EV to owner earnings, and 6.5x market cap to owner earnings. The company recently announced a buyback program of $100 million, almost 20% of market cap. It is difficult to put a number on the shares' fair value, as it is sensitive to the use of cash going forward. However, if DRIV maintains the current sustainable leverage level of 4.3x gross debt to owner earnings and keeps utilizing cash in a shareholder-friendly way (buybacks or value-adding acquisitions), the stock should return more than 15% annually over the next few years.

Business Overview

DRIV was founded in 1994 and is headquartered in Minnetonka, Minnesota. It provides end-to-end global e-commerce and marketing solutions to a range of companies in software, consumer electronics, gaming (computer and video) and other markets. The company's services include:

- design, development and hosting of online stores and shopping carts,
- store merchandising, order management, payment processing and product delivery (digital and physical)
- online marketing and paid search programs, and
- website optimization, analytics and reporting.

It generates a substantial majority of revenue on a revenue-share basis: if it manages an online store for a client, it receives a percentage of the selling price of each product sold at that online store. Sales outside the U.S. accounted for 47% of total sales in the first half of 2012.

Customers

Customers have included many of the largest software, consumer electronics and gaming companies as well as major retailers of these products. The list includes Allume Systems, Autodesk, CompUSA, Computer Associates, Canon, Electronic Arts, Hewlett Packard, Lexmark, Microsoft, Nuance, Symantec, and Trend Micro. In 2010, the company entered into an agreement with Microsoft to build, host and manage the Microsoft Store, an e-commerce store that supports the sale and fulfillment of Microsoft and third-party software as well as consumer electronics products to customers globally.

Competition: Strong and Diverse

- Clients' in-house development, e.g. Symantec migrated its online store to an internally developed system in 2009
- Other providers of e-commerce solutions, e.g. cleverbridge, eBay, Avangate, asknet, Arvato, Amazon and Buy.com
- Companies that provide technologies, services or products that support the e-commerce process, e.g. CyberSource (Visa) and PayPal
- Web infrastructure companies seeking to expand their offering, e.g. Network Solutions, Akamai, Yahoo!, eBay and Hostopia.com
- Disruptive technology or new e-commerce models, e.g. Apple app store
- Companies that offer various online marketing services, technologies and products, e.g. ValueClick and Microsoft Advertising

> *"The company recently announced a buyback program of $100 million, almost 20% of market cap."*

Recent Events

Q2 results missed management's revenue guidance, and the stock traded down 25% from $17.79 to $13.32 in a day, marking a nine-year low. I believe the market overreacted to the news, considering the company's stable revenue and earnings history as well as the low market valuation. DRIV now anticipates 2012 adjusted earnings of $0.96-1.08 per share on revenue in a range of $378 million to $390 million. The prior outlook was for adjusted earnings between $1.20-1.28 per share on revenue of $402-409 million.

Digital River – Financial Overview

($ in millions)	FY Dec-02	FY Dec-03	FY Dec-04	FY Dec-05	FY Dec-06	FY Dec-07	FY Dec-08	FY Dec-09	FY Dec-10	FY Dec-11	LTM Jun-12	Valuation 5-Year Avg.
Revenue	77.8	101.2	154.1	220.4	307.6	349.3	394.2	403.8	363.2	398.1	400.7	381.7
EBITA	4.8	21.7	43.0	75.4	79.7	81.5	80.0	71.1	20.8	38.5	36.2	58.4
OCF (incl. Interest)	17.6	47.8	85.1	119.8	117.5	146.4	95.2	137.1	57.8	94.8	69.8	106.2
Capex	-5.2	-6.3	-9.3	-8.3	-15.9	-18.7	-26.9	-31.9	-18.6	-23.9	-20.9	-24.0
Owner Earnings	12.3	41.6	75.9	111.4	101.6	127.7	68.3	105.1	39.2	70.9	48.9	82.2
Working Capital (ex Cash)	-19.9	-32.5	-66.5	-93.0	-89.0	-115.5	-131.1	-141.6	-138.0	-178.6	-97.3	-97.3
Cash	-41	-102	-128	-132	-390	-382	-490	-393	-565	-497	-422	-422
Investments	0	-30	-164	-221	-236	-316	-103	-135	-274	-322	-307	-307
Debt	0	0	195	195	195	195	195	9	354	354	354	354
Net Debt	-41	-132	-97	-157	-431	-502	-399	-519	-485	-466	-375	-375
Diluted Shares Out (m)	26.8	33.1	38.5	41.4	44.6	45.9	42.1	37.7	38.3	37.5	33.6	33.6
Price (USD)	13	22	33	30	56	33	24	27	35	15	16	16
Market Cap	348	727	1,272	1,243	2,500	1,515	1,011	1,018	1,342	563	537	537
EV	307	595	1,174	1,086	2,069	1,013	612	499	857	97	162	162
EV/EBITA	63.8 x	27.5 x	27.3 x	14.4 x	26.0 x	12.4 x	7.7 x	7.0 x	41.1 x	2.5 x	4.5 x	2.8 x
EV/Owner Earnings	24.9 x	14.3 x	15.5 x	9.7 x	20.4 x	7.9 x	9.0 x	4.8 x	21.8 x	1.4 x	3.3 x	2.0 x
Market Cap/Owner Earnings	28.2 x	17.5 x	16.8 x	11.2 x	24.6 x	11.9 x	14.8 x	9.7 x	34.2 x	7.9 x	11.0 x	6.5 x

Investments: As of June 30, 2012, the company had $275 million (fair value) or $289 million (cost basis) of total investments of $307 million as available-for-sale investments. Breakdown at fair value: $170 million corporate bonds, $51 million auction-rate securities, $38 million U.S. government-sponsored entities, $14 million asset-backed securities, and $2 million public equity investments.

Negative working capital: The company partly finances itself with negative working capital. Given historic numbers and DRIV's business model, current levels seem sustainable and unthreatening. However, year-end cash figures are overstated by around USD 60-80m given a seasonal working capital peak.

"The company offers an attractive full-service package. Customers can significantly reduce or eliminate upfront and ongoing hardware, software, maintenance and support costs associated with developing, customizing, deploying, maintaining, and upgrading an e-commerce solution."

Highlights

Good value proposition: The company offers an attractive full-service package. Customers can significantly reduce or eliminate upfront and ongoing hardware, software, maintenance and support costs associated with developing, customizing, deploying, maintaining, and upgrading an e-commerce solution.

Market tailwinds: The U.S. Commerce Department reported that e-commerce sales in 2011 rose 16% compared to 2010. Online retail is and will remain a growing market for years to come.

Customer stickiness: Clients face certain hurdles when moving to another provider, such as general set-up inconveniences, business interruption risks, or technical switching costs and difficulties.

Scalability: The business is highly scalable and a customer's sales increase has an immediate impact on Digital River's bottom line.

Inflation protection: The revenue-share contracts with online retailers would likely lead to higher revenues in an inflationary environment.

Buybacks: The company is utilizing its strong balance sheet to buy back shares at a very low market valuation.

Risks

Customer concentration: Sales of products to Microsoft accounted for 28% of revenue in 2011. A limited number of other software and physical goods clients contribute a large portion of revenue. In 2009, Symantec, accounting for 25% of revenue at that time, elected not to renew its contract with Digital River and migrated its online store traffic to an internally developed e-commerce system.

Possible value-destroying acquisitions: Acquisitions are a key element of the strategy. In the last five years, the company has acquired or invested in 11 firms.

Taxation of repatriated cash: 44% of cash is held in international subsidiaries.

Cash restrictions: As of June 30, 2012, $64 million of auction-rate securities recorded at $51 million fair value could not be sold due to market illiquidity.

Capital allocation: Aside from current buybacks, management has a somewhat poor capital allocation track record. Two convertible bond issues in 2004 and 2010 were meant for acquisitions that never materialized. Stock-based compensation has averaged $20 million annually over the last five years.

"Aggressive buybacks at the recent low market valuation could turn this stock into a double- or triple-bagger within a two- to three-year timeframe."

Conclusion

Digital River is a stable and capital-efficient company in a competitive but growing market. The company is moderately leveraged, and its recent market cap is lower than gross cash holdings plus investments. Returns to shareholders will depend largely on the company's use of cash going forward.

Aggressive buybacks at the recent low market valuation could turn this stock into a double- or triple-bagger within a two- to three-year timeframe. Even if the most bullish scenario does not materialize, the company's strong balance sheet as well as its solid free cash flow generation should be sufficient to lift the stock from current levels in a meaningful way going forward.