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Value Investor INSIGHT

The Leading Authority on Value Investing

Going Separate Ways

Corporate spinoff activity, today at historically high levels, has proven fertile ground for market inefficiency. Why is that so, and how can discerning investors separate the wheat from the chaff in sifting through prospects?

Bloomberg since the end of 2002 has maintained a US Spin-Off Index, which tracks the share prices of newly spun off companies with $1-billion-plus market caps for three years after they begin trading. Over that nearly 13-year period the index has increased 557%, versus a 137% return for the S&P 500.

This spinoff anomaly has been an open secret among value investors for longer than that. Early research on spinoff outperformance goes back more than 50 years. Joel Greenblatt wrote in detail on the subject in his 1997 book, *You Can Be a Stock Market Genius*. With spinoff activity near an all-time high, we examine the many structural reasons spinoffs can be mispriced and ask four experts where they're looking for such mispricing today.

INVESTOR INSIGHT

Jim Roumell
Roumell Asset Management

"Covisint would go in the category of a premature spinoff. From what we've learned, it wasn't fully baked yet."

Covisint [COVS], spun off from Compuware in a two-step process starting in September 2013, would appear to belong in the broken-spinoff category. When did you get involved?

Jim Roumell: We were owners of Compuware in 2013 when it sold a small stake in Covisint in an IPO at $10 a share. We weren't buyers then, but got our initial stake when Compuware spun off the rest of Covisint as part of its buyout by private equity firm Thoma Bravo in September of last year. As the stock kept coming down, we actively began building our position at less the $2 per share and then continued to buy up to about $3.

I would put Covisint in the category of a spinoff that happened prematurely. Going back to the beginning, it was launched in 2000 by Ford, General Motors and DaimlerChrysler to create a secure, online supply-chain buying and selling platform for the automotive industry. They spent hundreds of million of dollars on it and created an industrial-strength platform that was sort of pioneering in what's known as federated identity management [FIM], which lets multiple enterprises use the same identification data to obtain access to the networks of all enterprises in the group. Think of it as a big house where you can come in the front door, but there are lots of different rooms that only different subsets of people can enter. An FIM system manages all that securely and efficiently.

The supply-chain exchange never really took off, having more to do with the companies' and regulators' ultimate comfort with a common platform than the technology of the platform itself. Compuware bought the technology in 2004 and very deliberately started to build a business around it, but it was this small little software-as-a-service platform in this big mainframe-software company, so it never really got much attention. That changed when an activist, Elliott Management, came after Compuware in 2012, and one of the ideas hatched was to take advantage of the crazy valuations being put on software-as-a-service companies and spin Covisint off. It had $50 million in subscription revenues and 95% customer renewal rates, but from what we've learned, wasn't fully baked yet in terms of sales and marketing strategy and infrastructure.

We assume you think that's been fixed.

JR: For anyone who has tons of data and wants to create a secure environment to allow multiple stakeholders to view discrete parts of it, that's what the Covisint platform does. In an increasingly cloud-based

INVESTMENT SNAPSHOT

Covisint
(Nasdaq: COVS)

Business: Provider of platform software services enabling organizations to securely connect with distributed communities of customers, suppliers and business partners.

Share Information
(@11/27/15):

Price	**2.56**
52-Week Range	1.79 – 3.33
Dividend Yield	0.0%
Market Cap	$101.49 million

Financials (TTM):

Revenue	$82.09 million
Operating Profit Margin	(-25.5%)
Net Profit Margin	(-36.4%)

Valuation Metrics
(@11/27/15):

	COVS	Russell 2000
P/E (TTM)	n/a	146.0
Forward P/E (Est.)	n/a	18.5

Largest Institutional Owners
(@9/30/15):

Company	% Owned
Fidelity Mgmt & Research	12.9%
Neuberger Berman	8.0%
Elliott Mgmt	7.5%
Portolan Capital	7.5%
J. Goldman & Co	6.5%

Short Interest (as of 11/13/15):

Shares Short/Float	1.1%

COVS PRICE HISTORY

THE BOTTOM LINE

Jim Roumell believes the company has righted itself strategically after a premature spinoff, focusing on "big fish" potential customers that he expects it will soon to start to reel in. If the company grows as he thinks it can, he believes based on peer valuations that it could be worth 2.5x 2016 revenues, which would translate into a $5.50 share price.

Sources: Company reports, other publicly available information

world, there are countless applications for such technology, and the company already has blue-chip customers, including GM, Ford, Hyundai, Roche and Shell. For GM, for example, Covisint's platform powers its OnStar system, which provides emergency, diagnostic and communications services to GM car owners. Going back to the company's early days, suppliers wanting to sell to GM do so through Covisint technology as well. Automotive customers account for about 50% of current overall subscription revenues, with GM making up about half of that. With the increasing emphasis on "connected" cars, we think that's a strength going forward.

On the sales and marketing front, management has decided it wants to go after big fish. Key to that has been the signing of strategic selling partnerships with both Cisco and Tech Mahindra, a large Indian IT-services group. Cisco's deal is a three-year licensing agreement, at $6 million per year, to use Covisint's technology in the cloud-platform services it's selling. The $6 million per year covers a certain amount of sales and after that there's a revenue share. Tech Mahindra is using Covisint's technology in a key initiative it's rolling out to sell a comprehensive suite of "Internet of Things" technology and services.

To be clear, there's a great deal of skepticism about Covisint's growth prospects. Given its history, that's understandable. Our variant view is that the company has the right technology, is targeting the right customers and is enlisting the right partners. They're certainly acting confident, having hired 20 new account executives and systems engineers so far this year and establishing a new office in San Francisco. We believe they have a lot of big fish close to the boat, but they obviously have to start reeling a few in soon.

With the shares at around $2.60, how are you looking at valuation?

JR: The company is tiny, with just over $100 million in market cap. Subtract $40 million in net cash, and the enterprise value is only around $60 million. Against that is a run rate of $67 million in subscription revenue – ignoring $20 million in to-be-deemphasized professional-services revenues – which we believe can increase 10% over the next 12 months. So the current enterprise value is only 80-85% of our estimated 2016 revenues.

Software-as-service providers with sticky revenue tend to trade for 2x to 5x total sales. If we're right on sales growth, at what we'd consider a reasonable 2.5x revenues that would translate into an equity value of $185 million. Add in the cash and the total market value would be $225 million, or more than $5.50 per share.

Isn't profitability, or specifically the lack thereof, a concern here?

JR: When you have subscription revenue that is so sticky, you want to spend on product and sales development to create growth, which is what they're doing. If the growth isn't there, they could cut back on sales and marketing and be nicely profitable right away.

If the company can't grow to a sufficient scale, we think it's highly likely that it's bought out by somebody who can basically fold the operation in and eliminate SG&A. Cisco, for example, is paying $18

million just to license the code for three years. At today's enterprise value, they could pay a bit more than 3x that and own the entire company and $70 million of recurring revenue. Covisint wouldn't sell at that price, but we could imagine the math working for both sides at one point.

Are all the big-money investors out of the stock by now?

JR: Interestingly, no. Fidelity and Neuberger Berman are the two largest shareholders, and both added to their positions last quarter. Right behind is Elliott Management, which has kept the position it got after the spinoff. We were also pleased to see that Vector Capital, a well-regarded technology investor that often works constructively with firms it believes have real growth prospects, filed a 13D earlier this month disclosing a new 6% stake. VII

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