

CommerceHub: Uniquely Levered to E-Commerce Growth

Artem Fokin presented his in-depth investment thesis on CommerceHub (Nasdaq: CHUBK) at Wide-Moat Investing Summit 2017.

The following transcript has been edited for space and clarity.

Disclaimer provided by Artem: Caro-Kann Capital LLC and its affiliates own CommerceHub stock. We will be under no obligation to update anybody on our views, additional purchases, partial or complete sales. Please do your own work. This presentation is for educational purposes only and does not constitute and should not be construed to constitute investment advice.

Caro-Kann Capital LLC is the general partner of the fund with a similar name, Caro-Kann Capital Fund LP. The fund was launched in March 2015. We focus on special situations and compounders. Sometimes the same investment idea has both elements: a compounder can wear a special situations hat. This makes us even more excited. CommerceHub is such a “double hat” situation. We found it as a special situation (i.e., spinoff) but the quality of the business makes it a truly extraordinary compounder.

Let’s start with a capital structure, which will help us put all subsequent numbers into context. CHUB has enterprise value of slightly less than \$800 million. The balance sheet is pristine, with only \$10 million of debt.

CHUB is an outstanding company and an attractive investment opportunity:

First, CommerceHub will benefit from a long growth runway — five to ten years or even longer. That runway is mostly powered by continuous growth of e-commerce.

Second, CommerceHub has a particularly strong moat, based on a powerful network effect and high switching costs. There are about 50 retailers, including some of the largest retailers in the U.S. (QVC, Home Depot, Toys R Us) and ~10,000 suppliers. The moat is still being built. In our experience, most rewards accrue to holders while a company is building a moat as opposed to holders who buy once the moat has been completely established.

Third, we are buying a SaaS company at non-SaaS valuation. CHUB trades at ten or even 15 turns of [valuation multiple] discount to other SaaS companies in the retail vertical.

Fourth, the product and service offering has a compelling customer value proposition. It helps retailers and suppliers to solve mission-critical tasks at modest cost.

Fifth, we like the margin profile, with about 80% gross margin — similar to the best-in-class software-as-a-service companies — and 40+% EBITDA margin *after* stock-based compensation expense. Incremental EBITDA margins are 80+%. These margins are for the core drop shipping business.

Sixth, upside optionality is built into CommerceHub, but it may not be apparent at a first glance. CommerceHub is developing a second business “Brands Initiative” or “CommerceHub for Brands”. The current size is small relative to the size of the overall company. The Brands Initiative generated revenue of ~\$10 million, compared to total revenue of ~\$100 million, in 2016, but it has tremendous potential.

Seventh, we like the management team. The founder and CEO is at the helm of the company. The incentives are aligned. Frank Poore started the company, sold it, left, and then came back a few years ago. Shortly before the spinoff in July 2016, Poore received an option grant, which would make him a 5% shareholder. Those options are slightly in the money.

Eighth, in terms of the business model, we love ultra-low customer acquisition costs. CommerceHub is spending about 10% of revenue on sales and marketing. This compares favorably to 30+% spent on sales and marketing typical for a SaaS company.

Why does this opportunity exist?

First, this is a recent spinoff. CommerceHub was spun off in July 2016 from Liberty Ventures, which is one of Dr. Malone's companies. If you are a fan of spinoffs and especially if you are a fan of Dr. Malone, you need no introduction to why this situation immediately got our attention.

There is a second reason. Historically, CommerceHub was reporting stock-based compensation based on arcane and convoluted accounting rules. As a result, someone looking at a spinoff information statement would likely come to a conclusion that stock-based compensation was extraordinary high. The true level of stock-based compensation was overstated by about \$25-30 million due to accounting conventions.

The third reason this opportunity exists is the Brands Initiative. That small business, which is being developed inside CommerceHub, is masking the revenue growth of CommerceHub's core business and the true margin profile.

Let's look at what CommerceHub does. It provides software-as-a-service drop-shipping solutions to retailers and their supplier for a fee. This brings up the next question. What is dropshipping? Let's first talk about a traditional e-commerce fulfillment model. If a consumer goes online to a retailer's website and makes a purchase, in the old world, a supplier would ship or probably has already pre-shipped those goods to the retailer's warehouse. When a consumer makes an order online, retailer's employees go to a warehouse, pick up the right SKU, put it into a box and ship it to a customer. Then those items arrive and the customer got what he wanted.

The dropshipping fulfillment model is different. Goods do not flow from a supplier to a retailer and then to an end customer. A retailer does not store those items in its warehouse. In fact, a retailer never touches those items. When a customer makes a purchase, the retailer "communicates" with the supplier and the supplier ships that item directly to a customer. The customer will probably never know the retailer did not touch those goods. The box would look like as if it came from a retailer. Packaging would look like as if it came from a retailer. Receipt would look the same way. In other words, a drop shipping fulfillment model allows retailers to make a positive impression on the customer without touching the goods.

Dropshipping benefits everybody in the ecosystem. Dropshipping creates more of a level playing field for retailers in the world where e-commerce importance has grown. Retailers benefit from a wide assortment of SKUs without carrying actual inventory. Thanks to drop shipping, retailers can expand their SKU assortment from roughly 100,000, which typically one would find in a store, to millions on the website. This is what is called virtual inventory. Virtual inventory has many wonderful traits. A retailer does not need to store virtual inventory in a warehouse. Consequently, there are no storage costs and there are no working capital requirements. There is no aging risk for inventory. Isn't it beautiful?

Furthermore, retailers are capital constrained. They don't have millions and millions of dollars to

spend on building new warehouses and expanding existing ones. But without such bigger new warehouses retailers cannot expand their assortment of goods. However, virtual inventory and dropshipping would allow retailers to do exactly that with no capex.

Customers also benefit. We as customers like going to a retailer website and see a wider selection of goods.

Another benefit for consumers is getting their orders faster.

Retailers and consumers benefit from less shipping costs. Think about it. In a traditional model, there will be two shipments. From the warehouse of a supplier to a retailer and then from a retailer to an end customer. In a dropshipping model, there is only one shipment.

Finally, suppliers benefit because it becomes easier to get the shelf space because virtual shelf space has no limitations.

The CommerceHub customer value proposition has two key elements. First, when a customer makes a purchase on a retailer's website, the retailer needs to seamlessly communicate with IT systems of a particular supplier and make a simultaneous decision whether the item can be drop shipped, how quickly it can be delivered, which part of the country this item is located in a supplier's warehouse, in which state of the United States. That is a challenging technical task. On top of that, a retailer in question wants to be updated on the order status. For example, is it running late? If it is, the retailer wants to notify the customer. All those tasks are technologically challenging and non-trivial. CommerceHub takes this challenge and solves it for retailers and suppliers. This is the first element of the customer value proposition.

Let's move to the second element of the customer value proposition. Retailers always drop some suppliers and add others. This is a constant process. If a retailer had to bring onboard all those suppliers relying only on its own in-house personnel, it will be long, painful, and expensive. However, CommerceHub takes care of that as well. Let's talk more about it.

CommerceHub has a very interesting and unusual go-to-market strategy. CommerceHub operates a two-sided platform business. One side is retailers and the other side consists of suppliers. CommerceHub acquires only retailers as customers. So far it has acquired about 50 retailers, including some of the largest U.S. retailers. Then retailers bring their suppliers to the platform. There are about 10,000 suppliers. If a supplier wants to do business with a retailer and participate in the drop shipping program and that retailer uses CommerceHub, the supplier will have to use CommerceHub as well (suppliers will have to join CommerceHub platform).

Retailers cannot force their suppliers to participate in drop shipping, but our channel checks and conversations show almost all suppliers are happy to participate in the drop shipping program because it is likely to result in more revenue and profit.

This customer acquisition model results in very low customer acquisition costs, which run at about 10% of revenue. Intuitively, it makes lots of sense. It's significantly cheaper to acquire 50 customers rather than 10,000. QVC, which was the first large retailer, which CommerceHub won about 15 years ago or so, Best Buy, Costco, Toys R Us are among CommerceHub's customers.

Let's talk about the business model. CommerceHub has three revenue streams. There is a base subscription revenue, there is usage revenue and there are setup and professional service fees.

Revenue stream #1, subscription revenue. It's about 25-27% of total annual revenue. The subscription fees are paid by both retailers and suppliers. The subscription fee is dependent on the number of the

connected trading partners. The more trading partners you have, the higher the subscription fee will be.

The next revenue stream, revenue stream #2, is the usage revenue. This is the largest revenue stream (it's about 68% of total annual revenue). Usage fee is per transaction and it does not depend on an order value.

In practice and using aggregated data, usage fee ends up about 50 basis points of gross merchandise value, so CommerceHub will collect about 50¢ for every \$100 of GMV, which flows through its platform. If you add subscription and usage fees together at the aggregated level, we're talking about 75 basis points of GMV. In our opinion and our conversations with customers confirm that, this is quite affordable.

The third revenue stream is of ad hoc nature. This is setup and professional services revenue. They are about 5-7%, and they are one-time. If a retailer or a large supplier onboards on CommerceHub platform, and they have some technical challenges because of their legacy software, they may engage CommerceHub employees to help them and they will pay onetime fees to CommerceHub.

The revenue model of CommerceHub is interesting. It is a recurring revenue model, but with a twist. CommerceHub derives recurring revenue similar to many other software-as-a-service companies. However, here is a twist. CommerceHub usage revenue increases with every new e-commerce transaction that involves drop shipping. Unlike many other software-as-a-service companies, CommerceHub does not have to sign any new customers in order to keep growing. CommerceHub will continue winning new customers, both among retailers and suppliers. As a result of its recurring revenue model with a twist, CommerceHub is in our opinion uniquely leveled to secular e-commerce growth.

Let's talk about the outlook and the massive tailwinds that will benefit CommerceHub: first, total e-commerce growth; second, increasing penetration of virtual inventory and drop shipping among existing customers; third, CommerceHub will sign new customers; and fourth, there is real possibility of international expansion. CommerceHub appears well-positioned to grow from 13-18% for many years, with 11-14% coming from e-commerce growth, 1-2% from increasing wallet share and penetration, and 1-2% from new customer wins.

Let's talk about CommerceHub's expanding moat. There are two sources of sustainable competitive advantage. First source is switching costs and the second is the network effect. Switching costs are similar to many other SaaS players. Offerings become embedded in business and operating processes of the clients and it becomes difficult to switch. If a client switches, they need to train the personnel. There is always a risk something will go wrong during the transition. Your end customers may be unhappy. About 75 basis points of GMV flows through the CommerceHub's platform. A client could maybe save 25 basis points, but is it worth switching? This is the first source of CommerceHub's moat.

The second source of CommerceHub's moat is the network effect. Every new retailer or supplier who joins the CommerceHub network makes it stronger.

There are also significant economies of scale in onboarding. In a hypothetical example ten retailers who want to sign up a new supplier. If they were to do it by themselves, collectively they will do it ten times. If all of them happen to become CommerceHub customers, onboarding will happen only once. This creates massive collective savings. CommerceHub would retain some of those savings and will pass the rest of them to its customers. Thus, it will benefit everybody involved. Finally, the network effect results in low customer acquisition costs.

Let's talk about customers and churn, as this is a key metric for a typical software-as-a-service company. Retailer churn is minimal. During our due diligence, we were able to identify very few retail customers who left CommerceHub. One is Circuit City. Well, Circuit City had a good reason to leave CommerceHub. It went bankrupt in the '08-'09 crisis. Target decided several years ago to use its own in-house solution. There are also some smaller retailers whose names we do not know who left CommerceHub at different points in history, but typically it was a scale issue as such smaller retailers never got to a sizable drop shipping business. Those customers never generated enough of an e-commerce presence and as a result, a drop shipping business and CommerceHub's drop shipping solution was not relevant for them.

Supplier churn is significant, but this is exactly what benefits CommerceHub. First of all, suppliers do not leave CommerceHub on their own will. If a retailer terminates a supplier - for example, a supplier's product did not generate enough revenue - such a supplier would obviously stop being a CommerceHub customer in that particular case. There is, as a result, a higher churn among suppliers than among retailers, but the supplier turnover helps CommerceHub deliver the customer value proposition. One of the elements of CommerceHub's value proposition is helping retailers onboard suppliers. This is where the turnover of suppliers benefits CommerceHub.

Competition. Let's talk about competitors. There are three groups of competitors. First, the traditional legacy, on premise solutions. These solutions are based on point-to-point architecture and as a result, it is difficult and expensive to maintain and update them. There are also in-house solutions. Remember Target went in-house with its own drop shipping program. There are no benefits of scale there. Using in-house solutions makes it more expensive and only very few of the largest retailers can build in-house solutions, maintain them well and be at a frontier of technological innovation. Finally, there can be other SaaS players. However, we were not able to identify any SaaS player in the drop shipping space who is big and mature enough and whose products are strong enough to compete with CommerceHub at scale. For example, there is a company called DSCO (formerly DropShip Commerce). However, it has few large customers. It works with Nordstrom but other customers are way smaller.

Let's talk a little more about legacy software solutions and why CommerceHub taking market share from them. Legacy solutions are based on a multitude of point-to-point connections. Each supplier has to be connected to each retailer. Let's say there are three suppliers and three retailers - there will be nine connections. Assume Retailer 1 updates its on-premise software solutions. Then each supplier needs to do the same on their own and at their location. This is a painful process, and this is an expensive process. You need to have pretty smart IT team people who will do that. If there are any unfortunate mishaps, then the retailer all of a sudden cannot drop ship Supplier 1 products. Guess what - a retailer will not be happy! That's why those legacy, on-premise solutions are not as good as network-based solutions such as CommerceHub.

Let's talk about CommerceHub's drop shipping offering architecture. The architecture in this case works like a real, true network. Let's pick the same example with three retailers and three suppliers. There is only one connection per each supplier and per each retailer. CommerceHub inside its cloud connects retailers and suppliers to each other seamlessly. If there is a need to update software, CommerceHub will do it. There is no need to do massive updates on the backend at each supplier's or retailer's premises.

We were not able to identify any players who have good scale and a strong product. DSCO is smaller and has not grown much.

There are also what we call and what we found in our due diligence so-called drop shipping perceived competitors such as SPS Commerce and ChannelAdvisor. What do we mean by perceived competitors? When we went through SPS Commerce and ChannelAdvisor earnings calls and filings,

both of them talk about drop shipping. However, they provide a different product and they provide a different service than CommerceHub. Why? Solutions provided by SPS Commerce and ChannelAdvisor are used by suppliers only. They may be a de minimus use by retailers, but it's truly, truly de minimus. Suppliers may be using SPS Commerce and ChannelAdvisor for drop shipping. However, if a retailer on whose behalf they drop ship uses CommerceHub, then a supplier will have to use both CommerceHub's drop shipping solution as well as, for example, SPS Commerce. That is why they are not competing. They are more like complements. There is a lot of confusion about comparability of these three companies and their products among investors and such confusion is contributing to mispricing of CommerceHub shares.

Let's dive into the Brands Initiative, a "startup" within CommerceHub. It generates about \$10 million in revenue and it loses money. Brands Initiative enables consumer brands to manage their direct sales through marketplaces, social channels and other similar channels. Think of Brands Initiative's software-as-a-service offering as a master catalog a brand would update only once and then it syncs with all direct channels a brand is using for direct sales. Brief history is in order. In January 2015 CommerceHub acquired a company called Mercent for about \$20 million. Mercent was providing a software solution for brands that enabled them to create one central public catalog that would link to various websites and marketplaces. Mercent had about \$10 million of revenue at the time of the acquisition. CommerceHub paid only two times revenue — reasonable for an early-stage company with interesting technology.

CommerceHub acquired Mercent for technology and not its customer base. There were two groups of customers of Mercent at that time. One group consists of self-service customers while the second group consists of managed service customers. One group is attractive and the other one is not. Self-service customers use software as a service and require little hand-holding and human interaction. As a result, this business is highly scalable. Working with such customers leads to high gross margins, which makes them attractive customers. However, managed service clients are quite different. First, they still use SaaS offering, but a lot of services are provided by CommerceHub employees. There is lots of handholding. As a result, there is less scalability. These customers bring revenue with lower gross margin which makes this business fundamentally less attractive.

CommerceHub wants to focus on self-service clients. CommerceHub wants to focus on bigger clients. Thus, many legacy clients are not desirable for CommerceHub, and the company is intentionally churning them and it has been doing so since the time it acquired Mercent. So far, CommerceHub is doing a pretty good job in terms of getting rid of smaller clients, which require a lot of handholding and generate lower margins. CommerceHub Brands Initiative has already had two nice wins on the client side. One is Mattel and another is Adidas.

There are important implications for CommerceHub valuation and financial modelling caused by the existence of the Brands Initiative. One needs to analyze the core drop shipping business separately from the Brands Initiative because Brands Initiative makes CommerceHub's consolidated financials look weaker. First, its revenue growth looks lower. Gross margin is lower and EBITDA margin is lower and absolute number of EBITDA is lower as well because Brands Initiative is losing money.

In terms of strategic and financial importance going forward, Brands Initiative can create tremendous value for the company and its shareholders. First of all, CommerceHub can build a second, sizeable business. Second, Brands Initiative mitigates the risks of retailers and thus, CommerceHub, being disintermediated by brands going direct to consumer.

Valuation: CommerceHub trades at a large discount to SaaS players. We picked CommerceHub, ChannelAdvisor, and SPS Commerce as three companies that operate in the retail SaaS vertical. A couple of important notes. Our metrics whether it's revenue, adjusted EBITDA or EBITDA minus stock-

based compensation for CommerceHub include both businesses – core drop shipping as well as Brands Initiative. As you can see, CommerceHub trades at a higher revenue multiple than its peers (~6.6x for CommerceHub vs. ~4.1x for SPSC and ~2.0x for ChannelAdvisor). Such a premium seems well-deserved given a significantly better margin profile of CommerceHub, which shows up in EV/EBITDA valuation. Let's look at EV/Adjusted EBITDA multiples. By Adjusted EBITDA here, we mean EBITDA before stock-based compensation. CommerceHub has a discount of ten to twenty times (17.5x for CHUB vs. 28.1x for SPSC and ~37.4 for ChannelAdvisor). When we treat stock based compensation as a true economic expense, which it obviously is, and use enterprise value to 2017 EBITDA minus stock-based compensation multiples, you will see CommerceHub trades at an even bigger discount (22.5x for CHUB vs. 41.4x for SPSC). In fact, in the case of ChannelAdvisor, EBITDA minus stock-based compensation is negative and thus a multiple of minus ~31.1x is not meaningful.

Relative valuation does not in and of itself make a stock attractive. Is the absolute valuation attractive? Here, we need to make a few notes about how we approach the valuation exercise. First of all, there are few software analysts who cover CommerceHub and those who do lump financials of the drop shipping business and Brands Initiative together. We disagree with that approach. In our view, sum of the parts valuation is the most appropriate. We need to value the drop shipping business separately and we need to value Brands Initiative separately. We also treat stock-based compensation as a true expense and we treat capitalized software, if any, as a true expense as well. Our assumptions, which are shown in the presentation, provide visibility into our thought process and what we view as important metrics.

There are a couple of important notes here. First of all, many people say valuation is an art, not science. In the case of CommerceHub, this is definitely the case. It's an art, not science and it's also mixed with intelligent guesswork. Disclosure is limited as far as breaking financials into CommerceHub's core drop shipping business and Brands Initiative goes. Guesswork will be required. None of these numbers may ever show up in CommerceHub financials in the future because of the way it reports. It reports only aggregate numbers. We have stated our assumptions clearly and you can play with them.

In 3Q16, CommerceHub changed its accounting policies related to capitalization of software development and it started expensing almost all of it. We intentionally did not incorporate the impact of such changes so we have comparability to prior periods. In other words, what CommerceHub will be expensing going forward we still put in our model as capitalized software, but again because I expense such capitalized software to arrive to true economic EBITDA, there will no impact on the final numbers.

Where do we get with all this? Based on our work, CommerceHub in 2020 is quite likely to approach EBITDA minus public company costs, minus capitalized software, minus stock-based compensation of roughly \$75-78 million. We put a 16x multiple on that. We also incorporate the cash build-up over the next few years. We assume the cash will sit on the balance sheet rather than be used for something intelligent. Some of such intelligent options may include M&A transactions and share buybacks. Remember, this is an entity where John Malone still owns about 5% based on economic interest and has about 30% plus of voting power. Liberty entities are well-known for smart capital allocation decisions. We are incorporating annual dilution due to issuance of options going forward and we arrived to a price target of about \$30 based on drop shipping only. The stock recently traded at \$17 per share.

Is an exit multiple of 16x justified? In our opinion, yes. First, even in 2020, CommerceHub should still have a long growth runway. Second, by 2020, CommerceHub's moat will be even stronger than it is currently. Also, we are incorporating full impact of stock-based compensation. If you use adjusted EBITDA, which we do not like using, but this is how many sell side analysts operate, the headline

multiple would be lower – around 13.25x.

How should we value the Brands Initiative? There is no right answer. We'll give you three approaches and one can pick which one you like the most.

One approach is to capitalize losses, which are currently generated by Brands Initiatives, forever. We estimate Brands Initiative is losing about \$4-8 million of cash. This includes capitalized software. However, we view a scenario where the company will keep making those losses for many years and management does nothing is incredibly unlikely. Remember, CEO is well-align with his 5% option grant, John Malone still owns some shares in the company. That scenario seems unlikely.

Second scenario. Losses continues for two years, then CommerceHub declares Brands Initiative as a failure and shuts it down. In our opinion, this is more realistic than #1 due to aligned incentives.

More likely is Scenario #3. There will be losses for two years, 2017 and probably 2018 and then the business will become breakeven, moves to positive EBITDA territory and will become cash flow positive as well. We have no data on which to model that scenario. Can this business become a \$20 million revenue business, \$30M, \$50M? Can EBITDA margin be 25%, 35%? Quite frankly, any of these options is possible.

We will go with approach #2 even though we do not believe it's likely and if we use approach #2, this is how Brands Initiative valuation would look like. It's slightly negative, 63 cents per share. We're assuming \$15 million in cumulative losses in 2017, 2018, and 2019, even though management spoke about its aspirational goal of getting to breakeven in late 2018 or early 2019. We do not think Brands Initiative has a negative value. We are using the negative value above as a thought experiment to show CommerceHub is still a great investment despite this draconian approach.

Putting it together, we believe CommerceHub will generate a 15+% IRR through 2020. That year will not be the end of the story, as this special situation investment has turned out to be a compounder. If, as we believe, Brands Initiative is successful, the valuation will prove conservative.

Let's talk about risks. There are at least two big risks. First is overall health of retailers. To thrive, CommerceHub needs to be working in an environment where there are multiple retailers. Some of CommerceHub customers are weak – JC Penney and Sears would be good examples of such weak retailers. Other customers are strong – Home Depot, Costco. We are not betting on brick and mortar retailers' revival, not at all. We just need enough traditional retailers to stay in business. Massive store closures would likely shift traditional retailers' focus on e-commerce and drop shipping, and that would benefit CommerceHub.

The second risk is customer concentration. Two retail customers together with their suppliers accounted for more than 10% of CommerceHub's revenue in 2016 each. The third largest customer, which is most likely QVC, together with its suppliers accounted for 7%. Next three customers accounted for 5%-plus, so if you put it all together, at least the top six customers account for 42% of revenue. This is substantial. Needless to say, loss of any of them will be detrimental for CommerceHub. Based on our channel checks, retailers like working with CommerceHub. They like the software offering and they like constant innovation, which CommerceHub is pursuing.

Can a sizable retailer build something similar in-house? If they put enough resources, probably. Can they maintain it as a state-of-the-art technology going forward? Unlikely. Also, even if they build a software solution, they will still need to deal with onboarding, which is a real pain point, and they will not be able to benefit from the economies of scale CommerceHub has created. We are willing to bear those risks. We are bearing them in an intelligent way, i.e., we are well-compensated for them; we

constantly monitor developments on that front.

The following are excerpts of the Q&A session with Artem Fokin:

Q: Is a comparison to Amazon.com appropriate, and if so, how do you think about it?

A: At a conceptual level, it's comparable because it removes the pain points and helps fulfillment. That is where comparison is justified.

If we want to take it one step further and say, "Well, Amazon is building this fulfillment by Amazon business and it has been successful. A lot of their customers like it, end customer likes it, so is it a threat for CommerceHub?" That will be a logical continuation of what you asked and, while technologically Amazon is definitely capable of competing with CommerceHub, if they want to build something similar, there is an issue with Amazon trying to sell the solution to players like Home Depot, Toys R Us, and Best Buy. All those retailers justifiably view Amazon as a real existential threat. Imagine you are Chief of Strategy or Chief of E-Commerce for Home Depot and someone says, "Would you like to give all that data to Amazon?" The answer is no.

Customers like that CommerceHub is constantly innovating and adding new features and functions. A client said, "We like that CommerceHub watches closely what Amazon does in its business. If CommerceHub sees something that is valuable for retailers, they introduce those features quickly." Amazon is increasing the bar both from the end customer perspective such as you and me as well as the retailer's customer perspective every single day and CommerceHub is benefiting from that constantly rising bar. It would be difficult to create in-house solutions at the frontier of technological innovation and then constantly keep raising the bar.

Q: You did not mention PFSweb, a public e-commerce fulfillment company with clients such as See's Candies, Movado, L'Oréal, and Advance Auto Parts. Is PFSweb a relevant comparison?

A: Their offering is different from that of CommerceHub. It is not relevant.

Q: CommerceHub has a nice margin profile. Could there be pricing risk, i.e., competitors potentially undercutting CommerceHub on price?

A: We always worry about this when a company has a great margin profile. We think, "Are these margins defensible?" I would point out a few things here. Number one is the gross margin which CommerceHub has is comparable to other software-as-a-service players. Number two, the reason why they have high margins is mostly because they have low sales and marketing costs. Number three, CommerceHub is constantly investing in new features to keep customers happy and what we found out through multiple interviews is they typically introduce those new features without raising their prices. It is not an *à la carte* menu; it is all you can eat buffet. In other words, they will not come to the clients and say, "If you want this new feature, you need to pay a little extra." They are not doing that, so they are constantly working on delighting their customers, which is important both from an end customer perspective as well as maintaining the customer-focused culture. Customers feel like they are getting more value for the same price.

Another element at play is the network effect and switching cost which are high. Can someone try to come and eat into CommerceHub's margin? There is always a risk and that's why we want to monitor this position rather than invest in it and forget about it. However, there are a few things which make us comfortable. In order for someone to be at the same scale, they will need to go and first invest tens of millions of dollars, if not more into R&D. Then they will need to go and persuade Toys R Us, Home Depot, Costco and other retailers to try them, "Give us a try, we will give you a cheaper price." CommerceHub is running at about 75 basis points if you include both subscription fee and the usage

fee of GMV. Those fees are combined for retailers and suppliers. How much would a competitor need to drop prices in order to make a large retailer switch and take a risk of disrupting its order flow and upsetting its end customers? If you think about a retailer trying to switch, that is a painful process.

What do you do if you are a retailer who wants explore switching? Do you first send, let' say, 10-20% of your GMV to a new provider who is trying to replace CommerceHub and keep 80% on CommerceHub platform and then you shift the rest after a few months? You would need to double, if not more your staff who is working on those issues internally. That's the real cost. Also, when customers are happy and when customers are dealing with a mission critical tasks - and this is a mission critical task we are talking about - if you go and buy something on a website and it's not delivered at the time when it was promised to be delivered and it arrives two weeks later because there was some mishap in the software, guess what? Next time, you are not going to buy from that retailer and the retailers know that. Retailers are facing increasingly high competition from Amazon. While we always worry about a company with high margins, CommerceHub's margins are defensible.

Q: I understand why switching costs are high, and it makes perfect sense that you do not risk your business for 75 basis points. Does this effect work in the other direction, i.e., is it unlikely that companies change what they have and take a risk of losing customers to join CommerceHub?

A: If you switch from legacy software — and most customers are doing so — you get access to a superior software offering. Working with legacy software tends to be more expensive and burdensome. CommerceHub is giving customers a significantly better product. It has been successful in enticing customers to switch. CommerceHub has already signed up fifty large retailers, including some of the largest retailers in the country. CommerceHub is not a victim of switching costs from legacy software because it offers a significantly superior product and it is solving customers' pain points. The benefits are so significant that those retailers were willing to switch, and that process continues.

About the instructor:

Artem Fokin is the founder and portfolio manager of Caro-Kann Capital LLC, a hedge fund based in San Francisco. Prior to founding Caro-Kann, he was a principal at Outrider Management LLC. Before entering the investing industry, Artem was an attorney with Greenberg Traurig LLP in New York City. Artem earned an MBA from the Stanford GSB (Arjay Miller Scholar). Artem earned a Master of Laws degree from NYU School of Law (Newman Scholar) and a bachelor of law from the Higher School of Economics (Presidential Scholar) in Russia. Artem is admitted to the practice of law in the State of New York and is a dual citizen of the United States and Russia.

Caro-Kann Capital LLC is the general partner of an investment partnership based on the principles of value investing that focuses primarily on special situations and compounders. Caro-Kann Capital is named after a chess defense that emphasizes building safety and defensible position before contemplating an offensive strategy. The Founder's substantial legal experience brings a greater ability to analyze complex corporate documentation accompanying extraordinary corporate events. The Fund's core investment principles include: (1) concentration when properly compensated, (2) risk is not equivalent to volatility, (3) non-economic selling can lead to attractive opportunities; (4) capital allocation is often underappreciated by the market, and (5) incentives and insider ownership are paramount.