COHO CAPITAL

Coho Capital Management, LLC

12725 SW Millikan Way
Suite 300
Beaverton, OR 97005

TEL 503.906.7889
jrosser@cohocapital.com
www.cohocapital.com

August 5, 2019

Dear Partners,

Coho Capital returned 20.7% net through the first six months of the year compared to a return of 18.5% for the S&P 500. Despite an ebullient market, we continue to find value in misunderstood business models and special situations. We detail one of our recent purchases below.

"Ben Graham had a lot to learn as an investor…. buying those cheap cigar-butt stocks was a snare and a delusion." – Charlie Munger

The dean of value investing Benjamin Graham beat the market by an average of 2.5% a year over two decades and essentially invented security analysis as a profession. Graham focused his analytical efforts on the discrepancy between price and value and maintained strict rules on selling once the two converged. He was a cigar-butt investor through and through, happy to take the last puff if the price were right. Given his formulaic approach, it is interesting that Graham made the vast majority of his fortune by violating his signature rules; First with position sizing, putting 20% of his assets in a single stock, Geico, and second by never selling, despite Geico's valuation premium. In what is surely one of the greatest stock investments of all time, Geico rose over 200-fold from Graham's purchase price.

"Ironically enough, the aggregate of profits accruing from this single investment decision far exceeded the sum of all the others realized through 20 years of wide-ranging operations in the partners' specialized fields, involving much investigation, endless pondering, and countless individual decisions." – Benjamin Graham, Postscript of the *Intelligent Investor*

Many investors begin their education by studying Benjamin Graham, and they are right to do so, as an investment approach premised upon careful study and prudence is sure to protect individuals from their biological impulses. Safe and careful, however, while necessary, are not enough on their own to deliver outsized returns. Cheap is great, but we want cheap and good. One way to define good might be to assess what made Geico such a spectacular investment.

Reverse engineering Graham's Geico investment can help us divine where future Geicos may be found. Of course, it goes without saying that Geico's float combined with Buffett's investing acumen is a match made in heaven, but we are focused on the pre-Buffett Geico. Geico possessed several ingredients we look for in investments including scalability, recurring revenue, a long reinvestment runway and long-term industry tailwinds (in this case a post-war boom in automobile ownership). While growth attributes are a pre-condition for compounding nirvana they are

COHO CAPITAL

Coho Capital Management, LLC

12725 SW Millikan Way
Suite 300
Beaverton, OR 97005

TEL 503.906.7889
jrosser@cohocapital.com
www.cohocapital.com

insufficient without a competitive moat. While Geico operates in a commodity industry, its low-cost model has enabled it to achieve scale, growing to the second largest provider of auto insurance.

Unlike its competitors, which sold insurance through agents, Geico utilized direct marketing resulting in a vastly superior cost structure. Without the need to pay sales commissions or invest in agent offices, Geico was able to capture market share through discounted rates. With enough scale, a kind of feedback loop began to occur; allowing Geico to outspend competitors, further increasing its market share while filling its coffers for future marketing spend. Since its acquisition by Berkshire, Geico has been relentless in using Geico's scale economics in advertising to drive this flywheel faster, growing advertising spend from $31 million in 1996 to over $1.4 billion at present. Perhaps Buffett recognized that Geico's initial cost advantage (direct marketing versus agent) was a process advantage, an approach that could be copied by competitors. By ramping up advertising, Buffett converted Geico's process advantage into a scale advantage, a much more durable moat.

We relay the story of Geico as we believe it shares some commonalities with GoDaddy, one of our most recent purchases. Like Geico, GoDaddy benefits from scale economics in a commodity industry. GoDaddy is the global leader in domain name registration with a market share of 22%, 2.5x its next largest competitor. Like Geico, GoDaddy's markets can be characterized as having low barriers to entry but high barriers to scale. Growth beyond a certain scale requires greater data center capacity, robust customer service options, and enhanced analytics. Last, like Geico, GoDaddy benefits from a well-known brand name (81% brand awareness in the US according to BrandOutlook), lowering its customer acquisition costs.

Much like Geico, GoDaddy operates in a commodity industry generating 46% of its revenue from website domain name registration and 38% from website hosting. GoDaddy's unit economics, however, are anything but commodity-like with a gross profit contribution per customer of 64% and less than 15% annual churn. Fifteen percent may seem high but keep in mind many domains are a business dream with a web presence and creative destruction will do its work. The customers that stay with GoDaddy are immensely profitable translating into an LTV/CAC (lifetime value/customer acquisition cost) of over 10x.

What's going on here? How can a provider of commodity web tools possess such attractive economics? We believe GoDaddy's business is much more attractive than its market quotation suggests and reflects one of our favorite investing setups – business model arbitrage. Rather than valuation arbitrage (the Ben Graham approach), business model arbitrage offers both a valuation discount and an additional driver of multiple expansion once the market efficiently prices a higher quality business model. Disney is a great example with market pricing moving higher in recognition of the superior economics (eventually) of a streaming business model.

COHO CAPITAL

Coho Capital Management, LLC

12725 SW Millikan Way
Suite 300
Beaverton, OR 97005

TEL 503.906.7889
jrosser@cohocapital.com
www.cohocapital.com

Let's look at GoDaddy in more detail. There is much to like. Customers pay for hosting and domain name registration up front providing GoDaddy with negative working capital. Most domain/hosting customers are small and medium businesses (SMB). As such, they are typically resource constrained and often not proficient in business IT. Thus, switching costs are much higher than the market credits GoDaddy. In fact, customers from prior year cohorts compromise 90% of annual revenue providing GoDaddy a stable source of recurring revenue.

Perhaps GoDaddy's core differentiating factor is its maniacal commitment to customer service. With automated calls, bots and AI taking over the function of customer service, GoDaddy maintains its commitment to consultative support with 6,300 customer care reps spread through 56 local markets. In a digital first world, IT problems can paralyze a business. Having world class tech support available 24/7 is a distinct advantage. Many competitors can erect digital storefronts, but few can eliminate IT pain points as a business expands. It should be noted that GoDaddy's scale is a key enabler in providing a customer first approach toward business. By efficiently leveraging its scale, GoDaddy can provide a higher level of customer service than subscale competitors. Further, increased customer touchpoints enable frequent opportunities for upselling premium services with 25% of sales bookings coming through its customer care channel. In fact, GoDaddy's technical support is so efficient at providing solutions to its customer base that it is a profit center rather than a cost center.

Scale Player in a Fragmented Industry Positions GoDaddy as Natural Consolidator

GoDaddy's end markets are a play on increasing levels of entrepreneurial activity. The democratization of marketing (Facebook, YouTube and Instagram), hiring (Upwork, Fiverr), funding (Kickstarter, Lending Club) and distribution (Shopify, Etsy and Amazon 3P) has made starting a business easier than ever – though don't let anyone tell you it is easy. The digitalization of commerce has lowered the cost of entry. With less capital constraints, entrepreneurial activity is surging. According to the Kauffman Index of Startup Activity, 550,000 Americans launch new businesses each month. As the cloud provider for SMBs, GoDaddy is a picks and shovel play on the rise of the entrepreneur (like an Amazon AWS for start-ups without venture funding).

As we have seen with Geico, establishing scale in a fragmented industry can deliver attractive economics. The total addressable market (TAM) for GoDaddy remains substantial. Globally there are more than 500 million independent businesses that spend over $1,000 annually on cloud services. GoDaddy, with 18.5 million customers and an average spend of $168 a year, has a substantial runway for additional share gains.

With its large installed base of customers providing durable free cash flow, GoDaddy is well positioned to be a consolidator. In the past, GoDaddy has effectively utilized its balance sheet in the pursuit of growth. GoDaddy drove leverage to 5.0 net debt/EBITDA in 2017 to acquire Host Europe

COHO CAPITAL

Coho Capital Management, LLC

12725 SW Millikan Way
Suite 300
Beaverton, OR 97005

TEL 503.906.7889
jrosser@cohocapital.com
www.cohocapital.com

Group (HEG). The highly cash generative nature of GoDaddy's business allowed it to cut debt to 2.4x within a year. GoDaddy targets a leverage ratio of 2.0x-4x and is currently below 2.0x, suggesting ample head room for a large transaction. Given management's target of doubling sales to $5 billion by 2023, we fully expect GoDaddy to utilize its untapped balance sheet capacity.

While acquisitions can materially increase GoDaddy's return potential, organic growth alone offers plenty of levers. GoDaddy's captive customer base provides it ready-made expansion opportunities to migrate its customers toward adjacent products and services as their needs evolve. For example, a new business customer may only be interested in website building tools, hosting and domain name registration. By year four or five, however, this customer may need multiple email seats, search engine optimization, secure web certificates, social media integration and software subscriptions (GoDaddy is one of the largest resellers of Microsoft 365). As a customer of GoDaddy for years I can tell you this is where the company flexes its pricing power. GoDaddy knows its customers are loath to migrate their IT functionality, no matter how basic, to another provider. Most business owners decide it is not worth the brain damage to reconstitute their IT plumbing with another IT purveyor. Such intransigence underscores the inherent switching costs built into GoDaddy's business model.

GoDaddy's success in onboarding customers to new services is reflected in its steadily rising average revenue per user (ARPU), which has grown at a 7% CAGR between 2014-2018. Year-over-year ARPU growth jumped to 9% last year and we expect growth to remain elevated with higher attach rates for applications solutions (up 29% Y/Y in 2018), such as email, bookkeeping, Office 365 and marketing solutions. GoDaddy already has 1.1 million customers spending over $500 a year, suggesting newer vintages of customers will monetize at higher rates over time.

Ultimately, we believe GoDaddy is uniquely positioned to be a one-stop shop for the IT needs of SMBs. The shifting focus of online business identity from a static presence to an interactive broadcasting medium with dynamic content, human interaction, commerce and lead generation bodes well for future ARPU expansion and margin accretion.

The market typically pays a premium for consistent growth and subscription revenue yet GoDaddy can be had for 15x our estimate of 2020 cash flow. That is cheap for a steady top-line grower with durable free cash flow and secular tailwinds. Further, current multiples do not embed expectations for future acquisitions, which given GoDaddy's history is likely.

At present, GoDaddy is priced like an IT infrastructure provider rather than a digital service provider. Given GoDaddy's subscription revenue and expanding operating leverage we think it is more appropriate to value it as an SMB digital provider. Other SMB digital providers, such as Intuit, trade at much higher multiples. Like GoDaddy, Intuit is a dominant service provider to the SMB community with recurring subscription revenue. Intuit uses its tax platform to convert users to

COHO CAPITAL

Coho Capital Management, LLC

12725 SW Millikan Way
Suite 300
Beaverton, OR 97005

TEL 503.906.7889
jrosser@cohocapital.com
www.cohocapital.com

additional services much like GoDaddy uses cloud to convert customers to new products and services. Intuit trades for 33x forward free cash flow. Surely GoDaddy should not trade at a 55% discount.

In summary, GoDaddy has multiple levers to drive material upside in coming years including accretive M&A, rising ARPU and continued bookings growth. GoDaddy's business features durable free cash flow, pricing power and high switching costs, producing exceptional unit economics. Its scale, brand name recognition, customer-centric culture, and under-levered balance sheet position it as the natural consolidator in a highly fragmented market. At its current valuation, we believe GoDaddy can compound capital at 20% a year.

Respectfully yours,

Jake Rosser
Managing Partner
Coho Capital Management