

Wired Telecommunications

October 2015

TMT Industry Review Part (II)

Henri St-Pierre, Senior Analyst
Luohan Wei, Senior Analyst
David Marcovitch, Junior Analyst
Tony Ren, Junior Analyst



Telecom and Media Industry Review

Desautels Capital Management

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Telecom Industry









In-Depth Look: Wired Telecommunications



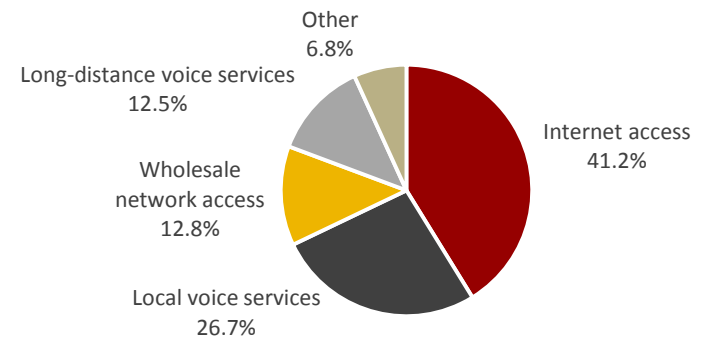
Wired Telecommunications

Industry Overview

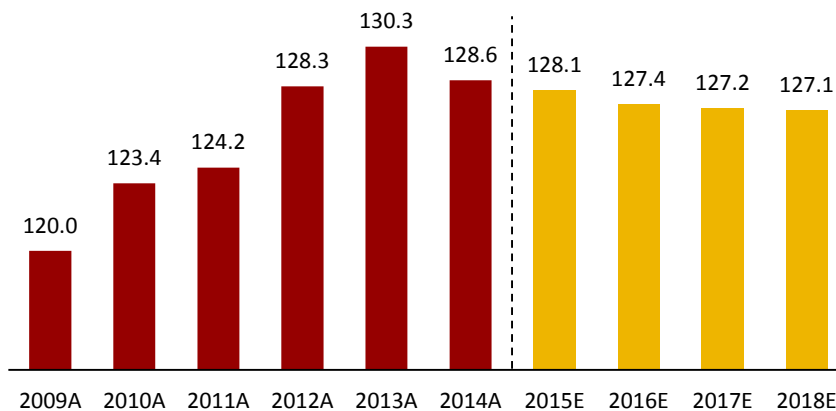
Industry Characteristics

Life Cycle Stage		Regulation Level	
Revenue Volatility		Technology Change	
Capital Intensity		Barriers to Entry	
Globalization		Competition Level	

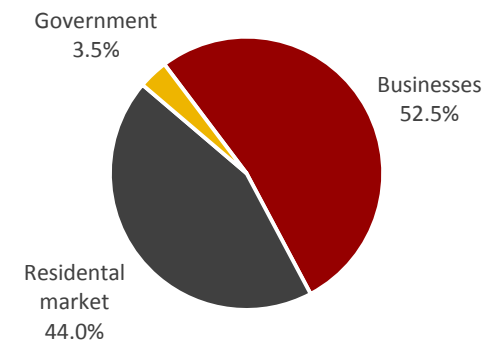
Products and Services Segmentation



Industry Revenue



End-User Segmentation

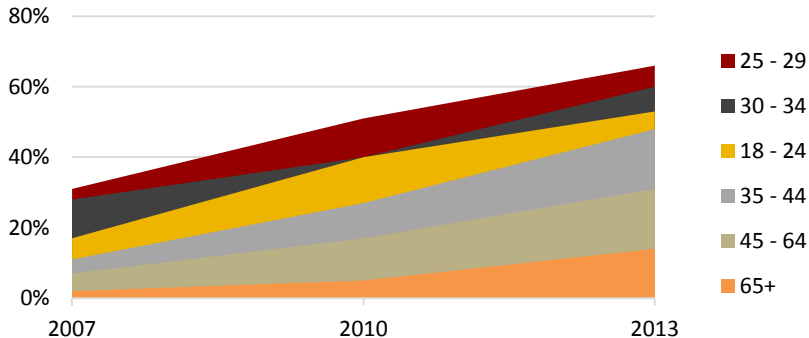


Source: IBIS World Report
All statistics are as of year-end 2014

Wired Telecommunications

Key Drivers

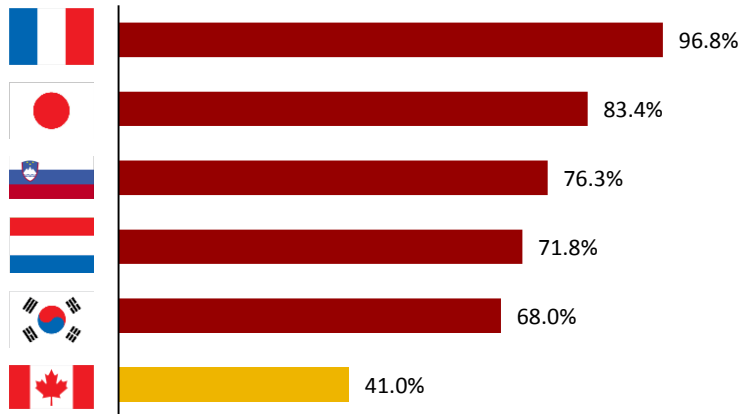
Negative: Cellphone-only Households



Positive: Mobile Data Offloading

- Mobile data offloading is the use of other network technologies to deliver data intended for cellular networks
- Wireless carriers buy backhaul capacity from wired carriers as part of the network strategy to increase network efficiency and reduce costs
- Mobile network operators are predicted to offload 60% of their smartphone and tablet data traffic to WiFi networks by 2019
- **Key takeaway: wireless carriers are relying on wired technologies to supplement their data networks, creating demand for wired telecommunications providers**

Negative: VoIP Adoption









Positive: Broadband Up, Voice Down

- Although demand for wired voice telephony services continues to decline every year, demand for wired broadband internet connections is increasing significantly
- However the overall market continues to decline because the growth in broadband does not fully offset decline in telephony
- Wirecos that are able to shift their revenue mixes away from telephony and capitalize on broadband will be successful
















Wired Telecommunications

Key US Enterprise Telco Players

Company	 CenturyLink	 Verizon	 at&t	 Level(3) COMMUNICATIONS	 zayo	 cogent
Market Cap	\$14bn	\$180bn	\$199bn	\$15bn	\$6bn	\$1bn
IP and Data	✓	✓	✓	✓	✓	✓
Transport	✓	✓	✓	✓	✓	✓
Cloud	✓	✓	✓	✓	✗	✗
Collocation	✓	✓	✓	✓	✓	✗
CDN	✗	✓	✗	✓	✗	✗
Managed Services	✓	✓	✓	✓	✗	✗
Dark Fiber	✗	✗	✗	✓	✓	✗
Security	✓	✓	✓	✓	✗	✗
Voice	✓	✓	✓	✓	✗	✗

Wired Telecommunications

Cable vs. DSL vs. Fiber

Technology	Theoretical Bandwidth	Per User Bandwidth	Cost (Price Per Megabit)	Prevalence in United States	Companies
 <p>Coaxial Cable</p>	<4 Gigabits per second	Average: 20 Mbps (1-105 Mbps)		58% (Increasing)	  
 <p>DSL or Copper Lines</p>	<1 Gigabit per second	Average: 10 Mbps (1-40 Mbps)		34% (Decreasing)	  
 <p>Fiber Optics</p>	>10 Gigabits per second	Average: 35 Mbps (15-75 Mbps)		8% (Increasing)	  

Cogent Communications

Mini-pitch



Mini-pitch: Company Overview

Cogent is a unique growth player in the mature wired telecommunications industry

Company Description

- Cogent is a wired operator which owns and operates fiber based assets to provide internet services to its customers
- Cogent's unique business model focuses on becoming a low-cost "dump pipe" to gain share from large incumbent players
- Cogent operates two segments, its corporate segment provides internet access to businesses in the United States, while its internet transit provides network access to ISPs and Content providers worldwide

Dave Schaeffer: Founder & CEO

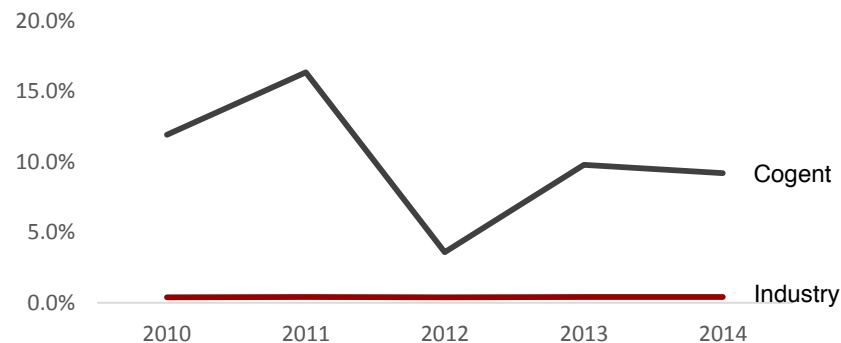


Dave Schaeffer is widely regarded as the brains behind Cogent and one of the smartest businessmen in telecommunications, having started 6 companies prior to Cogent.

Financial Overview

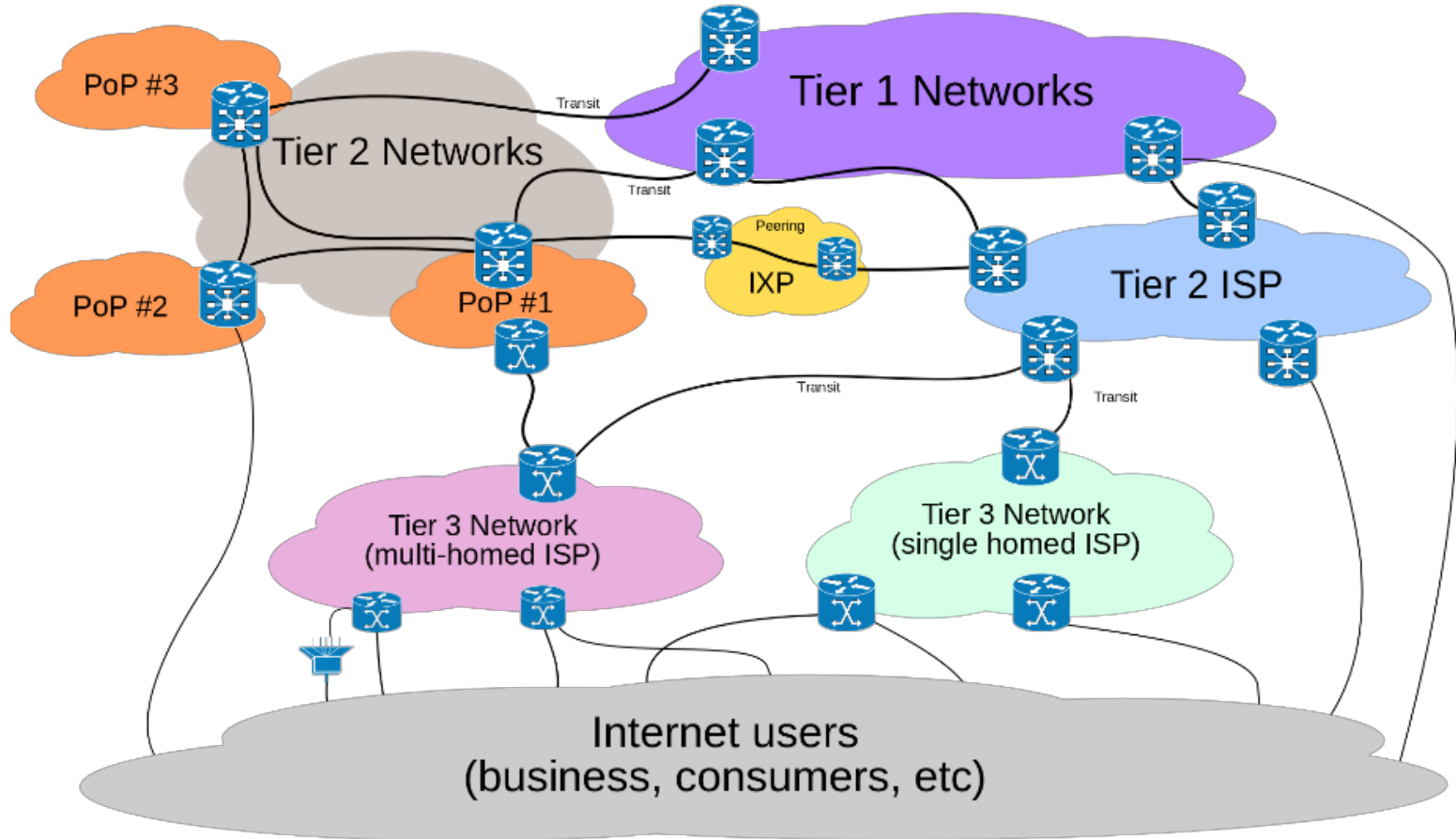
Revenue (2015E, millions)	\$402
Rev growth %	13%
EBITDA (2015E, millions)	\$132
Stock Price	\$27.16
Market Cap (millions)	\$1,240
52 wk high	\$40.48
52 wk low	\$25.84
Dividend yield	5.4%
EV/EBITDA	10.87x

Industry defying growth rates



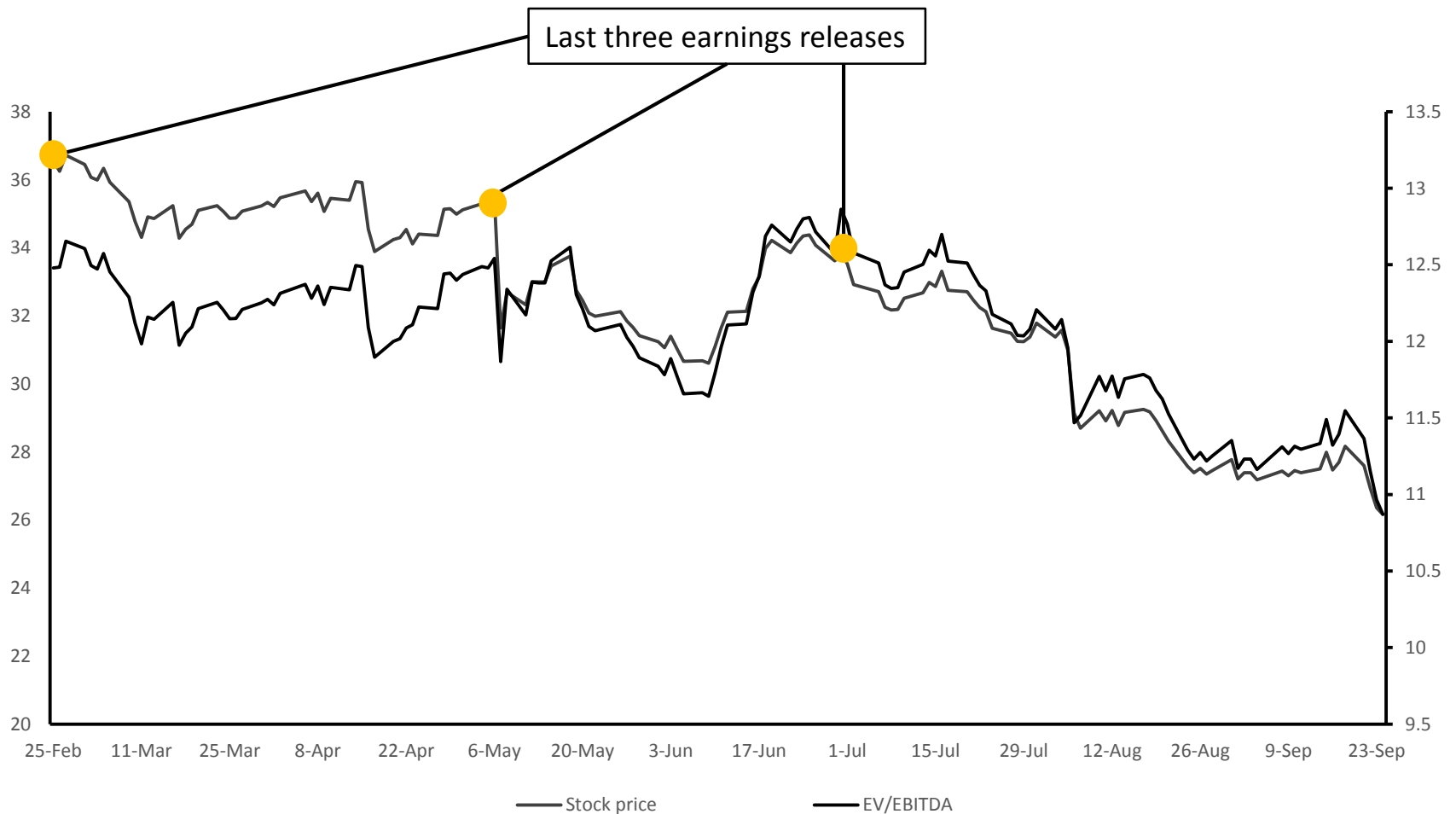
Internet transit 101

Cogent delivers 20% of all internet traffic across its network



Annotated stock chart

The market has punished cogent for missing guidance

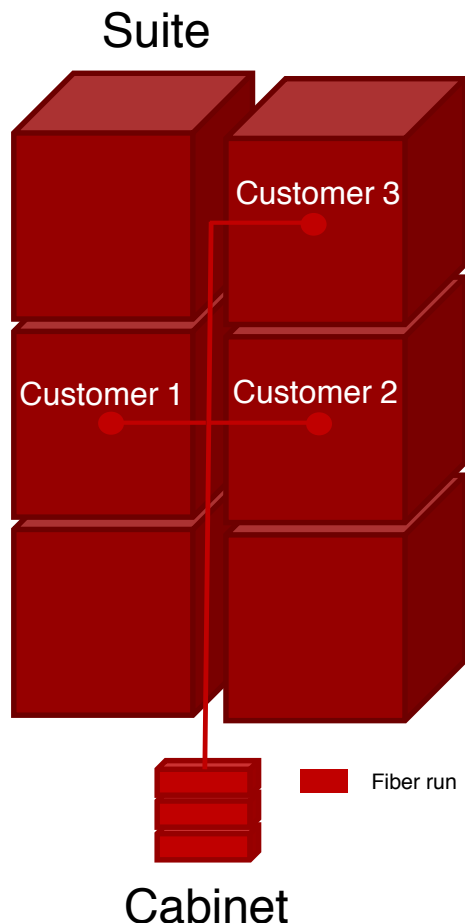


Source: Bloomberg as of 9/20/2015.



Cogent's On-net internet access business

Selective investments in high ROI corporate buildings



Building Economics

- Average 500,000 sq feet
- \$650 to connect new customer
- \$400/mo recurring cost to landlord
- Low cable presence in footprint
- 1 in 5 buildings with off-net service
- Little risk of overbuild from competitor
- Voice and other services provided OTT

Favorable trends

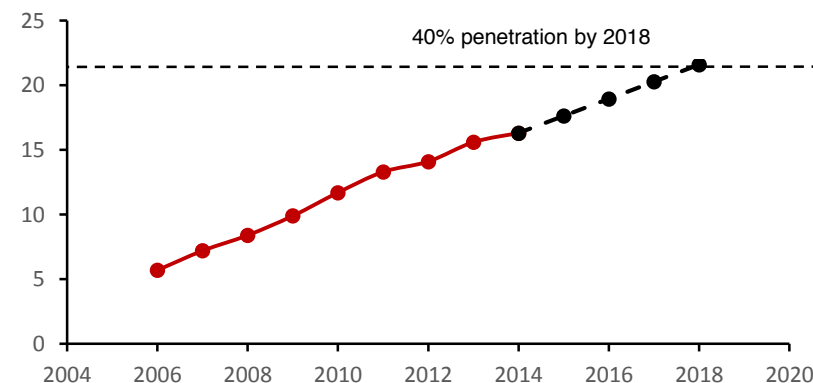
- Greater bandwidth demand from OTT services (SaaS, VoIP)
- Decreasing competitiveness of legacy copper

Corporate market profile

- 1500 corporate buildings in the U.S. representing 9% of all office space in America
- Average of 51 businesses per building and 16.3 current Cogent customers in building
- Most popular product is a \$700/month dedicated service with 100 mbps symmetric speeds, incumbent competition can only offer 3-4 mbps at that price point (mixed copper/fiber plant)

Growth from in-building penetration

Number of
Cogent customers
Per building



Source: MoffettNathanson, Company presentation



Net-centric Business enables internet

Interconnection regulation favors return of revenue growth



1. Netflix needs to deliver content to a user in New York, from their San Francisco servers

2. Cogent transports this data over its fiber network to a point in New York city near the end customer

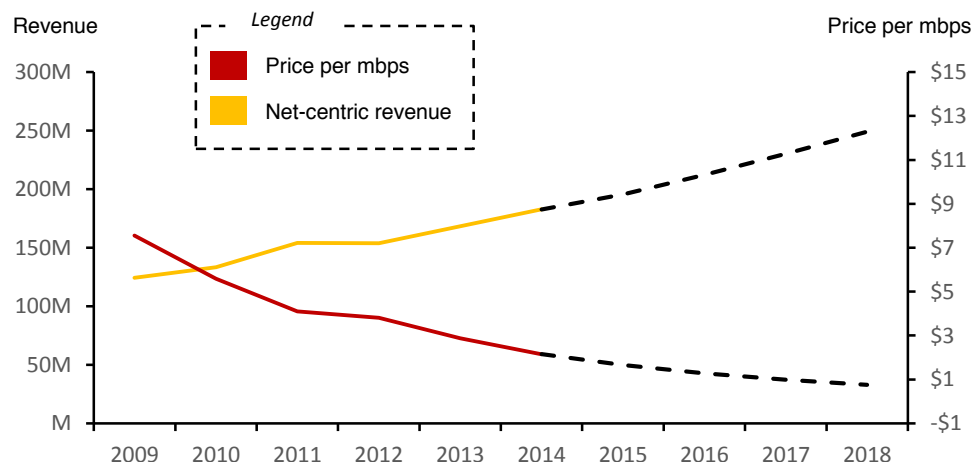
3. Data is transferred between Cogent and the access service provider at the **interconnection point**

4. End customer can then enjoy their video content

Interconnection points and the FCC

- Growth in internet transit has been stalled due to bottlenecks at interconnection points between access networks and internet transit players like Cogent
- Recent FCC “net-neutrality” favors Cogent and agreements have been made between Cogent and NSPs
- Cogent’s internet transit business should be able to benefit from growth in over-the-top video, while continuing to gain share with its cost advantage

Revenue growth despite falling unit price



Can management execute on growth prospect?

Cogent is the only wired player with +10% top-line growth



✓ **Strong growth prospects in corporate segment**

- Strong value proposition compared to competition
- Successful sales force re-engineering
- Clear path to double market share in next 8 years.

✓ **Interconnection settlements should enable top-line growth in net-centric**

- Continued OTT growth should enable organic growth in the industry
- Favorable regulatory environment in the United States and Europe (Net-neutrality)
- Knowledge transfer from corporate sales force

✓ **Undervalued by market due to recent underperformance**

- Even at lower forward growth rate of 7-9% Cogent may be worth more than current price
- Trading at EV/EBITDA discount compared to historical
- I think we've heard this story before (Amazon)



Technology, Media, and Telecommunications

October 2015

Deep Dive: Enterprise Software + FinTech

Henri St-Pierre, Senior Analyst

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Deep Dive: Enterprise Software + FinTech

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Deep Dive: Enterprise Software + FinTech

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Section I

Introduction to Enterprise Software

Introduction to Enterprise Software

What is Enterprise Software?

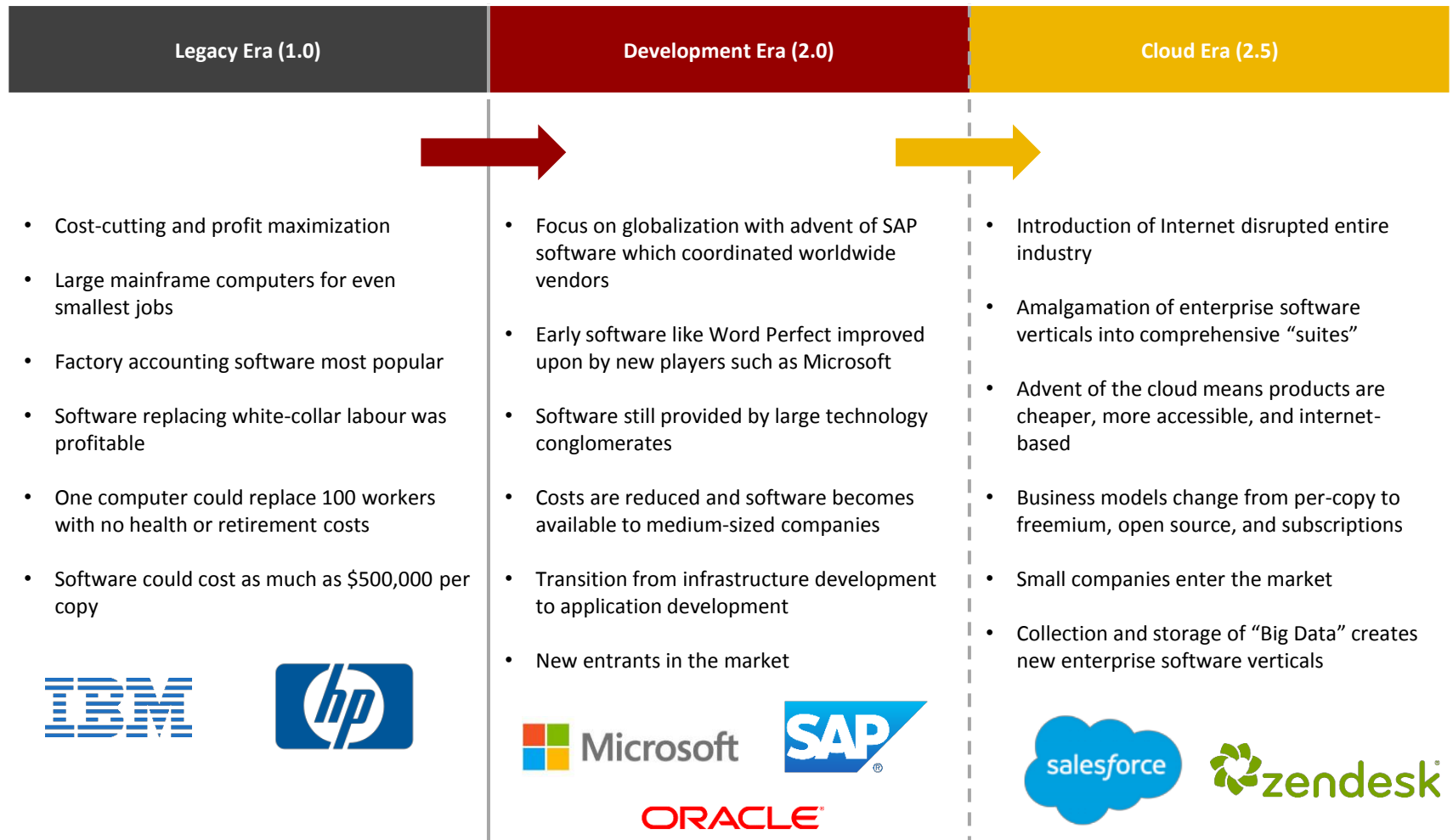
	Business Intelligence	Content Management System	Customer Relationship Management	Enterprise Resource Planning	Supply Chain Management
Function	Transforms data into meaningful representations	Manages content and documents from a central interface	Manages company's interactions with current and future customers	Connects business activities together (e.g. sales, marketing, inventory, etc.)	Manages flow of goods and services
Examples	 	 OPENTEXT	 	 	 

	Accounting Software	Business Process Management	Database	Enterprise Asset Management
Function	Streamlines business accounting processes	Helps manage organization's workflow and business processes	Manages and stores data from other business processes	Optimal lifecycle management of physical assets
Examples	 	 	 	 

Source: IBM Cognos Report

Introduction to Enterprise Software

Enterprise Software Through the Ages

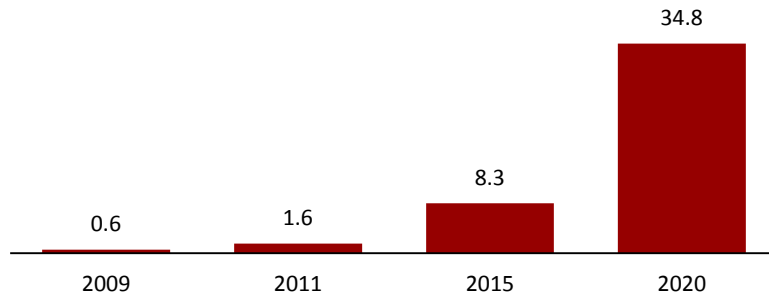


Source: IBM Cognos Report

Introduction to Enterprise Software Landscape 5 Years Ago...

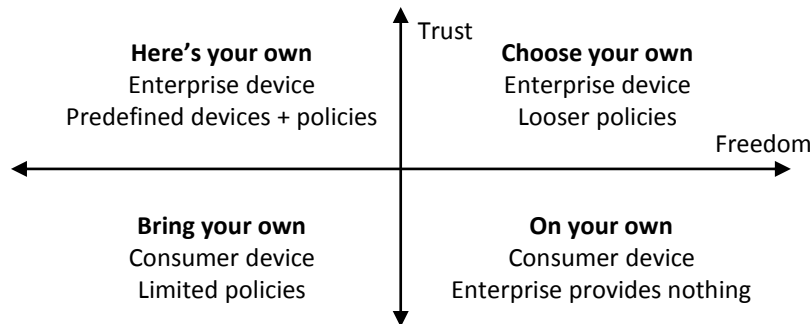
Data: The Bigger the Better

(zettabytes)



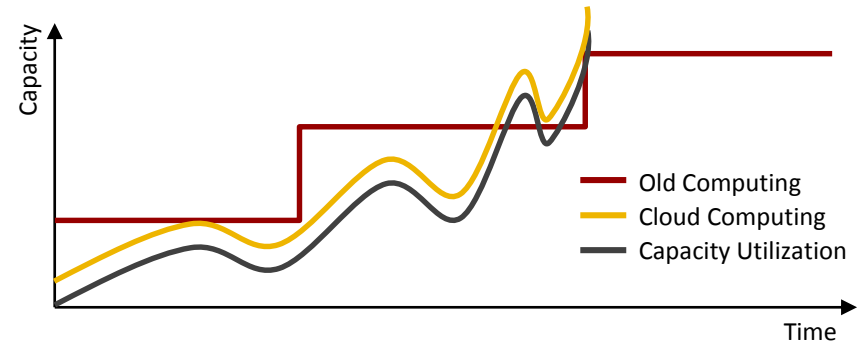
- **Takeaway:** enterprise software companies that can capitalize on big data and analytics will be successful

Mobile: Enterprise On-The-Go



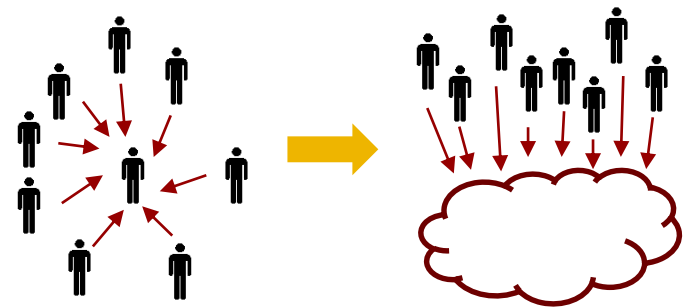
- **Takeaway:** once enterprises begin adopting high-trust policies and realize that workflows can be improved, companies that are already in the mobile enterprise space will be successful

Cloud: Up, Up, and Away



- **Takeaway:** companies will begin to utilize cloud services and vendors able to shift revenue in that direction and adapt will be successful

Web 2.0: Business Goes Social



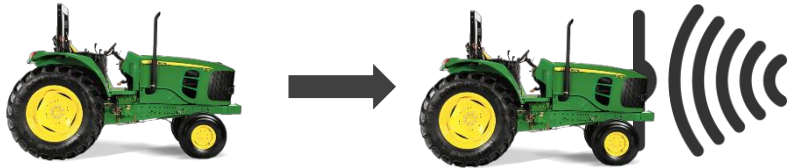
- **Takeaway:** enterprises will shift away from the email model and towards the Web 2.0 collaboration model, which means companies with an offering in this space will be successful

Introduction to Enterprise Software

Next Big Things

Digitizing Assets

- Traditional assets across many sectors can be digitized with sensors and data can be collected from those sensors
- This is made possible through cheap storage, cheap sensors, and cheap communications
- Case studies: Michelin tires, Caterpillar farming platform



Consumerization

- There is an convergence between consumer software and enterprise software in terms of usability, accessibility, and pricing
- Enterprise software has typically been sold through a convoluted vendor bidding process that can take months to complete
- Newer software can be purchased with the click of a button with limited need for training and set-up
- Business models are no longer representative of a per-copy system
- Case studies: Dropbox (Freemium), Office 365 (Licensing / Subscription)

Digitizing Services

- Traditional services that people thought would always have a physical presence in businesses are now being replaced as well
- Once each individual vertical crosses the early adoption phase and CIOs begin adopting the technologies, larger software companies will begin acquiring in the space
- Case studies: Kira Talent, Zendesk



Open Source



- Then: Open Source software unlikely to gain much traction with few niche functionalities related to infrastructure; Red Hat IPO was only successful Open Source move
- Now: Linux market share to rise in server from 22% to 33% over 3 years; other software like Hadoop and OpenStack beginning to receive recognition and adoption
- Relevance: Red Hat remains only pure-play Open Source software provider; it's success predicated on a number of circumstantial levers
- Hadoop (Teradata): 19% of CIOs indicate Hadoop has negative effect on data spending and HortonWorks' IPO pushing Dell, IBM, and Amazon to pursue Hadoop offerings

Section II

Enterprise Software Valuation

Enterprise Software Valuation

Valuation Universe

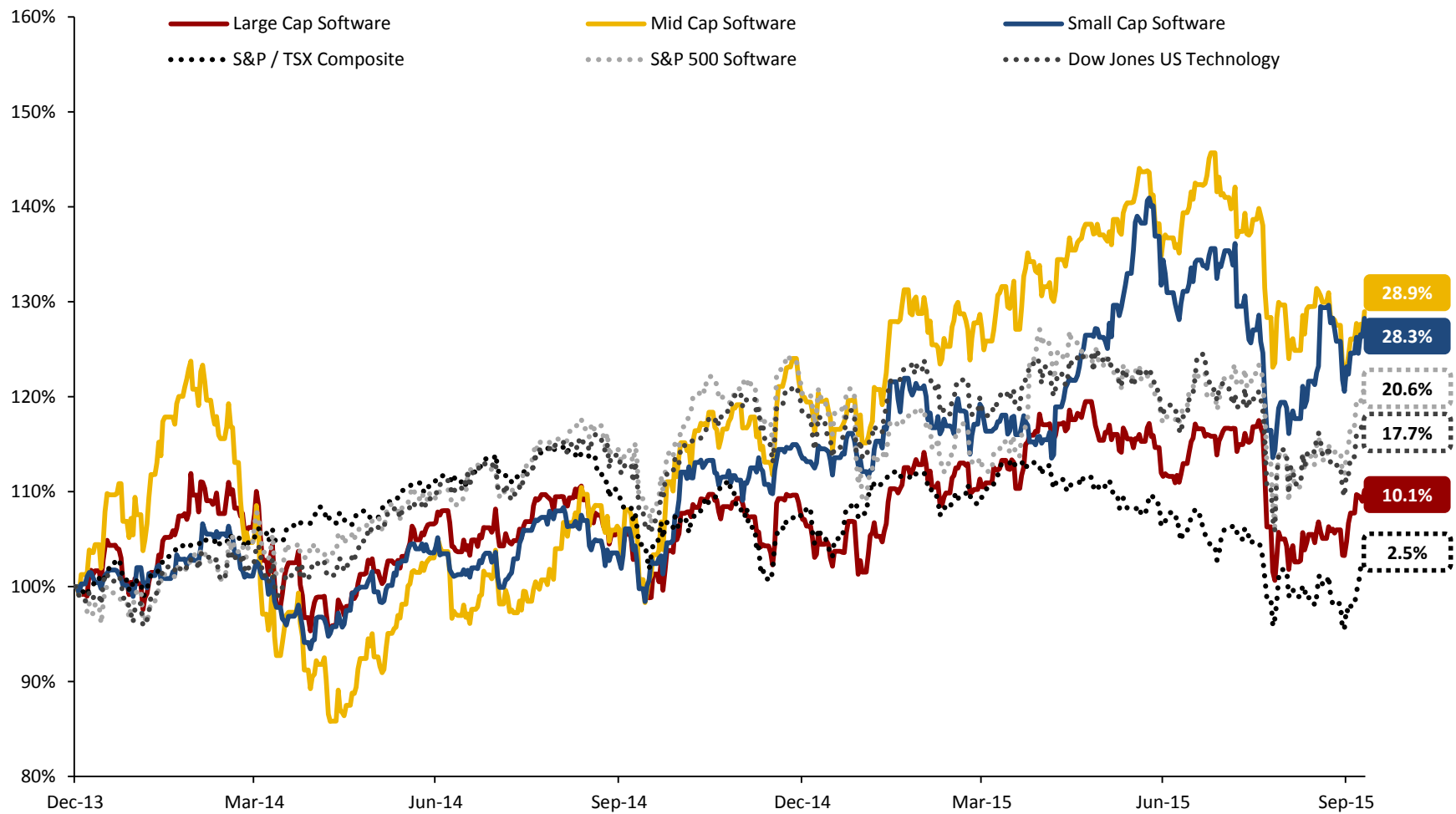
Large Cap	Mid Cap	Small Cap
       	            	         

Source: Capital IQ.



Enterprise Software Valuation

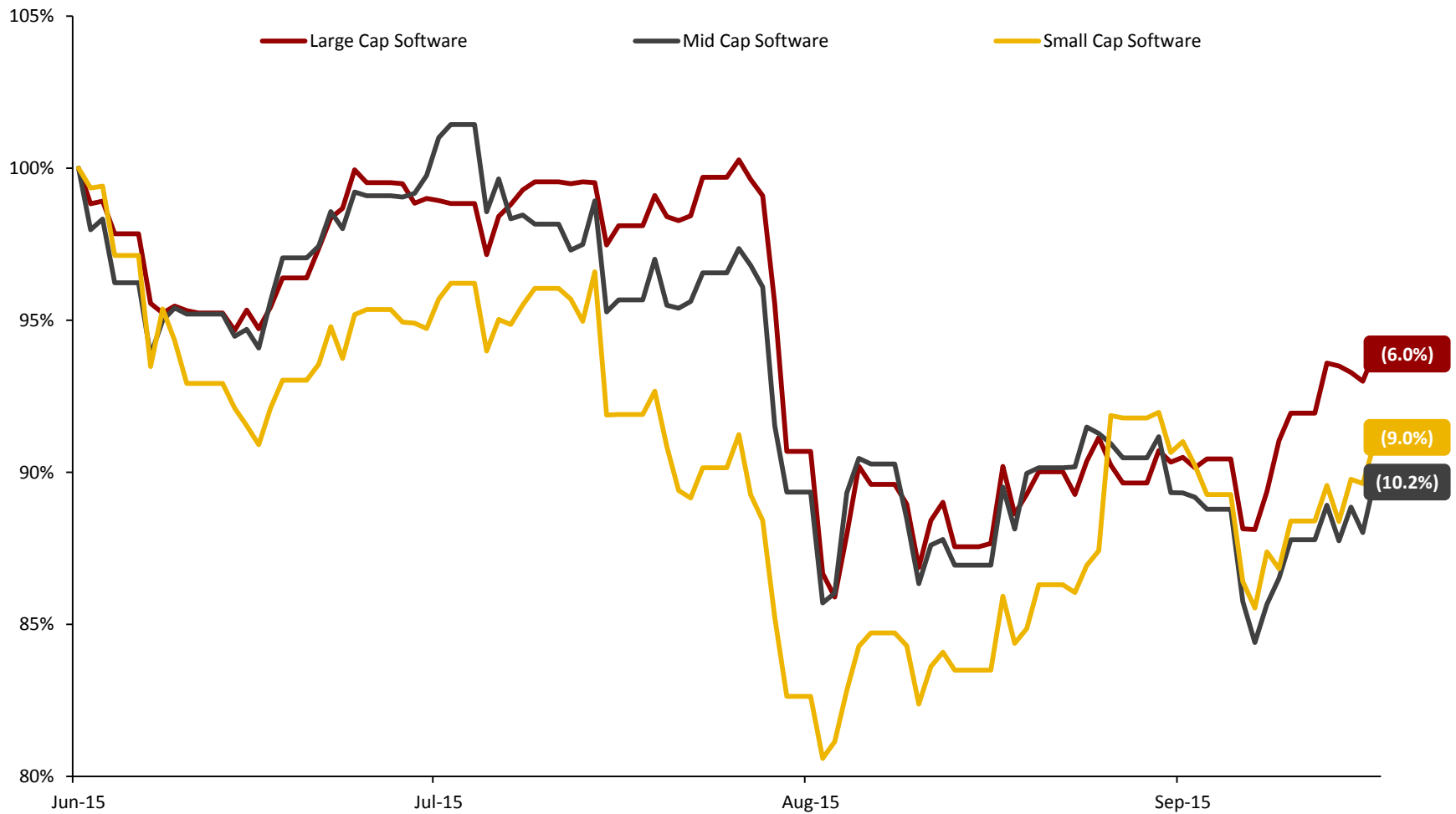
Industry Valuation Since 2014



Source: Capital IQ.

Enterprise Software Valuation

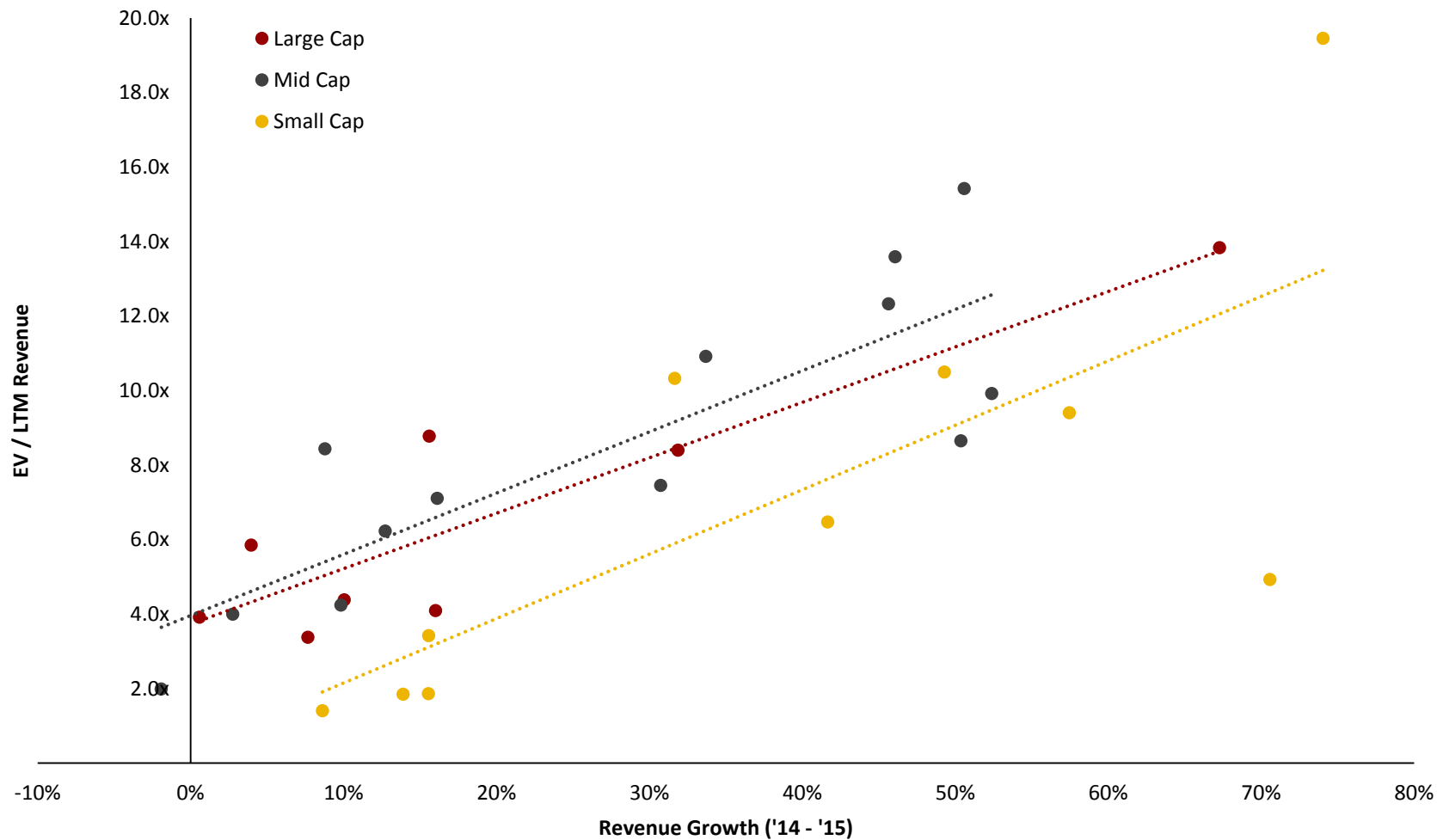
Industry Valuation Since H1 2015



Source: Capital IQ.

Enterprise Software Valuation

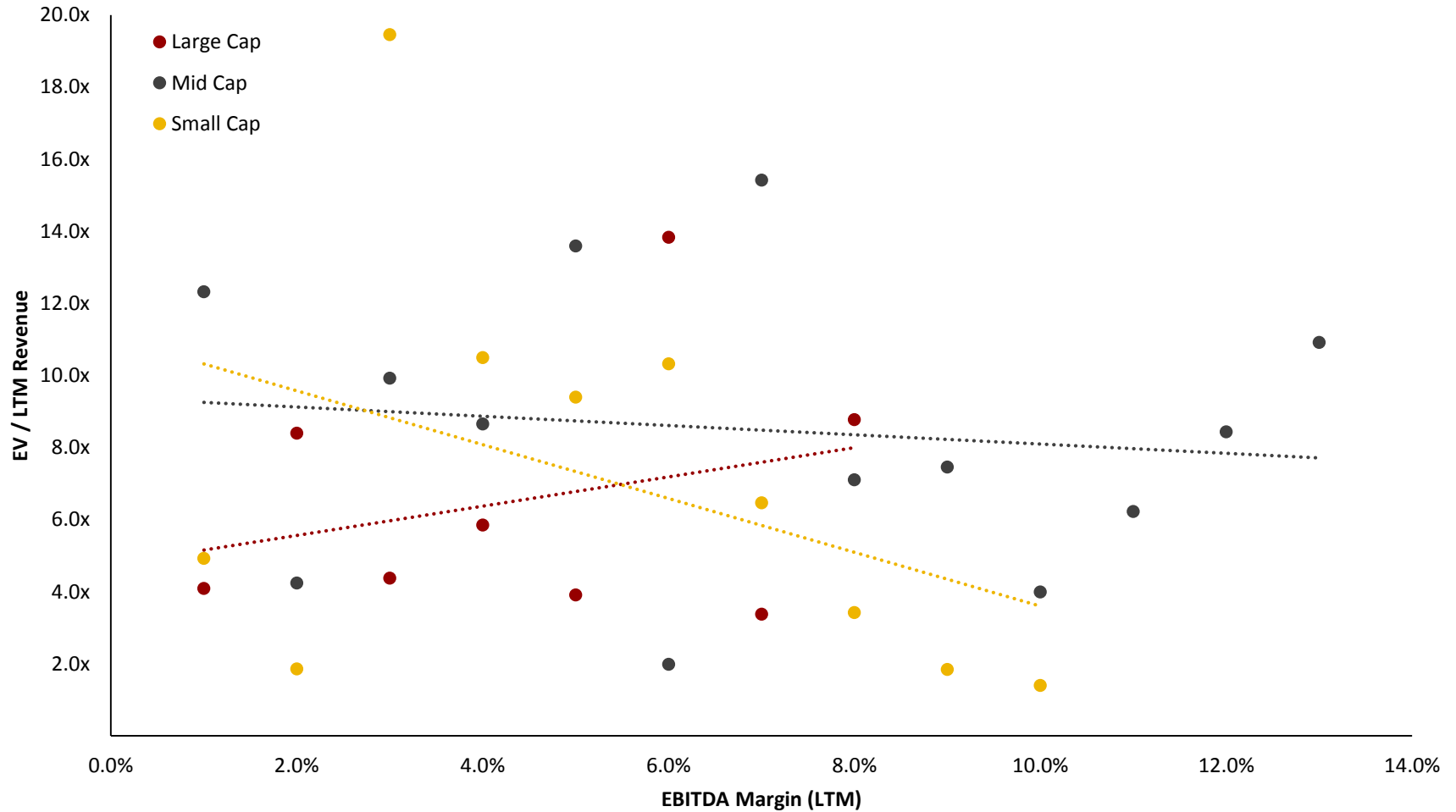
Valuation KPI: Top-Line Growth



Source: Capital IQ.

Enterprise Software Valuation

Illustrative Valuation not-KPI: EBITDA Margins



Source: Capital IQ.

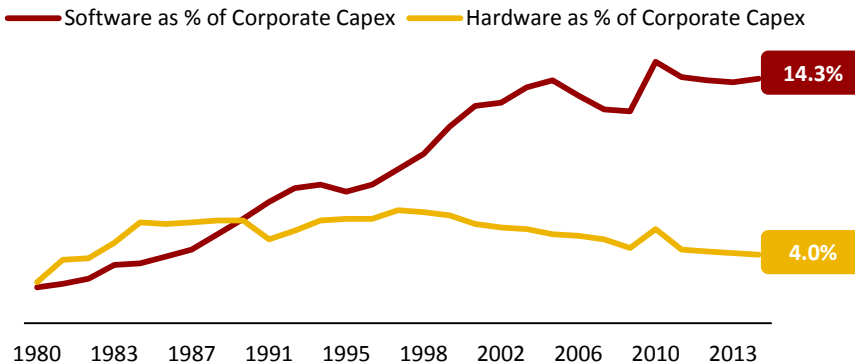
Section III

Outlook and Recommendation

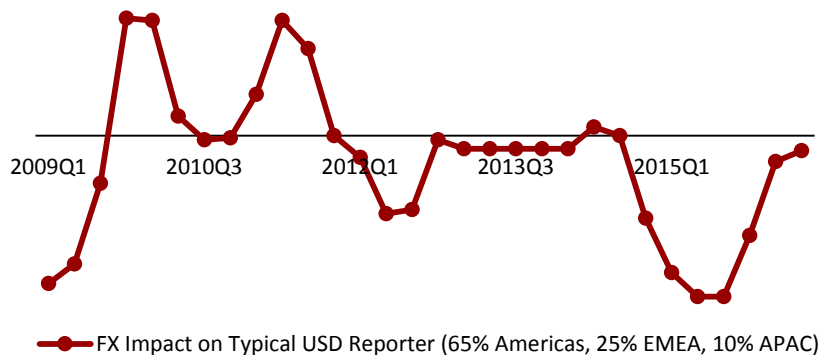
Outlook and Recommendation

Good, Bad, and Ugly

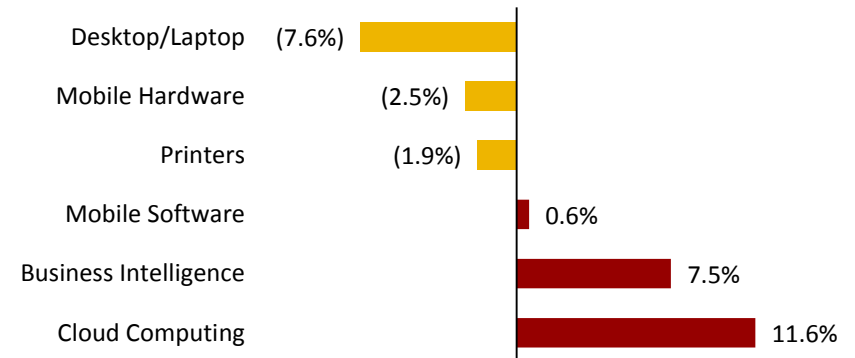
Good: Hungry, Hungry, CIOs



Bad: Software has no Borders



Good: Bytes Over Bricks



Ugly: Small-Caps Doomed to Fail

Path to Profitability

- Hard for small players to develop sustainable competitive advantage in an industry with high network effects, economies of scale, and cross-selling
- Barriers to entry are small for big players who can invest in R&D and grow through acquisitions

Rich get Richer

- Software companies that can provide integrated suites of companies and an all-in-one solution have been successful
- Most small-cap companies' growth eventually flatline until large company acquires them or they fizzle out of profitability

Outlook and Recommendation

How to Analyze an Enterprise Software Company

Positioned for Secular Growth

Which enterprise software vertical is the company in?

Low Growth

High Growth

e.g. Infrastructure



e.g. Cybersecurity



Macro Exposure

What geographical exposure does the company have?

Low GDP Growth / High FX HW

High GDP Growth / Low FX HW

e.g. ~40% EMEA, ~25% APAC



e.g. 0% EMEA, APAC



Ability to Execute

Does management have a clear vision on where the company is heading and how to get there (M&A, R&D)?

Low Vision

High Vision

e.g. Single product with no pipeline

e.g. Business model shift to adapt



Cash is King

How much net cash does the company have? Is it cash flow positive? If not, when does the company expect to become cash flow positive?

Low Net Cash / Cash Flow -ve

High Cash Balance / Cash Flow +ve

e.g. Net cash (17%) of market cap

e.g. Net cash 16% of market cap






Outlook and Recommendation

“Incumbent” Case Study: Adobe

Proven Company....

- Adobe has been a leader in the media, marketing, and publishing software verticals for decades
- Since its inception, it has consistently grown its top-line year over year through both organic growth and several acquisitions
 - Generated US\$4.6bn in revenue in the last twelve months and currently sits at ~\$40bn total enterprise value
- Adobe is an international company with almost 50% of its revenue coming from the EMEA and APAC regions
- Most of Adobe’s management have been present since 1982 with experience in the software or media industries beforehand

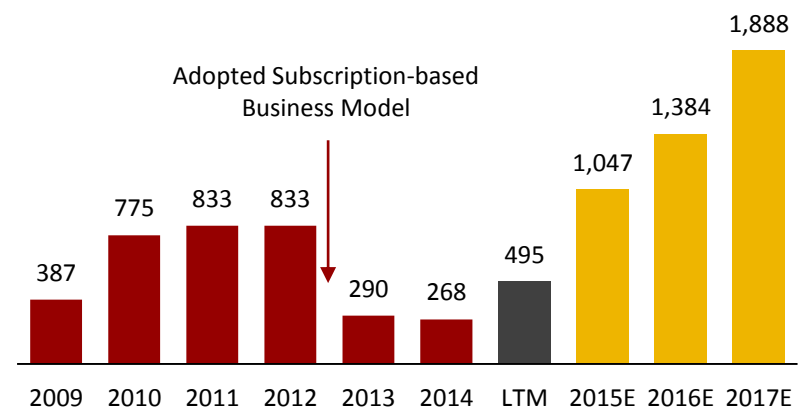
... With an Outdated Business Model....

Then	Now
<ul style="list-style-type: none"> “Boxed” perpetual license software for an up-front purchase price Updates are released every few months Cost: \$700 one-time fee 	<ul style="list-style-type: none"> Subscription-style business model for a cheaper monthly fee (bundled with accessories) Customers can stop using the software at any time Cost: \$10 / month
	 

... In a Proven Market ...



Digital Media - \$14bn	Digital Marketing - \$21bn
Creative Pro - \$5.8bn	Analytics - \$2.4bn
Creative Marketplace \$4.0bn	Campaign - \$5.7bn
Consumer - \$1.7bn	Experience Manager - \$4.8bn
Document Services - \$2.5bn	Target - \$2.1bn
	Media Optimizer - \$3.1bn
	Social - \$1.9bn
	Primetime - \$0.8bn

... Proves Itself Once Again



Outlook and Recommendation

Investment Classes in Enterprise Software

Hyper-Growth	Story	Value
<ul style="list-style-type: none"> Typically niche enterprise software companies experiencing double digit growth In newer verticals with low saturation and penetration and very few competitors Will be EBITDA – negative most of the time Trade at significant premiums to story and value peers due to immense forecasted growth Tipping point: once companies in this group become profitable and demonstrate ability to sustainably grow with competitive advantage, investors will realise their returns DCM view: goes against almost every value investing principle, no margin of safety 	<ul style="list-style-type: none"> Enterprise software companies that operate in a few verticals experiencing varied growth prospects Typically companies that face an opportunity: <ul style="list-style-type: none"> Just made major acquisition Changing business model completely Entering new verticals High-profile companies with significant press coverage based on “market hype” Tipping point: once the hype dies down and investors are focused on the actual assets and earnings of the company – if the company is able to deliver numbers to back-up the story, investors will realise their returns DCM view: important to look behind the “fluff” and analyse the intrinsic value of the company, but could have good investments 	  <ul style="list-style-type: none"> Traditional large incumbent software companies who have experienced a period of declining growth Includes small-cap companies that have been unable to sustain growth and are “fizzling out” Typically have large cash balances and depressed valuations Tipping point: any near or long-term catalysts that will result in either top-line growth or margin expansion will allow investors to realise their returns DCM view: this is the most favourable investment class – it is aligned with our philosophy

Section IV

Teradata Holding Review

Company Overview

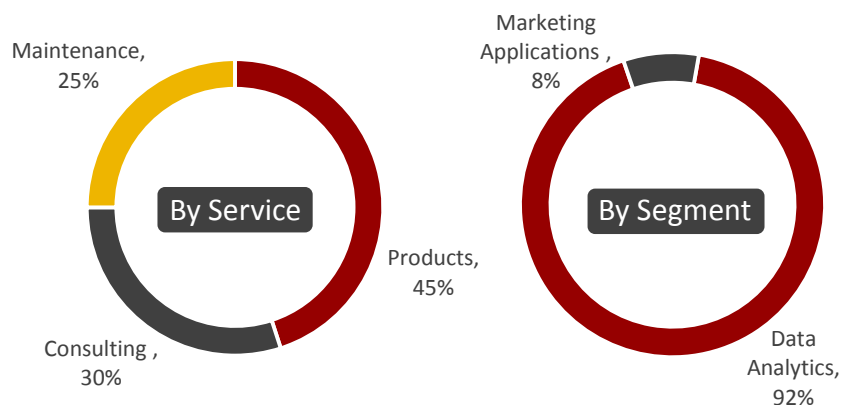
Teradata



Company Description

- Teradata is global provider of data warehousing and big data solutions
- Potential customers include airlines to price fares, banks to detect fraud and retailers to track buying trends
- Reputed for providing the highest quality solutions in the data warehousing space

Revenue Distribution



Market Capitalization

Shares Outstanding (mm)	141.9
Add: Dilutive Securities	-
FD S/O	141.9
Price per Share (CAD\$/Share)	29.5
Market Cap (MM)	4173.0
Add: Total Debt	600.0
Less: Cash & Cash Equivalents	921.0

Enterprise Value 3852.0

Valuation Summary				
	FY 2013	FY 2014	FY 2015E	FY 2016E
Revenue	\$ 2,692.0	\$ 2,732.00	\$ 2,583.60	\$ 2,634.80
YOY Growth	1.0%	1.5%	-5.4%	2.0%
EBITDA	\$ 696.0	\$ 693.0	\$ 605.0	\$ 629.1
Margin	26%	25%	23%	24%
EV/EBITDA	13.9	10.0	6.4	6.1
EV/Sales	2.5	2.2	1.5	1.5

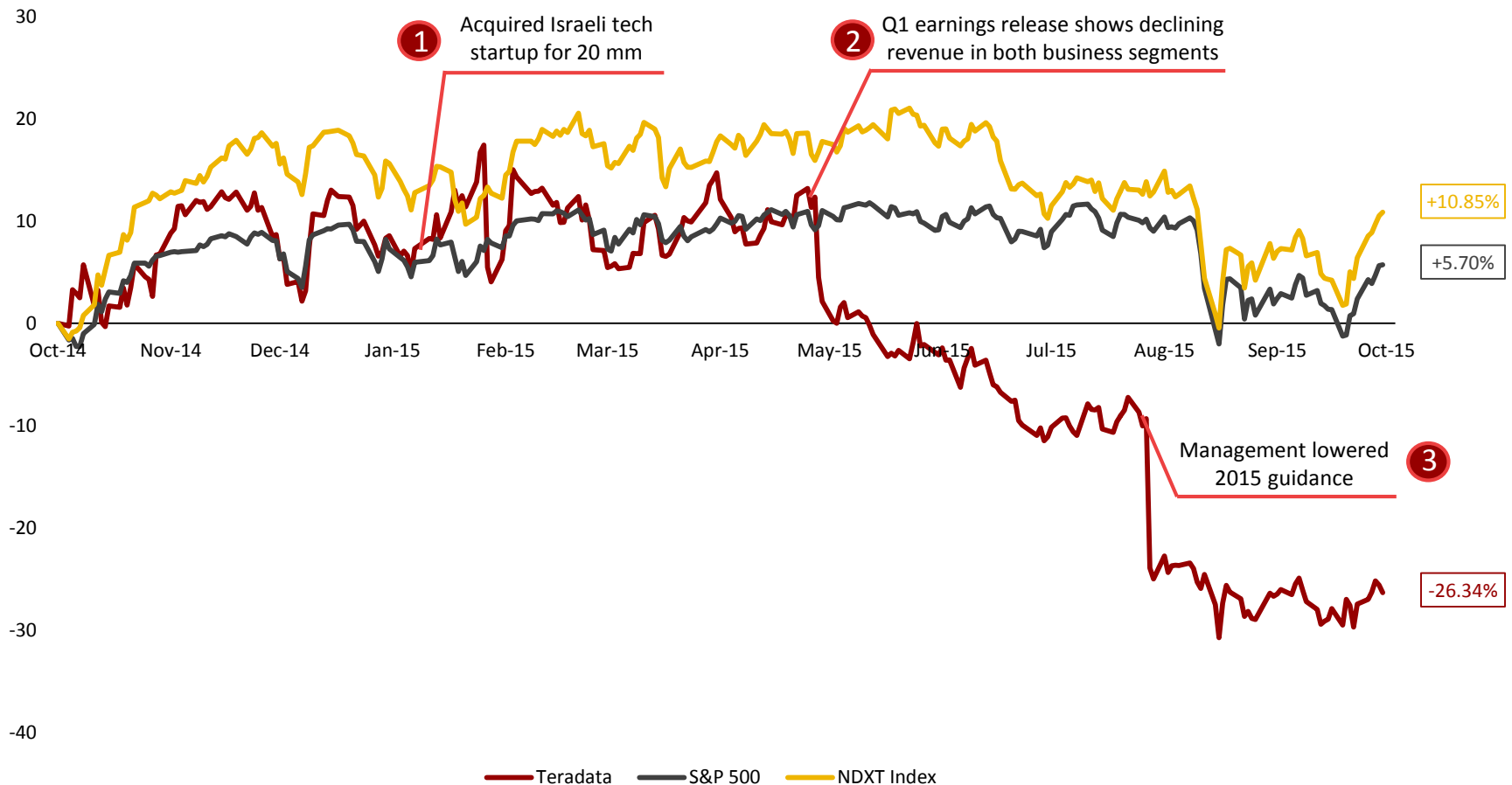
Source: Bloomberg as of 10/10/2015.



Annotated Price Chart

Consecutive Weak Earnings

TERADATA.



Source: Bloomberg as of 10/10/2015.



Investment Thesis Revisited

How Did Things Play Out?



1

Teradata is in a strong position to capitalize on **secular growth** in the data warehousing and analytics industry

2

The firm's market leading product and best in class consultants will allow Teradata to generate **sustainable recurring revenues** with **healthy margins**

3

The recent sell-off in Teradata stock creates an **attractive valuation** with current EV/LTM EBITDA of 10.2 well below historical 15.9x historical average



DESAUTELS

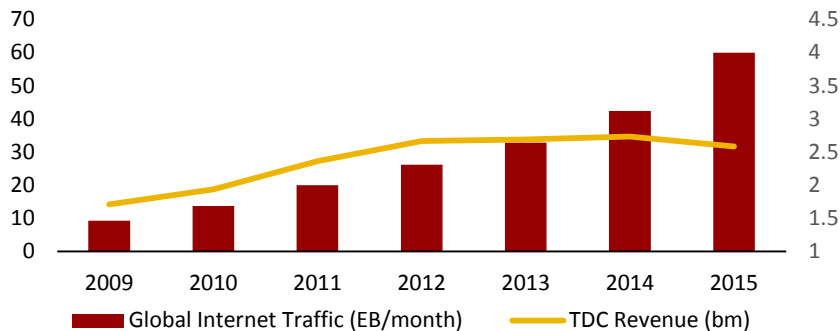
Capital Management
Gestion de capitaux



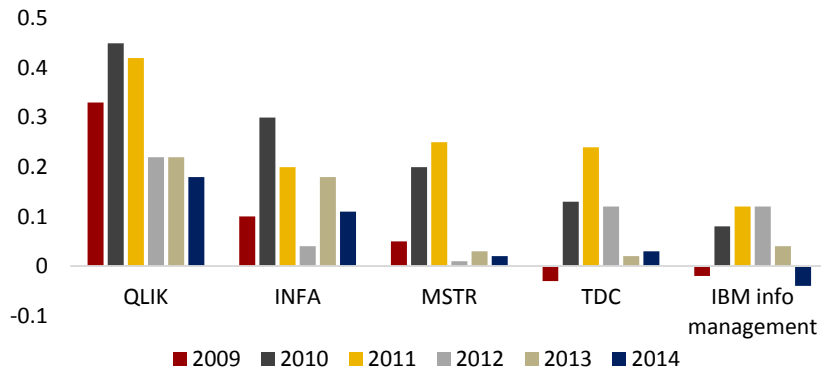
Investment Thesis 1

Secular Growth

Internet Traffic Uncorrelated to Sales

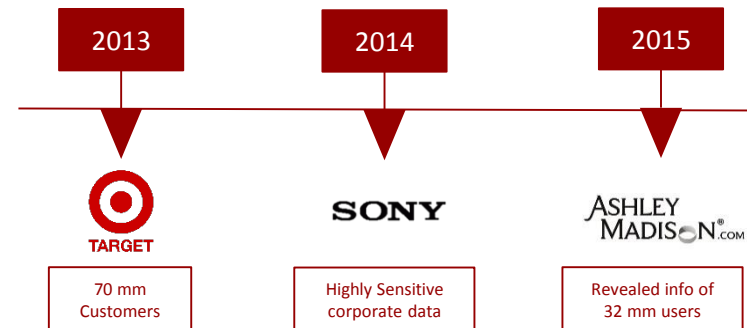


Corporate DW Spending on the Decline



Source: Cisco, Street Research, Company Reports

Security Threats Ramping Up



Will Revenue Growth Recover?

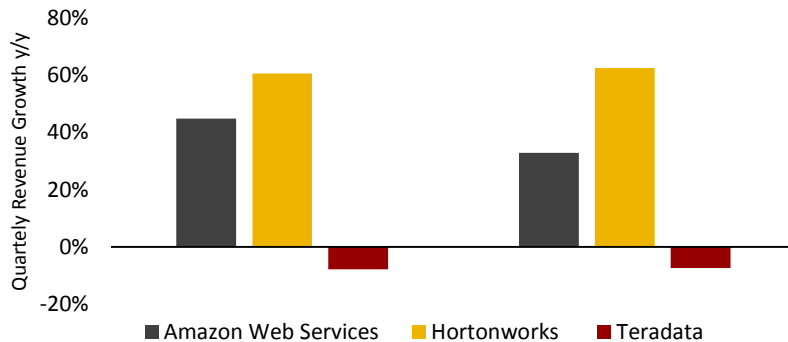
- Teradata claims that the current period is a “cycle time out” and that revenue decline has “bottomed out”
- Companies must eventually upgrade their aging hardware in so-called floor sweeps
- DCM holds the opinion that this idea is speculative and not reliable as an investment thesis

Investment Thesis 2

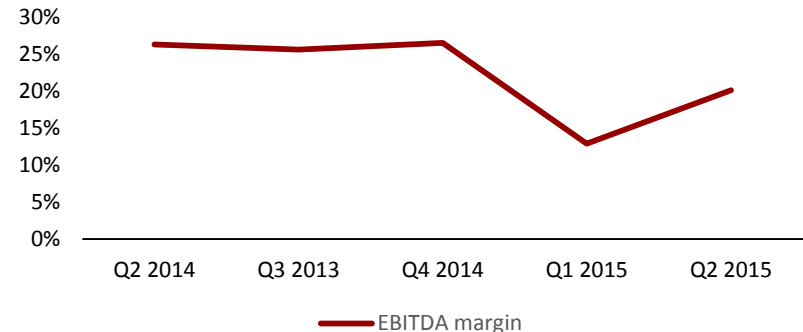
Recurring Revenues and Stable Margins

TERADATA

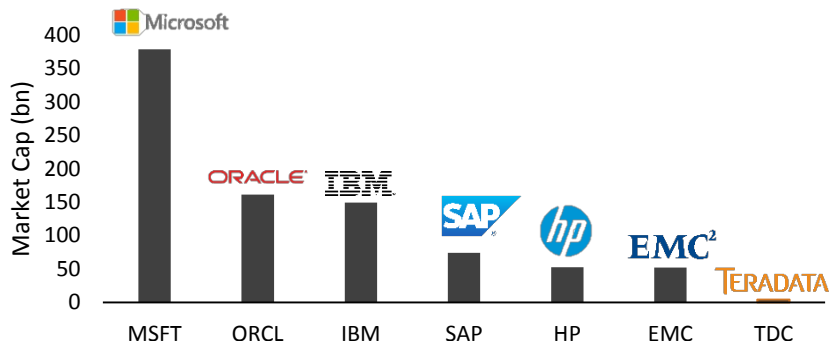
Open Source and Cloud Threats are Real



Changing Product Mix Affecting Margins



Daunting Competition Increasing



Core Business at Risk

- Open source products are not well suited for complex analytics, ie. TDC core business
- “SQL on Hadoop” is still in its infancy, but seems to be improving
- Continued advancement in open source alternatives present a long term threat to TDC core business

Source: Bloomberg as of 10/10/2015, Street Research, Company Reports

Investment Thesis 3

Is Teradata a Value Trap?

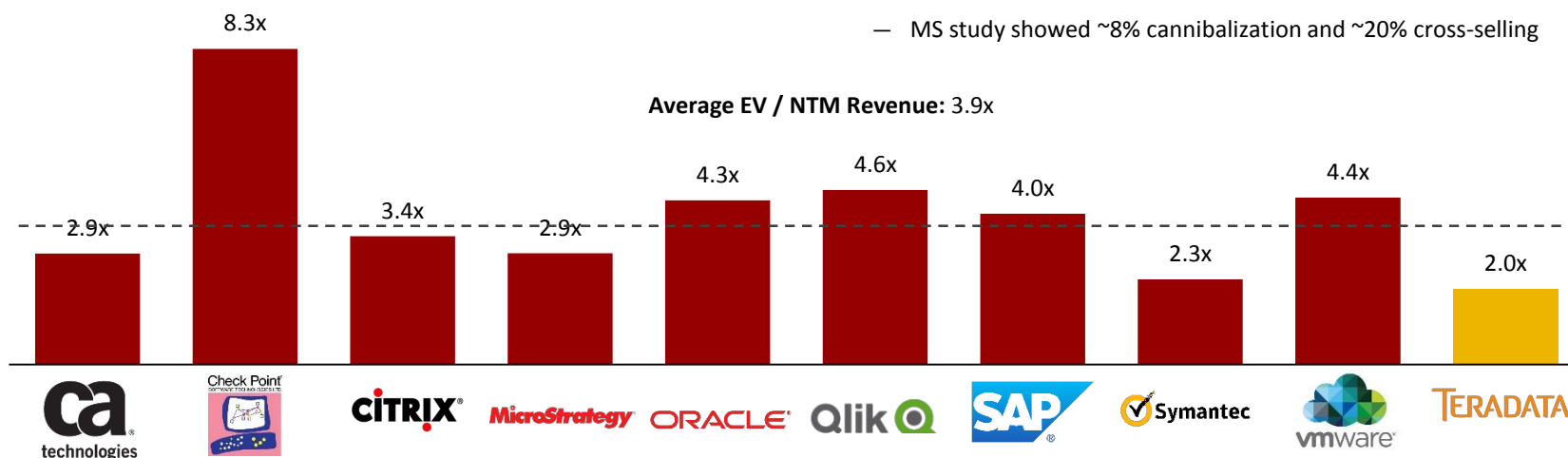


What the Market Thinks

- There is an active and relevant threat to the overall data warehousing and analytics market from open source software like Hadoop and next-gen data technology
- Sluggish demand for mature relational data management products (large scale data operations that cannot use open source software)
- There is a positive bias towards software companies as a whole and business intelligence / analytics company specifically but that means companies whose top-lines are not growing with the market will be punished
- Teradata's Hadoop service cannibalizing its existing core services is a red flag

What Your TMT Analysts Think

- Threat from Hadoop is unknown but distant and not expected to materially affect core business in the short term
 - On that note, we believe open source will not catch up in terms of complexity and depth until late 2016
- CIOs have continued to indicate that DW/BI/Analytics are a top priority and net investment in these projects grew 7.5% from 2014 to 2015
- Teradata continues to remain a take-out and activist story in the making, although this is never a good element of an investment thesis
- There are indications that the adoption of Hadoop will be positive for Teradata's top line rather than negative, as they can be seen as complementary offerings
 - MS study showed ~8% cannibalization and ~20% cross-selling



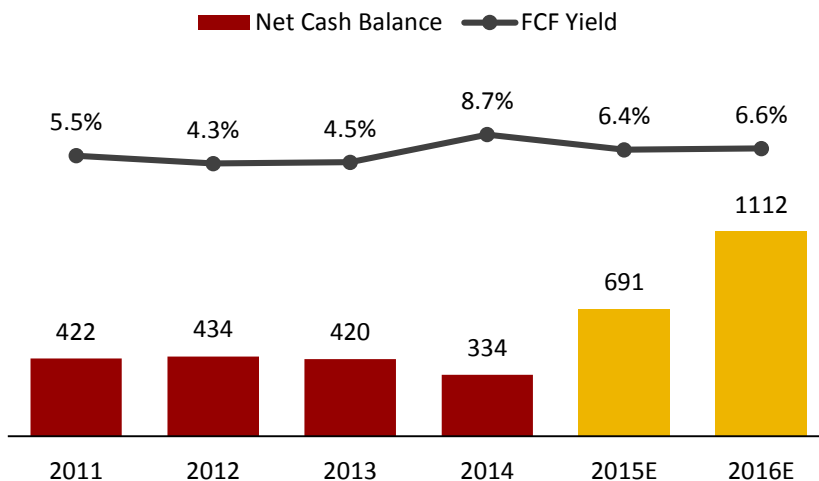
Outlook

What's Next?



Option 1: Get Bigger

- Teradata has a net cash balance that is projected to grow substantially over the next few years
- This means that Teradata can gain traction and push back on competitive headwinds through acquiring 1) scale or 2) adjacent offerings to diversify its revenue mix
- This will allow Teradata to bump shoulders with its competitors at other levels (other than high-level DW / analytics) and become the dominant force in the industry



Option 2: Get Better

- If Teradata is able to substantially differentiate its product from open-source and cheaper alternatives, it will be able to sustain its “economic moat”
- This can be accomplished through hire R&D as a % of Revenue or investments in client retention to add value to Teradata’s offerings
- Teradata also has the potential to improve margins as macroeconomic conditions begin to improve (higher product gross margins, less international revenue, less pricing pressure in consulting business)
- With Teradata’s growth profile and size, we would consider Teradata as a company transitioning from a growth stage to a mature stage, which means this is an important junction for the company
 - If Teradata can successfully push back on external competitive forces and adapt to changing trends in IT expenditure and investment, they could be a great mature company
- Nonetheless, valuation speaks for itself and TDC is a great value play in and of itself

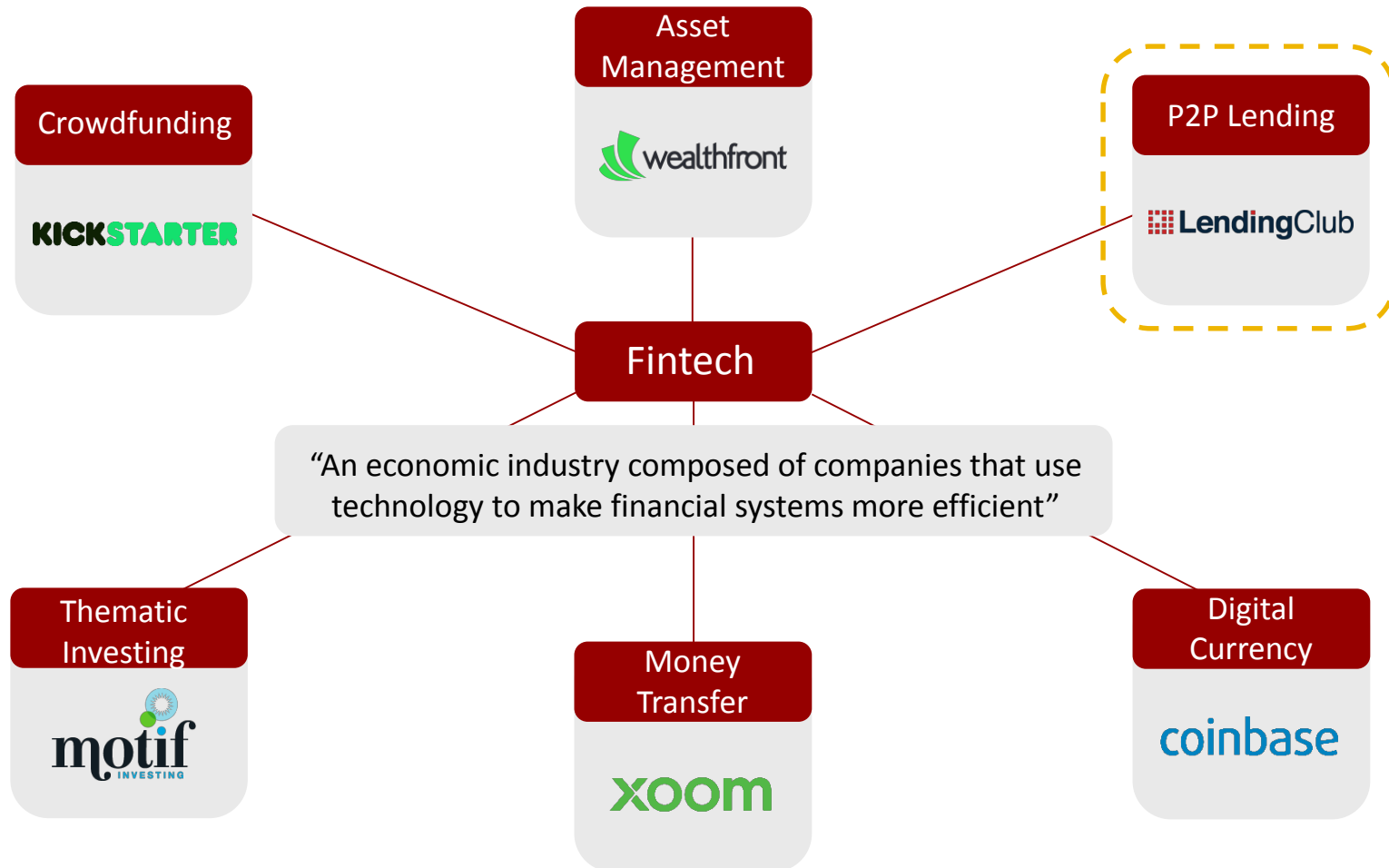


Section V

FinTech Overview

Fintech Industry Primer

Wide range of sub-industries



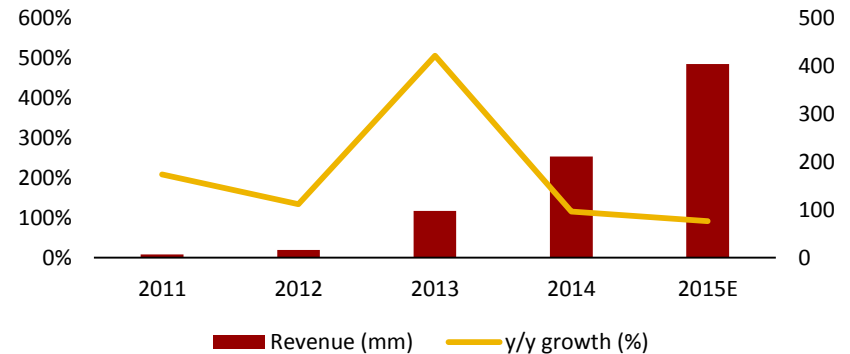
Case Study: Lending Club

P2P Lending Platform

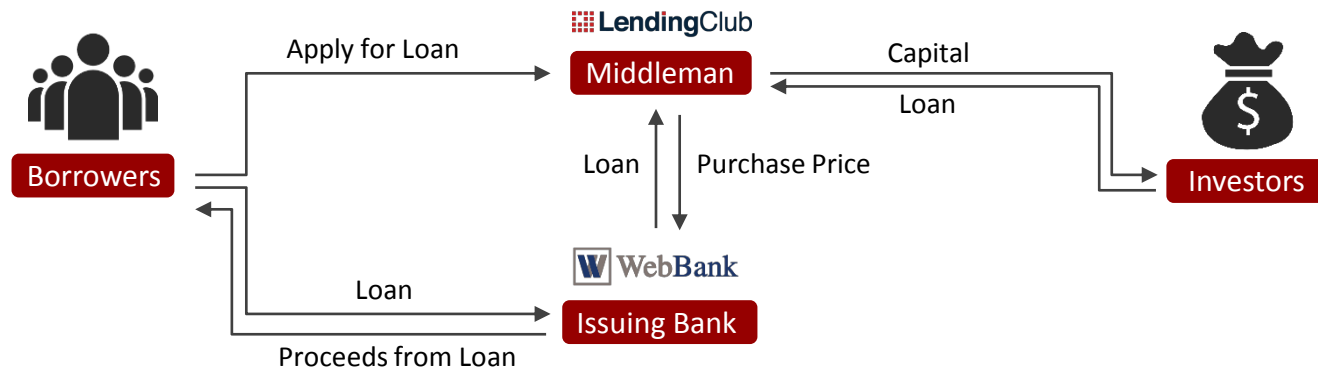
Company Description

- Lending Club was the first P2P lender to register with the SEC and create an online marketplace for loans
- The company simply connects borrowers to investors and does not carry any credit risk
- LC serves as intermediary and charges fees to both parties
- Leading lending platform in the US with 70% market share

Revenue Growth Chart



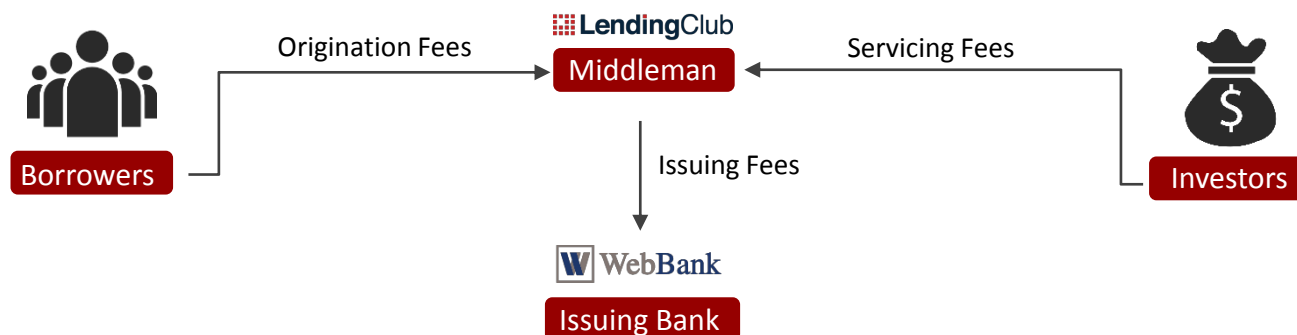
Business Structure



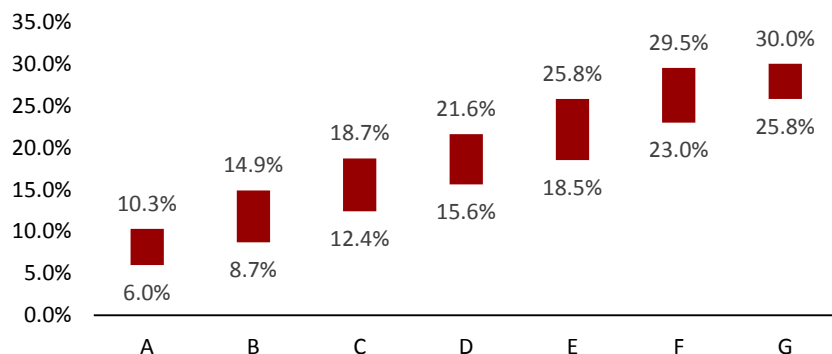
Business Model

Skim a Bit Off of the Top

Business Model



APR Based On Risk Profile



Source: Street Research, Company Reports

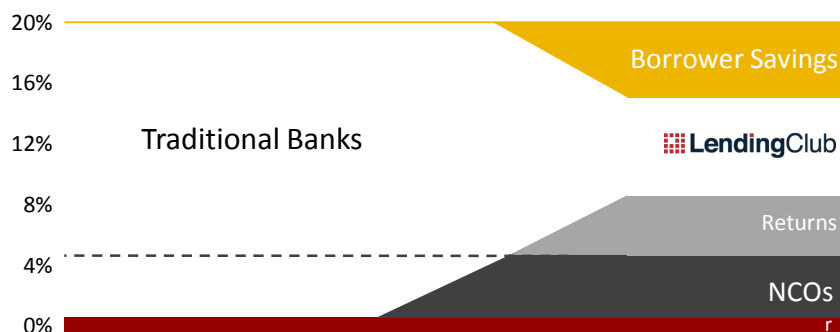
Why the Issuing Bank?

- Lending Club does not have to register as a lender in each state; therefore, it is not subject to individual state interest rate restrictions
- Under Federal Law, WebBank can “export” the interest rate where the bank is located regardless of the borrower’s residence
- It is just so happens interests rate and fees charged by banks are not limited under Utah Law....

Potential Investment?

Huge Potential but Substantial Risk

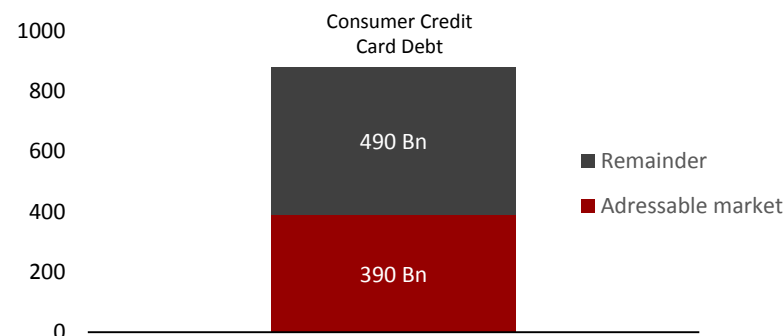
Attractive to Borrowers and Lenders



Poster Child for Overvaluation

Valuation Summary				
	FY 2014	FY 2015E	FY 2016E	FY 2017E
Revenue	\$ 211.3	\$ 405.10	\$ 630.30	\$ 900.90
YOY Growth	115.5%	91.7%	55.6%	42.9%
EBITDA	\$ 19.0	\$ 32.8	\$ 97.0	\$ 166.7
Margin	9%	8%	15%	19%
EV/EBITDA	448.8	148.7	50.3	29.3
EV/Sales	40.4	12.0	7.9	5.5

Substantial TAM

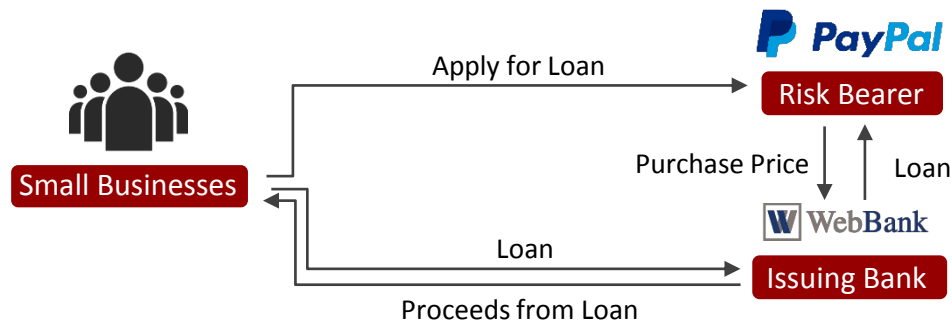


Regulatory Risk not to be Ignored


- LC could face penalties/invalidated loans due to legislation surrounding state usury legislation
- Under the Dodd-Frank Act securitizers must retain a minimum of 5% of the credit risk for any ABS
- Uncertainty about whether or not LC's notes are considered ABS as each note is not backed by a pool of assets but rather an individual loan

Source Street Research, Company Reports, Seeking Alpha

Business Structure of PayPal Working Capital



Advantage vs. Traditional loans

		
Application Time	5 min	Hours
Credit Check	✗	✓
Personal Guarantee	✗	✓

PayPal Investing in Fintech

- Paypal acquired Braintree together with Venmo in 2013 for 713 mm
- Acquired Xoom in 2015 for 890 mm
- TMT will look closer at core business and macro trends to determine if PYPL is worthy of a full pitch

Source: Street Research, Company Reports, PayPal website