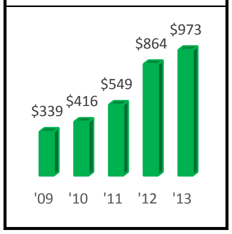
Liquidity Services
January 15, 2014

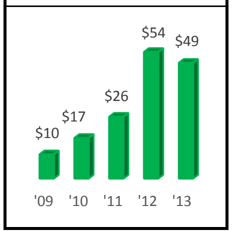
SELECTIVE
WEALTH MANAGEMENT

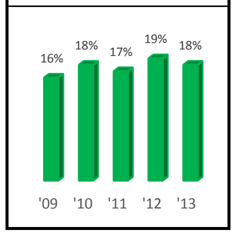
General Overview

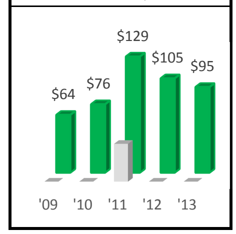
Liquidity Services Inc ("LQDT") provides online auction marketplaces for surplus and salvaged assets. The assets could be returned retail items, old fork-lifts, military beds, or scrap metal from a battle ship. They sell it all. In exchange for connecting buyers and sellers they receive an 18% - 20% commission, or 'take', on the gross merchandise volume sold.

GMV	Gross Profit	Owner Earnings	Take Rate	Balance Sheet
$973,325,000	$216,310,000	$49,104,600	2013 = 18%	Cash = $95M
5-Year CAGR = 30.2%	5-Year CAGR = 21.1%	5-Year CAGR = 48.1%	5-Year AVG = 18%	Debt = $0









Purchase Logic

LQDT gets paid for connecting buyers and sellers through consignment or profit-sharing arrangements. As a business they have a very strong competitive position due to their network effect. The more buyers that participate in each auction the higher the sale prices and the faster the assets are liquidated. They have the largest buyer base in the world with more than 2.4 million registered buyers – many of those being entrepreneurs and businesses that buy in bulk. This large buyer base has attracted the world's largest sellers with more than 600 corporate government sellers. Their seller clients include behemoths such as Walmart, Target, Amazon, Best Buy, Home Depot, and the Department of Defense.

The business model is very simple to understand, but their accounting is rather complex. There are three primary ways they offer to auction goods on behalf of their seller clients: consignment, profit-sharing, and purchase. Each transaction type creates very different *reported* revenues and margins, but almost identical income as a percentage of the merchandise sales price. For this reason we ignore the *reported* revenue and margins and instead focus heavily on the total sales value of all the merchandise sold through their marketplaces, or gross merchandise volume (GMV), and the income they generate off those sales. Historically their net income has been extremely consistent between 4% and 6% of the GMV.

In 2013 LQDT reported net income of $42 million dollars. This included a one-time charge of $5 million associated with an acquisition they made in a prior year. We added this back to forecast 2014 net income. They also have a $7 million amortization expense associated with a customer relationship that they acquired in 2012, which is a phantom expense. This was added back. After these additions, factoring in a 40% tax rate, and forecasting 12% growth for 2014 we estimate they will earn $54 million in the next twelve months.

We paid roughly 13x earnings for the business.

Divisions

They operate one reportable segment consisting of online auction marketplaces for sellers and buyers of surplus, salvage, scrap, or returned assets. This one segment operates through several channels, such as, www.liquidation.com, www.govliquidiation.com, www.govdeals.com, www.liquibiz.com, www.networkintl.com, www.truckcenter.com, www.secondipity.com, www.go-dove.com, and www.goWholesale.com, .

Problem & Solution

Problem

There are two problems that LQDT helps to address:

Problem #1: Retailers experience large volumes of returns every year – especially following the holiday season. These returns are typically opened and need repackaged. In some instances the goods are actually damaged. The returned goods need to be repackaged and refurbished and then resold. Large retail stores, such as Best Buy, do not sell refurbished or repackaged goods but want to obtain value from these return products. Through LQDT they retain approximately 80% of the auctioned sale price.

Problem #2: Governments, such as the Department of Defense or a local municipality, have millions of dollars in products that were purchased as surplus (like buying too many computers or chairs) or are older products that become obsolete. These government bodies would like to sell the surplus and obsolete products to obtain value. This includes things as obscure as selling metal from a decommissioned battle ship.

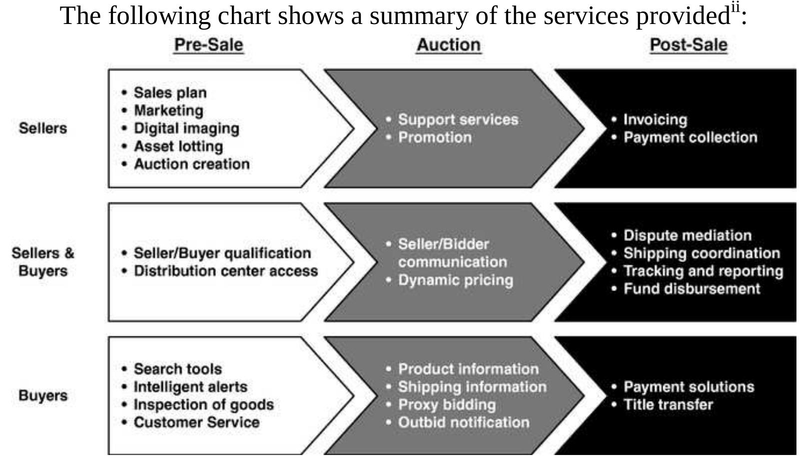
Solution

LQDT operates online market places were sellers, such as government bodies or retailers, are connected to buyers. This gives the sellers an avenue to obtain value from customer returns, surplus or salvaged assets.

Products & Services

The primary service provided by LQDT is allowing buyers and sellers to transact in an efficient online auction environment in over 500 product categories. For buyers they provide access to a global, organized supply of surplus and salvaged assets with customer focused information on the listed products. For sellers they enhance their financial return on excess assets by providing a liquid marketplace and value-added services that integrate sales and marketing, logistics and transaction settlement into a single offering.[i]

The following chart shows a summary of the services provided[ii]:



Customers

Sellers – Their customers on the sell side are large corporations (big retailers, such as Walmart), medium to small corporate accounts, and government accounts. They select the service based on LQDT's ability to obtain a fair value for their assets, quickly, and at low cost. The large number of buyers and auction process helps to ensure excellent value.

Buyers – Their customers on the buy side are mostly individuals functioning as entrepreneurs. Many of these individuals by the liquidated inventory in bulk and resell the products through alternative channels, such as eBay or their own local store. They use LQDT because of the large volume of products, transparency in the goods being purchased and discounted value that could not be obtained through other asset procurement channels.

They have customers such as Walmart, Best Buy, Target, and Amazon.[iii]

Sales & Marketing

Sellers – They sign up new sellers through their direct sales force of 130 individuals. These individuals target large corporate accounts (big retailers, like Walmart), medium to small corporate accounts, and government accounts. The sales personnel are paid salary and performance-based commissions. A significant portion of the sales efforts goes toward further penetrating existing clients. There is a huge opportunity in this vertical. It is possible for them to double the size of their business through existing business relationships simply by winning a larger percentage of their seller client's salvageable assets.

Buyers – They market to new buyers and attempt to increase existing buyer participation. They have 64 individuals focused on buyer marketing efforts. They also use paid search advertising, search engine optimization, and print media. The number of buyers is large with more than 2.4 million registered. The number of registered buyers is slightly misleading, because registered buyers don't necessarily participate in auctions. A more appropriate number to monitor is the total number of auction participants. This has been relatively stable the last 4 years.[iv]

Supplemental Operating Data:					
Gross merchandise volume from continuing operations(2)	$ 338,721	$ 416,314	$ 548,552	$ 864,226	$ 973,325
Completed transactions(3)	469,000	522,000	475,000	501,000	530,000
Total registered buyers(4)	1,202,000	1,403,000	1,604,000	2,186,000	2,424,000
Total auction participants(5)	2,118,000	2,247,000	1,936,000	2,105,000	2,458,000

The total auction participants is not a critical measure at this point in time because the business is presently sell-side constrained and has been for several years. They need additional sellers to provide goods to continue with their growth. Due to the constraints on the sell-side it is logical that the last four years are not an indication of LQDT's ability to expand the auction participant base.[v]

Revenue Creation

LQDT generates revenue by receiving a commission from the sellers when the products are sold. The commission can be paid in a few forms:

Profit-Sharing Model – In this model they share in the profits of a future sale.

Consignment Model – Under this model they receive a commission based on the sale price.

Purchase Model – Under this model the sellers receive a fixed amount (as opposed to a share of the profits) from the completed sale in the form of a distribution. LQDT keeps the remainder.

It should be noted that all three models have nearly identical economics for LQDT. In both the profit-sharing model and purchase model payment the cash conversion cycle is negative. They guarantee a purchase price from the seller, but get favorable terms on when payment is due. They take money from the buyer after the auction, hold on to the money until the buyer receives the product, and then remit the payment to seller. These economics are identical, if not more favorable, to the consignment model, just reported differently.[vi]

In addition to generating revenue from the seller they also receive revenue in the form of a buyer's premium. This is charged to the buyer in excess to the sales price.

When evaluating the concentration of the customer base is it is more appropriate to evaluate the GMV produced by each seller client rather than the reported revenue for reasons discussed in the section "Accounting Quality".

Their revenue is fairly concentrated with the Department of Defense (DoD) being the largest seller. The DoD has two contracts, a Surplus Contract and a Scrap Contract. The Surplus Contract was 15% of the GMV sold in 2013. This is much more relevant than the percentage of total revenue (see Accounting Quality section for an explanation). The Scrap Contract was 7% of the GMV for 2013. The total GMV from the DoD contracts was 22%.

Walmart also accounts for 11% of the GMV under multiple contracts / programs.[vii] In addition to these two major sellers they have 600 corporate clients that each sold in excess of $10,000 of surplus or salvaged assets.[viii]

The pricing is very consistent at 18%-20% of the GMV. This was calculated by adding 1) Operating Income and 2) Selling, General, & Administrative, divided by the GMV. This is known as the 'Take Rate' in the tale below. The actual Take Rate will be *slightly* higher because the handling and storage of client assets is included in the cost of goods and not taken into account in this formula. This is not material because this percent will be very low and relatively constant over time. The calculated value is a reasonable proxy.

The pricing has not materially changed over the last decade and pricing pressure is minimal.

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013
GMV (Millions)	$ 102	$ 173	$ 233	$ 359	$ 338	$ 416	$ 548	$ 864	$ 973
Take Rate	18%	20%	20%	16%	16%	18%	17%	19%	18%
Net Income / GMV	3%	5%	5%	4%	3%	4%	5%	6%	5%

Expenses

The primary sources of expenses include purchasing and transporting property for auction, credit card transaction fees, technology and operations. The technology expenses consist primarily of personnel costs related to the programming staff that develop and deploy new marketplaces and continuously enhance existing marketplaces. The expenses have a lot of operational leverage that should benefit LQDT greatly as it increases in scale. Some of the benefits are already materializing as the Net Income / GMV ratio has been improving.

The efficiencies are already being realized as SG&A as a percentage of GMV has been steadily declining since 2004 from 13% down to 9%. It is likely this trend will continue and this demonstrates favorable operating leverage.

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013
GMV (Millions)	$ 102	$ 173	$ 233	$ 359	$ 338	$ 416	$ 548	$ 864	$ 973
Take Rate	18%	20%	20%	16%	16%	18%	17%	19%	18%
SG&A / GMV	13%	12%	13%	11%	11%	11%	9%	8%	9%
Net Income / GMV	3%	5%	5%	4%	3%	4%	5%	6%	5%

The lower percentage of SG&A as a function of GMV could allow LQDT to lower their take rate and maintain the same Net Income / GMV. As it currently stands it looks as though they have maintained a consistent take rate and increased their Net Income / GMV. This is wonderful margin expansion and shows some pricing power. It might be an excellent business decision to lower the take rate and drop the net income / GMV in order to gain further market share. That would allow them to leverage their platform further, lower SG&A as a percentage of GMV, and expand Net Income / GMV again. Repeating this process continually would widen the moat considerably. If they elect to enjoy the wider margins rather than pass the savings on to seller clients that would be profitable as well.

Real Income

They have a few amortization expenses that are non-cash charges that must be added back to calculate their actual income. The Jacobs Trading acquisition created an intangible asset for the exclusive rights to the Walmart contract. These rights were valued at $33.3 million and that is being amortized over 55 months on a straight-line basis. This equates to roughly $7.2 million per year. This amortization expense should be added back because there is an extremely high probability that the Walmart contracts will be renewed and the possibility of the relationship expanding. They also had a similar charge of $3.9 million over 20 months for the NESA contracts.

There also was a one-time charge of $5.1 million for the Jacobs Trading earn out liability. This was also added back. After the theoretical tax liability on these additions their real income was closer to $49 million than the reported $41 million. Assuming 12% growth (extremely conservative given the 28% geometric average GMV growth since 2006 and huge market opportunity) their forward looking real income should be roughly $54 million. They'll report less due to the continuing amortization of intangibles.

Growth

The growth of the business has been sensational for the last decade. The GMV has compounded at a rate of 30% per year for the last 10 years. After adjusting the net income for one-time items and amortization expenses the net income also has had a very steady trend upward. The average net income as a percentage of GMV has been extremely consistent at 5%. The size of the market is tremendous, they are expanding internationally, and they are the largest player in the space. There are economies of scale due to the operating leverage inherent in their technological solutions and the network effect which will allow them to capture more and more market share.

Using a 12% growth forecast for GMV and a 5% net income margin (based on GMV) seems very conservative.

The growth of the business can come from two channels: new clients and existing clients. The existing clients are actually a huge market opportunity. They currently serve many of the nation's largest retailers, but are very underpenetrated on each relationship. For example, they currently liquidate roughly 33% of Walmart's business, which is by far their highest penetration, but a much lower percentage (single digits) of other clients, such as, Target, Amazon, Best Buy, Home Depot, Lowes, etc. They have the data analytics necessary to demonstrate to these clients the ROI for selecting LQDT as their liquidation partner of choice. They can easily double their GMV through existing client relationships.

Traditionally they have grown their business at a rate of 7% to 8% just from their existing clients by gaining additional business. In 2013 their YoY same seller client GMV was flat for the first time in their history. This is likely an anomaly and YoY same seller client GMV should continue the historic upward trend.

They focus on servicing their existing clients to the best of their abilities first, prior to seeking additional business from new clients. Their existing client base is sufficiently large for them to hit the $2 billion GMV mark, but they have to continue to win additional business from them.

One challenge with growth is that if LQDT signs up seller clients too quickly they could disrupt the service level for existing seller clients because there is excess supply relative to the buyer base. It is important to on board clients carefully not to disrupt existing business. As it currently stands the business is seller side constrained – meaning there is excess buyer demand. This is the best position to be in for LQDT because they could theoretically add new seller clients and effectively liquidate their assets without disrupting current relationships. The opposite constraint would be more difficult (meaning buyer side constrained).

One area of concern is the growth in total auction participants. This has been growing slowly for the last 5 years. This does make sense given that the business is currently seller side constrained and we suspect that if the constraint reverses LQDT could increase marketing spend and attract additional buyers to increase the growth. Based on personnel it is evident that they have been targeting seller side growth.

Competition

The competition is highly fragmented and largely unsophisticated. The weak competition and benefits garnered from the network effect will likely increase LQDTs competition position over time and afford them a much larger market share.

The biggest threat of competition would be if corporate seller clients and governments began establishing their own surplus, scrap, and salvage asset sites to remove the costs associates with contracting LQDT.

This is not likely given the complexity of the IT solution for small government bodies or medium to small corporate accounts. The 18% take rate would be nearly impossible to re-coop for small players.

For a large player, like Walmart, it would probably be easier to purchase LQDT if the reverse supply chain became an important part of their model. The buyer base would be very advantageous. We do not view this threat as likely.

Consolidated Balance Sheet

They have a positive net cash position with a very simple balance sheet. No real complexities to analyze. Their inventory fluctuates seasonally and is based on return trends. The highest return season for retailers is the second quarter (January – March) and the highest return for scrap is the first quarter (October – December). They have very low levels of inventory (3% of GMV on average).

The currently level of working capital equates to returns on tangible equity in excess of 60%. Any earnings retained for organic growth are sensational.

Accounting Quality

Their revenue is highly arbitrary and should be largely ignored due to the following:

Profit-Sharing Model – Under this model they share the profits from the sale with the seller. The entire sale price of the goods sold is counted as revenue for LQDT. This creates much higher reported revenue than the consignment model. Revenue under this model was 25.5%, 16.1%, and 13.5% of total revenue for the fiscal years 2011, 2012, and 2013, respectively. The merchandise sold under this model was 15.4%, 8.9%, and 7.0% of the GMV for the same years, respectively. The more sales performed under this model as a percentage of GMV the higher the reported revenue. However, LQDT never makes payment to their seller clients until the product is sold – so the economics are nearly identical to the consignment model – only reported differently.

Consignment Model – Under this model they receive a commission from the sale of the seller's goods. The only portion reported as revenue under this model is the commission received. Revenue under this model was 8.8%, 12.5%, and 20.1% for the fiscal years 2011, 2012, and 2013, respectively. The merchandise sold under this model was 44.7%, 52.3%, and 59.1% of the GMV for the same years, respectively. The more sales performed under this model as a percentage of GMV the lower then reported revenue.

Purchase Model – Under this model the sellers receive a fixed amount (as opposed to a share of the profits) from the completed sale in the form of a distribution. The entire sale price of the goods sold is counted as revenue for LQDTs. This creates the same reported revenue as the Profit-Sharing Model. Revenue under this model was 65.2%, 71.4%, and 66.5% of the total revenue for the fiscal years 2011, 2012, and 2013, respectively. The merchandise sold under this model was 39.6%, 38.8%, and 33.9% of the GMV for the same years, respectively. The more sales performed under this model as a percentage of GMV the higher the reported revenue.

Take Rate – It should be noted that the take rate, or the cash received from the sale, is nearly identical under all three models. The take rate historically has been between 18%-20% of GMV. This is what truly matters.

When it comes to accounting the *reported* revenue is not a major concern. The appropriate way to evaluate the health of the business – both through margins and growth – is by carefully monitoring the GMV, the Take Rate, Net Income / GMV, and SG&A / GMV. Below is a simplified example as to why the revenue figures are not terribly important.

Imagine two identical transactions where one is a consignment transaction and the other is a purchase transaction. Assume a television is sold for $1,000 and the take for LQDT under both models is $200.

Revenue Analysis

Consignment Transaction	Purchase Transaction
Television Sale Price: $1,000	Television Sale Price: $1,000
LQDT Take: $200	LQDT Take: $200
Cash Received By Seller: $800	Cash Received By Seller: $800
S,G,&A = $150	S,G,&A = $150
Reported Revenue: $200	**Reported Revenue: $1,000**
Reported Expenses: $150	**Reported Expenses: $950**
Operating Income: $50	**Operating Income: $50**

In both transactions LQDT sells a television to a buyer for $1,000 and receives $200. However, the purchase transaction reports revenue of $1,000 whereas the consignment transaction reports revenue of only $200. The revenue isn't terribly relevant because the method of reporting has a huge impact. Now imagine the same scenario using GMV metrics:

Consignment Transaction	Purchase Transaction
Television Sale Price: $1,000	Television Sale Price: $1,000
LQDT Take: $200	LQDT Take: $200
Cash Received By Seller: $800	Cash Received By Seller: $800
S,G,&A = $150	S,G,&A = $150
GMV: $1,000	**GMV: $1,000**
Take Rate: 20%	**Take Rate: 20%**
S,G,&A / GMV = 15%	**S,G,&A / GMV = 15%**
Income / GMV = 5%	**Income / GMV = 5%**

By calculating these values it eliminates the impact from changes in the makeup of transactions and allows direct annual comparisons and clear observation of trends.

Additionally, it should be noted that the cash conversion cycle for both methods is extremely favorable. The capital requirements are very low for both models due to the terms LQDT receives from the seller under the "purchase" transaction model.

They consistently receive an unqualified opinion from auditors.

Legal

They have zero legal proceedings.

Market

According to the National Retail Federation the total value of merchandise returned in the United States for 2012 was estimated to be $217 billion, up 14% from 2010.[ix] The addressable piece of the return market is roughly $50 billion for LQDT. Manfredi and Associates estimates the global market for surplus capital assets to be approximately $100 billion annually.[x] The total market for LQDTs is sufficiently large for exceptional growth. With only $973 million in GMV they have less than 2% of the domestic return market alone – and they are the largest player.

The market in general is growing due to more liberal return policies for most retail stores that increase customer satisfaction and loyalty. This likely will continue to grow as we produce more goods globally. The long-term trend is upward.

LQDT is rapidly growing with GMV increasing 28% per year since 2006. The consolidation of this market makes tremendous sense because of the network effect provided by auction spaces. Sellers need buyers and buyer need sellers – the more sellers the more buyers and the more buyers the more sellers. I suspect LQDT will grow their dominance in this space over time.

Corporate Governance

The CEO and founder William Angrick III owns 16% of the company through various trusts. This is a wonderful sign. He is 45 years old and seems passionate about the business. He has set goals to grow to $2 billion GMV that he will likely attain relatively soon.

Compensation

Share based payments are recognized to employees, including grants of employee stock options, through the income statement based on their estimated fair values.

This form of compensation was $13 million in 2013 and seems to grow consistently with revenue. This is one area of weakness for the business – but no business is perfect.

Allocation of Capital

Expectations for capital allocation based on their most recent conference call:

1) Minor tuck in acquisitions that are intelligent. The Jacobs Trading acquisition was very well done and we'd like to see more of similar quality. This could potentially be an area were finances are squandered if acquisition prices are too high. They have spent 66% of their earnings on acquisitions over the last decade, but we expect this to drop going forward. They bought many of these businesses to 'buy in' to existing relationships, such as Walmart, and then use that relationship to win additional businesses from the new client. They have a lot of the major retail players in the US and acquisitions to establish relationships domestically aren't as likely as they have been historically. This may be a method for growth internationally.
2) No dividends. They haven't paid any since going public and we would like for them to continue not paying dividends.
3) Organic growth will constitute a very small percentage of their capital allocation. The returns here are sensational with ROE on tangible equity in excess of 60%. The problem is the reinvestment opportunity just isn't there (or necessary, they can expand business further without spending organically).
4) It is our expectation that the majority of their net income would be spent on share repurchases. At the current price level this would be ideal. They recently instituted a share repurchase program, mentioned this on their conference call, and the CEO is a 16% owner so would benefit from the reduction of shares

greatly. As the founder we expect he would be inclined to reduce the share count. If this does not materialize and the acquisition route is taken instead that outcome would be acceptable.

Additionally, their CFO mentioned on their most recent conference call a willingness to leverage the balance sheet to return capital to shareholders. With such a strong balance sheet and reliable cash flow this could be very lucrative for shareholders. This would not be required for a successful investment, but would be most welcomed.

Risks

The biggest risks facing this investment are the loss of the DoD or Walmart as customers. This is unlikely given that Walmart contracts many different liquidators and LQDT is just one provider. They are a major provider though. I believe their Data Analytics demonstrate the ROI of using their services, as opposed to a less sophisticated competitor, is helping them win market share.

They have owned the DoD contract exclusively for 13 years and the contract is fairly complex. There are compliance issues that make switching liquidators more risky for the DoD. For example, they have a rule that you cannot sell any items that are affiliated with an F-14. If there was a sowing machine used for the stitching of the F-14 seats, that sowing machine is not eligible for sale. An accidental sale of that machine would constitute a violation of compliance. In the 13 years they've held the contract they have never had a compliance violation. This makes it likely for them to win the contract in the future. An RFP should be due shortly (it is temporarily suspended).

The fluctuations in scrap metal prices aren't terribly material. They will have good and bad years in this regard and prices are not possible to forecast.

Last, but not least, if the DoD winds down the military spending and close several bases it would impact their DoD contract. The end of the two wars will likely reduce the DoD spending as well. The effect of this may be a little counter-intuitive though.

There are some 300 odd bases domestically and only 8 have been closed in the last several years. It is highly controversial politically to close a base and this is not likely. In the event of mass base closures it actually would create a temporary *boom* (perhaps 5 years) in their income due to the increase surplus and salvage from the liquidated bases – but long term it would hinder results.

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[i] LQDTs Inc, 10-K filed 11/21/2013, page 1.
[ii] Ibid., 4
[iii] http://seekingalpha.com/article/1248051-liquidity-services-management-presents-at-deutsche-banks-dbaccess-21st-annual-media-and-telecom-conference-transcript
[iv] Liquidity Services Inc, 10-K filed 11/21/2013, page 30.
[v] http://seekingalpha.com/article/1248051-liquidity-services-management-presents-at-deutsche-banks-dbaccess-21st-annual-media-and-telecom-conference-transcript
[vi] Ibid., Search "We also do have, at times, especially in our retail"
[vii] Liquidity Services Inc, 10-K filed 11/21/2013, page 36.
[viii] Ibid., 36
[ix] Ibid., 1
[x] Ibid., 1