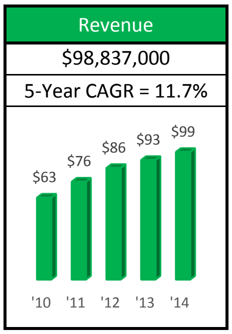
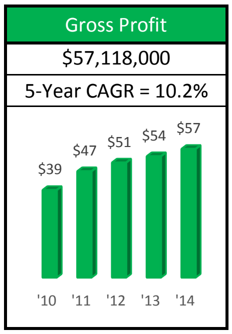
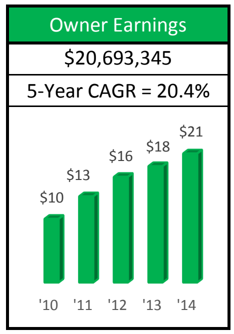
National Research Corp
March 23, 2015

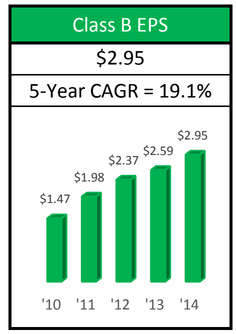
General Overview

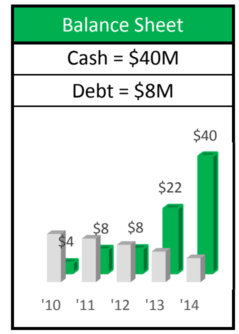
National Research Corp (NRCI) is a leading provider of analytics and insights that help medical practices grow top-line revenue and increase patient, employee, and customer retention. The company helps perform roughly 500,000 patient surveys per year to help medical practices understand how they can improve patient care. These services are subscription based and annually renewed by more than 8,100 facilities across the United States with some client relationships lasting several decades. The strong recurring revenue has allowed the company to post 15 consecutive years of increasing revenue and profit.











Purchase Logic

Our purchase of NRCI was based on the merits of the business and a strange anomaly in the stock market. The business itself is extremely profitable with a dominant market position. The company was founded in 1981 by Michael Hays at the age of 27. Since that time NRCI has grown to more than $100 million dollars in revenue and in the last decade increased profits from $6 million per year to more than $20 million. During this same timeframe the company posted zero year-over-year declines in revenue or income. Michael Hays continues to operate the company today as CEO at the age of 60. While the business certainly has enjoyed tremendous success in the last 10 years our opportunity to purchase was born in a 'recapitalization' of the business that occurred in May 2013.

Prior to May 2013 the company had one share class that had equal rights in terms of voting power and economic interest in the earnings of the company. In May 2013 the business announced a recapitalization plan that would create two classes of stock: Class A and Class B. For each share held prior to the recapitalization a shareholder would receive three shares of Class A stock and ½ of a share of Class B stock. One Class A share is entitled to 1/6th of the earning power and 1/100th of the voting rights when compared to one Class B share. There was, however, a unique catch – in the event that the business was acquired both shares would receive identical proceeds per share. The economics of each share class are summarized below:

Table 1: Share Class Summary

	Per Share				Entire Share Class		
Class	**Earnings**	**Voting Rights**	**Acquisition Payout**	**Total Shares**	**Economic Interest**	**Voting Rights**	**Acquisition Payout**
Class A	1/6th	1/100th	1	20,955,678	49.9%	5.6%	85.7%
Class B	1	1	1	3,505,352	50.1%	94.4%	14.3%

Table 1 shows that the Class A shares are entitled to 49.9% of the overall earnings of the business, commanded 5.6% of the vote on all shareholder matters, and would receive 85.7% of the purchase price in the event that the business was acquired. Class B is entitled to 50.1% of the overall earnings of the business, commands 94.4% of the voting power, and would receive 14.3% of the purchase price in the event the business was acquired.

Under this scenario it would make sense that the aggregate of the 20,955,678 Class A shares should trade at a slight discount to the aggregate of the 3,505,352 Class B shares. The logic behind the discount is that the Class B shares receive more income and command almost the entire vote on all shareholder matters. The takeover provision slightly complicates matters, because the Class A stock would prefer to be acquired due to the 1 for 1 payout the share class would receive, however, with no meaningful ability to vote this desire would likely not materialize.

It is very apparent that the market does not understand the economics of these two share classes and has badly mispriced the two. At our time of purchase the Class A shares were trading at $15.00 per share for an aggregate value of $314 million. This share class is entitled to 49.9% of the total earnings of the business or roughly $10 million dollars; therefore trading at a P/E ratio of 31. The Class B shares were trading for $32.14 per share for an aggregate value of $112 million. This share class is entitled to 50.1% of the total earnings of the business or roughly $10 million dollars; therefore trading at a P/E ratio of 11. The Class B shares are roughly 1/3rd of the price of Class A shares and command 19x the voting power. We bought a sizeable portion of Class B shares *only*. It should be noted that Michael Hays, the majority shareholder, has the overwhelming majority of his net worth in Class B shares. Our purchase price of 11x earnings compares very favorably to the average P/E ratio of 20x earnings for an S&P 500 constituent.

Key Metrics

The key metrics for the business are Revenue, Gross Profit, Owner Earnings, Class B EPS, and the Balance Sheet. For each of these metrics we consider how the entire business is performing. To arrive at our economic interest in the overall business we can multiple the overall business performance by the economic interest of the Class B shares. Share repurchases, option grants, and other changes in shares outstanding for each class of stock will impact the economic rights of the other class. For this reason we will continue to monitor the economic rights of both classes to ensure our economic interests are moving forward year over year. The business factors that drive the key metrics are described in detail below.

<u>Revenue</u>

The majority of revenue, more than 82%, is generated through subscription services that are paid for monthly or annually by medical practices across the United States. The retention rate for these subscription services are sensational which brings tremendous stability to NCRI's revenue and validates the value proposition for clients. The company is split into four business divisions: Growth Solutions, Retention Solutions, Engagement Solutions, and Thought Leadership Solutions.

Growth solutions provide hospitals the IT solutions necessary to measure community perception, brand tracking, advertising ROI, and physician reputation. These solutions allow the hospital to properly advertise and positions itself, both online and in the community, to gain additional market share and capture revenue. Retention solutions provides the tools necessary to collect data on patient, resident, and employee experiences to get timely feedback on areas to improve hospital operations. By collecting this data medical practices can make the necessary adjustments to attract and retain patients and employees. Engagement solutions help NRCI's clients to efficiently reach out to the patient population once discharged to impact behaviors and minimize the chances of readmission. Thought leadership solutions includes national conferences, publications, and an online portal to help educated NRCI's clients on best practices across the industry. All the services provided by NRCI are aimed at providing hospitals the data and tools necessary to understand their customer, employee, and physicians to improve patient care.

Gross Profit

The gross profit is calculated by subtracting the costs directly associated with providing the various services to clients. The subscription based services have historically provided very stable gross profit margins of approximately 60%. The gross margin is a leading indicator on NRCI's ability to dictate price. If NRCI were to face increased competition or the company's services became less desirable clients would demand lower pricing and compress margins. If gross margins remain stable it suggests that NRCI is able to maintain pricing power with the existing client base validating the strong value proposition offered to clients.

Owner Earnings

The owner earnings for NRCI are calculated by subtracting all fixed expenses from the gross profit. The fixed expenses include corporate salaries, lease payments for space, legal and accounting fees, and commissions to sales force. The sales force has a low base pay and high commission payout which helps NRCI retain the best sales employees and has contributed substantially to the company's success. The owner earnings are typically higher than the reported earnings due to the amortization of certain intangibles and deferred revenue earned upfront each year. This metric is the key driver of business value and the primary source of dividend payments to shareholders.

Class B EPS

The Class B EPS represents the earnings per share of Class B stock. This value is calculated based on the two-class method whereby Class B shares are entitled to 6x the dividend payout of Class A shares. At our time of purchase the Class B shares were entitled to 50.1% of the total profits of the business, or $10 million dollars, and there were 3,505,352 Class B shares outstanding.

$$Class\ B\ EPS = \frac{Total\ Earnings\ of\ the\ Business \times Class\ B\ Economic\ Interest}{Number\ of\ Class\ B\ Shares}$$

$$Class\ B\ EPS = \frac{\$20{,}693{,}345 \times 50.1\%}{3{,}505{,}352} = \$2.95$$

Balance Sheet

The balance sheet is a measure of cash, cash equivalents, and all on and off balance sheet liabilities. In plain English it is the cash versus debt of the business.

Historical Performance of Key Metrics

Year	'10	'11	'12	'13	'14
Total Revenue	$63,398,000	$75,767,000	$86,421,000	$92,590,000	$98,837,000
Gross Profit	$38,763,000	$47,100,000	$50,960,000	$53,746,000	$57,118,000
Owner Earnings	$9,856,501	$13,355,515	$16,370,991	$18,038,311	$20,693,345
Class B EPS	$1.47	$1.98	$2.37	$2.59	$2.95
Cash	$3,519,000	$8,082,000	$8,286,000	$22,092,000	$40,042,000
Debt	$16,486,000	$14,912,000	$12,763,000	$10,438,000	$8,219,000

Revenue

In the last 5 years revenue has compounded at a rate of 11.7% due to increases in market share and cross-selling of products to existing clients. Currently only 25% of NRCI clients utilize more than one service and the opportunity to cross-sell is large moving forward. We anticipate revenue to continue to grow between 2% and 15% per year with a 10 year average of 6%.

Gross Profit

Gross profits have grown roughly in line with revenue during the last 5 years. We anticipate the gross profit margin to remain relatively stable at ~60% (fluctuating between 55% and 65%). Over the next 5 years our expectations for growth are identical to revenue.

Owner Earnings

In the last 5 years owner earnings have grown at a pace of 20.4% demonstrating the strong operational leverage inherent in NRCI's business model. As revenue continues to climb the fixed operating expenses become a smaller percentage of overall revenue and increases the net income margin. The net income margin has grown from 15.5% in 2010 to more 20.9% today. We expect the owner earnings to continue to climb at a pace that exceeds revenue as the business enjoys additional operating leverage in the future. Our expectation for growth is between 5% and 18% per year and a 10 year average of 9%.

Class B EPS

The EPS of the Class B shares has compounded at a rate of 19.1% over the last 5 years or roughly in-line with growth in owner earnings. We anticipate Class B EPS to grow proportionally to owner earnings at a rate of 5% and 18% per year with a 10 year average of 9%. The capital allocation practices of the business could have a material impact on the growth of the Class B EPS. For example, if the earnings of the business are used to repurchase Class B shares the rate of growth in Class B EPS will be significantly higher than the overall growth in owner earnings. We view the repurchase of Class B shares to be extremely advantageous at present prices and would prefer for capital not to be allocated to the repurchase of Class A shares. It should be noted that if the price of the Class A shares decreases to 11x earnings, comparable to the Class B shares, repurchasing the Class A stock would also have a positive impact on the Class B EPS.

Balance Sheet

In 2012 the company had $8 million in cash and $12 million in debt for a net debt position of $4 million. Following the recapitalization in 2013 the company suspended its dividend began accumulating cash on the balance sheet. In the last 18 months the majority of all earnings have been retained and the cash balance has grown to $40 million while debt has been reduced to $8 million. The large cash build up on the balance sheet lowered our effective purchase price and was a major reason for the timing of our purchase. The Class B shares were available roughly 18 months ago at similar prices, but without the additional $36 million in cash. The payment of dividends resumed in January 2015 and we would not be surprised if a special dividend is declared in the upcoming years to reduce the cash balance. In the event of a special dividend the Class B shares would receive 6x the payment of Class A. Historically NRCI has maintained a debt free balance sheet with occasional exceptions to perform acquisitions. These borrowings are typically paid off quickly – within 3 to 5 years.

Summary of Key Metrics

Metric	Expectations
Revenue	Growth between 2% and 15% per year 10 year average of 6%
Gross Profit	Growth proportional to revenue
Owner Earnings	Growth between 5% and 18% per year 10 year average of 9%
Class B EPS	Growth proportional to Owner Earnings Potentially accelerated by repurchasing Class B shares
Balance Sheet	Potentially large special dividend in upcoming years No debt with the exception of occasional acquisitions

The Moat Around The Metrics

The moat around NRCI's competitive position stems from four contributing factors: A vital product, a large network effect, a strong brand name, and outstanding management.

Vital Product

The surveys conducted by NRCI are extremely valuable to medical practices nationwide. A small portion of the surveys performed are required by law and impact the reimbursement rates on Medicare and Medicaid. In addition to the small portion of mandated surveys medical practices pay NRCI to conduct market research on patient outcomes across the entire healthcare continuum. These survey results are typically reviewed bi-weekly or monthly by the highest decision makers at the organization and are deeply ingrained in the workflow of the medical practice. The surveys are a vital source of best practices and continued improvement in operational excellence. The price of the surveys is relatively small compared to the huge value added. Many clients have been utilizing NRCI's services for multiple decades.

Network Effect

NRCI also benefits from a slight network effect. As the largest patient survey company in the United States NRCI has more data on patient outcomes than any other firm. This allows the company to compile the data and create educational seminars based on industry trends. NRCI sells subscriptions to "The Governance Institute" that provides seminars and classes on best practices in the industry. Due to the breadth of NRCI's data base many medical practices subscribe to The Institute to stay current on the latest developments in the industry.

Brand Name

Over the last 3 decades NRCI has been widely recognized for outstanding customer service and operational excellence. The long track record of success and large client base has created a brand name around NRCI as one of the leading providers of medical information nationwide. The company has several award ceremonies per year recognizing the best medical practices in the United States. NRCI's reputation brings credibility to the award programs. NRCI's client base believes in NRCI's services and the strong brand name has allow NRCI to continue to win additional customers in the patient survey and data collection marketplace.

Outstanding Management

The company also benefits greatly from outstanding management. The CEO, Michael Hays, has been leading NRCI since its foundation and his talents and expertise are a powerful competitive advantage as one of the best managers in the industry. At the young age of 60 Michael Hays has more than 33 years of experience as the CEO of NRCI and we believe that he will be able to continue to build wealth for shareholders long into the future.

Risks

As owners of NRCI we've assumed a variety of short-term and long-term risks. Despite the consistency in revenue and earnings we believe that the risk inherent in owning NRCI is slightly more than the majority of businesses we typically purchase. In light of the additional risk we have limited the position size to 7% of assets and paid significantly less than our typical purchase price. The opportunity for upside and limited position size makes ownership extremely attractive. Each of the risks we've assumed as business owners are detailed below.

Short-Term Risks

- Loss of major customer. NRCI receives approximately 16% of revenue from the company's 10 largest clients. While the loss of any one of these customer could materially impact the business in the short-term, no single client represented more than 5% of revenue during 2014. At the company's current growth rate replacing the revenue lost from the largest customer would take approximately 8 months.
    - Low Risk

Long-Term Risks

- The company is acquired. In the event that the company is acquired our investment would lose value. The Class B shares would likely receive approximately $60-80 million as a payout representing a 33% to 50% loss on our initial investment. We view this situation as extremely unlikely. Michael Hays currently owns 56% of the voting rights of the company and the majority of his net worth is tied to Class B stock. His net worth would materially decline if he accepted an offer to be acquired at a reasonable price level. Additionally, the Class B stock maintains 94% of the voting rights and all Class B shareholders will be against an acquisition. We believe that the ownership structure and voting rights send a clear indication to all shareholders and potential acquirers that NRCI will continue as a going concern.
    - Low Risk
- Regulatory changes. The largest risk we face is political. Medical practices across the United States have certain surveys and patient population data that must be collected by law. These legal mandates make up a small percentage of NRCI's revenue, but helps to establish customer relationships for cross-selling. We believe that the current political environment is increasing the market opportunity for NRCI and the services provided have strong value adds for the client base. In the event that the regulatory environment changes we will reassess the new legislation at that time. We believe that the largest risk we have assumed as owners of NRCI is this political risk.
    - High Risk

- Consolidation. In the event that medical practices continue to consolidate it could put downward pressure on the gross profits of NRCI. As medical facilities consolidate the larger entities have more purchasing power when it comes to negotiating prices for NRCI's services. We believe this trend may continue in the future, but the effects will be gradual and NRCI will maintain high levels of profitability if the industry continues to consolidate.
    - Low Risk

Conclusion

NRCI is a leading provider of analytics and insights that help medical practices grow top-line revenue and increase patient, employee, and customer retention. The company has a highly fractured customer base with more than 8,100 facilities renewing subscription contracts annually. The business has flourished for more than 31 years under the leadership of Michael Hays, the company's founder. In the last 10 years revenue and profits have posted sequential gains year over year without exception. In May 2013 the business announced a recapitalization plan that created two classes of stock: Class A and Class B. The Class B stock is entitled to 6x the earning power and dividend payments of the Class A shares and 100x the voting rights. The two issues trade at drastically different valuations with Class A priced at 31x earnings and Class B priced at 11x earnings. This discrepancy allowed us to purchase a large block of Class B stock at a very attractive price. We believe the company will eventually payout a substantial special dividend from the $40 million in cash that has accumulated on the balance sheet in recent years and yield excellent returns for the Class B shareholders.

Works Cited

1) *NRCI Annual Report - SEC Filing 10-K.* EDGAR, 2015.

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