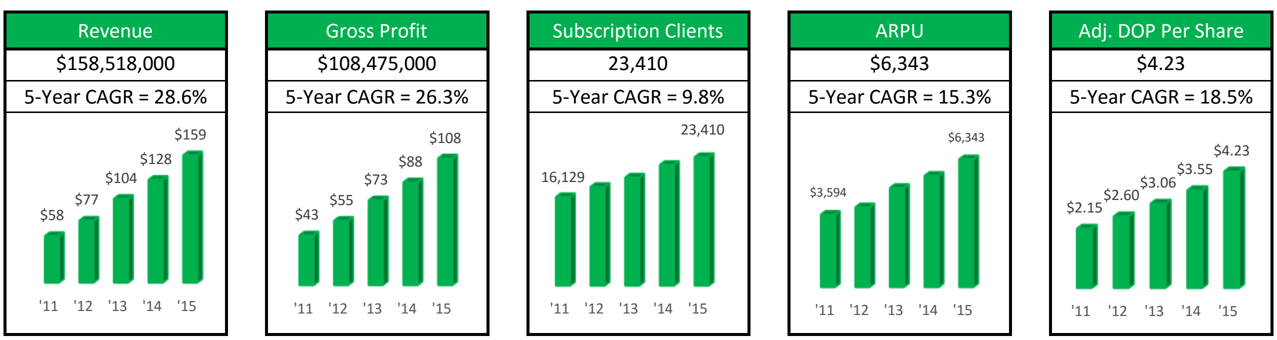
SELECTIVE
WEALTH MANAGEMENT

SPS Commerce
March 15, 2016

General Overview

SPS Commerce (SPSC) is a leading provider of cloud-based supply chain management solutions. In order to understand the usefulness of supply chain management software it's important to first understand the relationship between retailers and suppliers. Each trading relationship is complex and significant communication is required between the two parties – ranging from invoices to order verifications. Traditionally, the communication between trading partners occurred by establishing strict procedures for how information was exchanged. In order to accomplish this task suppliers had to maintain IT departments that would customize electronic data interchanges (EDI) for tight integration into a retailers ERP software system (accounting, purchasing, etc.). Unfortunately, each retailer had nuanced requirements that made integration complex and difficult. A single retailer would provide a rule book that outlined exacting demands on suppliers to meet compliance requirements.

SPS Commerce created a software platform that standardized this data exchange between retailers and suppliers allowing for rapid integration. Today there is a massive network of pre-established connections that is owned by SPSC, which in turn allows retailers and suppliers to rapidly form trading relationships. The software platform reduces the time it takes for a retailer to add a new supplier from months down to days. The company has seen tremendous success as more than 23,000 retailers have adopted the platform and established more than 42,000 connections to suppliers. In the last 10 years SPS Commerce has grown revenue from $19 million to more than $160 million today.



Purchase Logic

SPSC is an outstanding company with a highly fractured customer base, zero debt, $150 million in cash, and predictable revenue. Retailers and suppliers both receive substantial cost savings by subscribing to the SPS Commerce platform. We purchase SPSC because of the wide economic growth, strong value proportion for clients, and long runway for growth. At our time of purchase SPSC had forward looking revenue of >$180 million and a potential net income of >$50 million. At the beginning of 2016 the enterprise value of the business was more than $1 billion dollars or 20x the potential income of the business. In February, the many software companies saw dramatic price declines as the entire sector was sold off due to weak earnings forecasts from several large businesses. SPSC was part of the massive selloff – despite strong business results. The enterprise value of the company decline over 45% and we were able to purchase the company for less than $550 million or ~12x forward looking potential net income. Our purchase price was the lowest available price in more than 2.5 years (and the company was much smaller back then). As a dominant, debt-free business, with a long runway for growth SPS Commerce fits the mold as a Selective Growth Company and we intend to own the business for several years.

Key Metrics

The key metrics for SPSC are Revenue, Gross Profit, Subscription Customers, ARPU, Adjusted DOP per Share, and the Balance Sheet. The business fundamentals that drive each these metrics is described in detail below.

Revenue - $159 Million

The company generates revenue by charging a monthly fee for five primary services: Trading Partner Fulfillment, Trading Partner Analytics, Trading Partner Assortment, Trading Partner Sourcing, and Trading Partner Community Development. The contribution of each service is not explicitly stated in the annual reports, but the success of the combined services is evident by the increasing ARPU for each customer. Each of these services is described in more detail below.

Trading Partner Fulfilment

This service is an automated solution that replaces an organizations existing EDI solution. The transmission of invoices, purchase orders, compliance verifications, and much more is automated through this platform. This is the flagship product and is creating tremendous cost savings for retailer and supplier clients. Fees are paid monthly to utilize the platform and contracts are cancellable with 30 to 90 day notice, but the overwhelming majority of clients are retained each year (>92% retention rate).

Trading Partner Analytics

As retailers join the SPSC platform the company is able to collect data at the point-of-sale from retailers and provide this information to suppliers. Real-time analytics on purchase volumes at the retail level allow suppliers to manage lead times on production to match supply and demand more closely. The analytics portion of the platform currently accounts for 17% of the overall revenue of the business, but is growing very rapidly. As additional trading partners sign up for analytics the ARPU will continue to rise. This is one of the most promising services for SPSC in the upcoming years.

Trading Partner Assortment, Sourcing, & Community Development

These three services help to build out the network of retailer and supplier partners on the SPS platform. Retailers are able to utilize the “Retail Universe” social network to find new items from suppliers. This helps retailers ensure they can keep up with the ever changing demands of shoppers, while simultaneously adding the most trusted and dependable supplier partners. Suppliers are able to win new business as they receive referrals for potential retail clients that might want to sell their products. The community development platform allows best practices across the entire industry to be shared between all trading partners. This particular service contributes minimal amounts to revenue.

In the last 5 years the majority of growth has been from signing up new clients for the fulfilment solutions. This particular service has seen compound annual growth rate in excess of 20% and has a long runway for growth as more and more retailers and suppliers continue to join the network. The data analytics service is relatively new, but is gaining tremendous momentum. Suppliers love the additional information about their retail partners so they can appropriately balance lead times on production. We anticipate analytics to grow more than 20% for the foreseeable future. In addition to adding new customers there is a very high probability that SPSC will be able to enforce steady price increases across their customer base allowing them to even further accelerate revenue growth. Our expectation is that revenue will compound between 5% and 30% per year for the next 10 years with an average annual growth rate of 18%.

Gross Profit - $108 Million

As a software company the gross profit margin on additional business is impressive. The company currently has a gross profit margin of roughly 70%. A portion of the "cost of revenues" is integration expenses for establishing new trading partner relationships. As the company's growth decelerates we would expect these integration expenses to be a lower percentage of revenue since fewer customers will be added annually. In the last twelve months SPSC had gross profits of $108 million and this figure will grow in-line with revenue for the next 5 years, but then become grow faster than revenue as the profit gross profit margin expands.

Subscription Customers

Each trading partner that pays a monthly fee to SPSC is known as a subscription customer. In the last 5 year the number of subscription customers has grown from 16,129 to 23,410 today. This growth is largely attributed to customer referrals from existing retailers and suppliers. The SPSC platform naturally generates additional leads for the business as existing retailers want to establish new connections with suppliers. These suppliers are referred to the SPSC platform. In the last twelve months more than 600 retailers referred new business to SPSC, up for 400 retailers only 3 years ago. As the network continues to expand the number of customer referrals continues to grow. In addition to 23,410 subscription customers SPSC's platform connects with 42,000 additional trading partners that do not pay monthly subscriptions, but must be connected to the network in order to access SPSC's customer base. These 42,000 non-paying customers can be potentially converted to paying customers through additional services, such as the analytics platform. We anticipate new subscription customers to grow at a rate between 1% and 10% for the next 10 years.

ARPU - $6,343 per year

The average revenue per user (APRU) is calculated by dividing the total recurring revenue from a specific cohort of customers in a given period by the number of customers in the cohort. The APRU for SPSC has been steadily increasing at a rate of 15.3% for the last 5 years. SPSC prices their services based on the number of connections each retailer forms with trading partners. This pricing strategy drives APRU upward through three primary factors: Larger retailer clients pay more and SPSC is consistently winning larger and larger clients, existing clients establish new trading partner connections, and existing clients sign up for additional services; such as analytics. APRU is currently $6,343 per year and we anticipate this figure to continue to climb between 1% and 15% per year for the next 10 years. SPSC has not historically enacted baseline price increases, but has increased APRU by making additional trading partner connections at each retailer. We anticipate that at some point in the future SPSC will be able to increase the price per connection and the profitability of the business will rise dramatically. SPSC has pricing power because of the strong network effect (described in the section "Moat Around the Metrics") and the huge cost savings experienced by their customers. We believe that retailers and suppliers save more than $30,000 per year by subscribing to SPSC's platform rather than performing EDI functions in-house.

Adjusted DOP per Share – Approximately $4.23

The metric "Adjusted DOP per Share" was carefully outlined in our analysis on LNKD and is a very important metric for understanding the potential earning power of a software enterprise. The original discussion on Adjusted DOP per Share is presented in Appendix A to this report. The equation used to calculate Adjusted DOP is:

$$Adjusted\ DOP = Gross\ Profit - Maintenace\ (S\&M + R\&D + CapEx) - G\&A + Stock\ Compensation$$

Gross Profit = $108,475,000

- Obtained from the company's 10-K filing.

Maintenance S&M = Estimated at less than $0

- SPSC is in a unique position where the company's revenue retention rate is in excess of 100%. If the company paid nothing for Sales and Marketing the recurring revenue would increase at a rate that is faster than the churn of the business. This cannot be maintained forever, but it can be maintained long enough to evaluate the intrinsic value of the company using a 10-year projection. Using a value of $0 for the Maintenance S&M would actually be conservative, because this assumes no revenue growth. If we owned SPSC entirely we could cut out nearly all of the S&M spend and still experience an increase in revenue due to ARPU rising faster than churn.

Maintenance R&D = $17,954,000

- Obtained from the company's 10-K filing. We used the entire R&D expense as a 'maintenance' expense to be conservative. We could theoretically exclude the portion of R&D allocated to new product features.

Maintenance CapEx = $8,757,000

- Obtained from the company's 10-K filing. This figure is the capital expenditures of the business during 2015 (not the depreciation expense). This figure is relatively small because SPSC outsources the majority of their data center requirements.

G&A = $24,817,000

- Obtained from the company's 10-K filing.

The final step in calculating Adjusted DOP is to add back the stock compensation expense. Stock compensation is a non-cash expense and fluctuates based on the market value of the stock. The real expense for stock compensation is not the dollar figure reported in GAAP statements, but the dilution experienced annually by shareholders. SPSC will likely average between 1% and 3% share dilution through options and grants for the next 10 years. This is accounted for in Adjust DOP per Share.

Adjusted DOP ~ $72 Million

Adjusted DOP per Share ~ $4.23

In the last 5 years Adjusted DOP per share has increased at a rate of 18.5%. We anticipate Adjusted DOP per Share to increase between 5% and 25% per year with an average annual increase of 15% of the next 10 years.

<u>Balance Sheet</u>

The company has a pristine balance sheet with $129 million in cash and zero debt. We expect SPSC to utilize this cash for acquisitions that will accelerate the growth assumptions outlined in this report. We do not anticipate the company will need to utilize debt in the future.

Historical Performance of Key Metrics

Year	'11	'12	'13	'14	'15
Total Revenue	$57,969,000	$77,106,000	$104,391,000	$127,947,000	$158,518,000
Gross Profit	$42,603,000	$55,066,000	$72,610,000	$87,956,000	$108,475,000
Subscription Customers	16,129	17,977	19,690	21,983	23,410
ARPU	$3,594	$3,964	$4,920	$5,524	$6,343
Adjusted DOP Per Share	$2.15	$2.60	$3.06	$3.55	$4.23
Cash	$31,985,000	$66,050,000	$131,294,000	$130,795,000	$129,055,000
Debt	$0	$0	$0	$0	$0

Summary of Key Metrics

Metric	Expectations
Revenue	Growth between 5% and 30% per year 10-year average of 18%
Gross Profit	Growth in-line with revenue for 5-years Growth exceeding revenue after 5-years
Subscription Customers	Growth between 1% and 10% per year
APRU	Growth between 1% and 15% per year
Adjusted DOP per Share	Growth between 5% and 25% per year 10-year average of 15%
Balance Sheet	Debt free balance sheet with cash being allocated for acquisitions

Risks

- *Interruptions or delays from third-party data centers*. SPSC pays third parties to host and run their software platform. This is an intelligent business decision and reduces costs as the company scales, but there is a chance that the third party provider would experience downtime which would impact SPSC's business. The company currently has redundant providers in different parts of the country for a rapid uptime in the event of an issue with one provider. We view this is type of event as low probability and the remedial costs would be low.
- *Cyber Attacks*. SPSC has data from trading partners that is valuable to hackers. In the event of a security breach it could materially impact clients trust. We view this risk as low probability in any given year, but a high probability over long periods of time. In the event of a breach we would anticipate moderate remedial costs, perhaps as high as a full year's income.
- *Political Unrest in Ukraine*. The company has a large software development center in Kiev, Ukraine. This center was near the hostilities between Ukraine and Russia during 2015. Employees were forced to move to a safer location, and in the event of future hostilities between Ukraine and Russia it could have a material impact on the business. We view this as a low probability event and the remedial costs would be moderate. The company would be forced to move employees or re-staff in another outsourcing location. We would not anticipate the client experience would be impacted by these events.

The Moat Around The Metrics

SPSC benefits from one of the strongest network effects in the world. When a retailer joins the platform the nuanced rule book requirements of that retailer are understood by SPSC and integrated into the universal platform. That retailer has the ability to rapidly add trading partners that are compliant with their custom ERP software system. As more retailers join the SPSC system it attracts more suppliers, because these suppliers can expand their business without the integration costs of EDI exchanges with each individual retailer. As more suppliers join the network, retailers receive additional value because they can source new products quicker among a larger number of suppliers. Also, the network is reaching a critical size where data between various members of the supply chain is now being shared to reduce costs for all parties. For example, point-of-sale data at a retail store is automatically piped to suppliers to help them with production lead times for various products. This ensures that they always have items in stock for retailers without over producing. The cost advantages of this network benefit all members.

In addition to a strong network effect SPSC customers also have high switching costs relative to the annual price of the platform. Each new retailer performs integration work between SPSC suppliers' standardized format and their custom ERP system. This integration takes time and would be very expensive for all 23,000 suppliers to switch to a new software provider when compared to an annual subscription fee of only $6,343. The economic moat surrounding SPSC's business continues to get wider each year as more retailers and suppliers join this global platform.

Conclusion

SPSC created a software platform that standardized the data exchange between retailers and suppliers allowing for rapid integration and a massive network of pre-established connections. The software platform reduces the time it takes for a retailer to add a new supplier from months down to days. The company has seen tremendous success as more than 23,000 retailers have adopted the platform and established more than 42,000 connections to suppliers. In the last 10 years SPSC has grown revenue from $19 million to more than $160 million today. We purchased SPSC when the software sector experienced steep overall decline at a price of roughly 12x forward earnings. The key metrics for the business are Revenue, Gross Profit, Subscription Customers, ARPU, Adjusted DOP per Share, and the Balance Sheet. The company faces a few risks that we view as low probability and in the event of occurrence would only have a moderate financial impact. The company's competitive position is protected by a powerful network effect and high switching costs for clients. We are excited about the large market opportunity ahead of SPSC. SPSC fits the mold as a Selective Growth Company and we anticipate owning the business for several years.

Works Cited

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

Appendix A

Adjusted DOP ("Digital Operating Profit") is a term we've coined specifically for digital companies to highlight the potential net income of the business. As a digital enterprise the GAAP reported results look materially different then a brick-and-mortar counterpart – even for similar economic results. In order for a brick-and-mortar company to grow, the business would have to generate operating profit, pay taxes, and then purchase additional property and equipment to increase production. This may include more inventory, new manufacturing lines, a new factory, etc. The purchase of plant, property and equipment is not an expense on the income statement immediately, but rather, it is charged off through depreciation over long periods of time. These companies report a healthy GAAP net income and typical ratios, such as Price to Earnings, can be readily applied to value the business. Digital businesses are different.

When a digital business is growing the company's operating profit is predominately invested into hiring more individuals for software programming and sales and marketing. Research & Development ("R&D") and Sales & Marketing ("S&M") are the digital equivalent of adding production. The Digital Operating Profit estimates how much money a digital enterprise would earn if the company elected *not* to grow the business. This would be equivalent to Operating Profit for a brick-and-mortar business.

In order to calculate Adjusted DOP three variables must be estimated:

1) The level of S&M required to offset customer churn and maintain the current recurring revenue run rate. This is the Maintenance S&M.
2) The level of R&D required to maintain a leadership position in the market. This is the Maintenance R&D.
3) The level of Capital Expenditures required to maintain leadership in the market. This is the Maintenance CapEx.

Spending in these three areas maintains the company's competitive position and the remaining cash flow could be extracted as profit - which is the Adjusted DOP. Below is the formula for calculating this metric:

$$Adjusted\ DOP = Gross\ Profit - Maintenace\ (S\&M + R\&D + CapEx) - G\&A + Stock\ Compensation$$