

Ubiquiti Networks, A Case Study in Business Model Disruption

Our private equity mindset means conducting deep research and placing heavy emphasis on people to build a concentrated portfolio of investment opportunities that exceed a 15% IRR hurdle.

Ewing Morris & Co. Investment Partners is a Toronto-based investment firm founded in 2011. We have never described ourselves as value investors. This reason is because there is no opposite of value when it comes to investing. For instance, have you ever met someone who intentionally overpays for low-quality, shrinking businesses run by crooks? Rather, we apply our investment Playbook approach based on two core thesis types: Cheap Assets and Compounders. Cheap Assets trade at discounts to private market value. However, our preferred approach is to find Compounders which come in two varieties: Great Capital Allocators (Tom Murphy, Henry Singleton, John Malone, etc.) and Great Businesses. We believe that Ubiquiti Networks (NASDAQ:UBNT) is an example of the latter.

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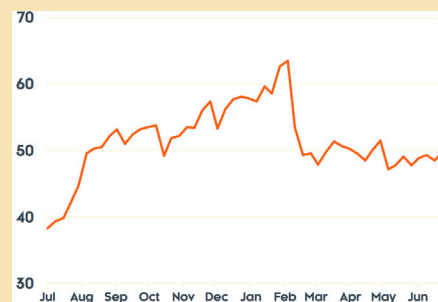
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Summary

Ubiquiti Networks, Inc. develops performance networking technology for service providers and enterprises. The Company offers a portfolio of networking products and solutions.

Tickers	NASDAQ: UBNT
Price	US\$ 49.54
Mkt Cap.	US\$ 3.98B
EV	US\$ 3.67B
52 Wk. Range	US\$ 36.13 - 64.62
EPS	US\$ 3.04
P/E:	16.29x

12 Month Performance



As of EOD June 21, 2017

Business Model Innovation: A Case Study

Over the years, our observation has been that capital markets are often willing to pay a high price for potential profits from new products (Tesla Model 3, GoPro) or services (Snap), but are much slower to appreciate new business models (Price Club, Dell, Southwest Airlines, mini-mills).

One such “business model disruptor” is Ubiquiti Networks (NASDAQ:UBNT), led by Robert Pera. The company has already transformed two industries. Although the term “disruptor” is commonly applied to companies, the people working at the company are the real change agents.

People

“Any architect can design a desk that will cost five thousand kroner, but only the most highly skilled can design a good functional desk that will cost one hundred kroner.”

Ingvar Kamprad

Prior to founding Ubiquiti, Pera worked at Apple as an engineer designing Wi-Fi products. He identified an opportunity to improve a wireless router’s performance by increasing its power. When his managers showed little interest in his ideas, he pursued them in his spare time at home. He realized that customers in remote areas without cable or telephone connections represented a market for high-power Wi-Fi

radios. Recognizing the opportunity, Pera left Apple and founded Ubiquiti in 2005 when he was 27 years old. Today, Ubiquiti reports its results under two segments: Service Provider Technology (~\$450M in revenue) and Enterprise Technology (\$372M).

Service Provider Technology

Ubiquiti’s first product was a mini-PCI radio card that it sold to Wireless Internet Service Providers (WISPs). Although this original product was successful, it was easily copied by other component suppliers. Instead, Pera adopted an integrated business model and began selling complete systems to WISPs that allowed his customers to focus on selling their services rather than assembling equipment from a variety of suppliers. Network performance improved when customers bought all components from Ubiquiti because the

equipment was engineered to work together. It is important to note that Ubiquiti’s success was largely attributable to successful business model innovation rather than having better technology or protected intellectual property. This echoes Apple’s successful business model innovation with the iPod and iPhone. This insight, combined with a lot of hard work, allowed Ubiquiti to grow its Service Provider business from \$0 to \$450 million of revenue by 2014, with EBIT margins in excess of 30%.

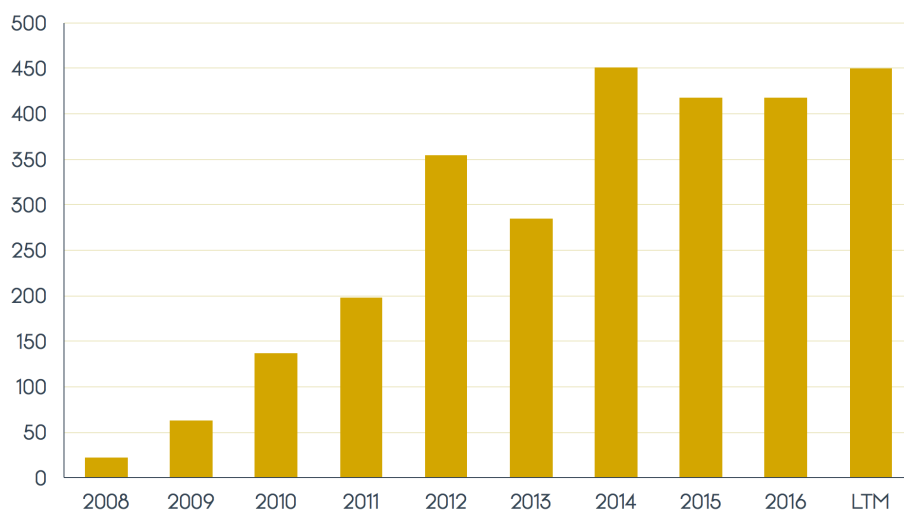
Enterprise Technology

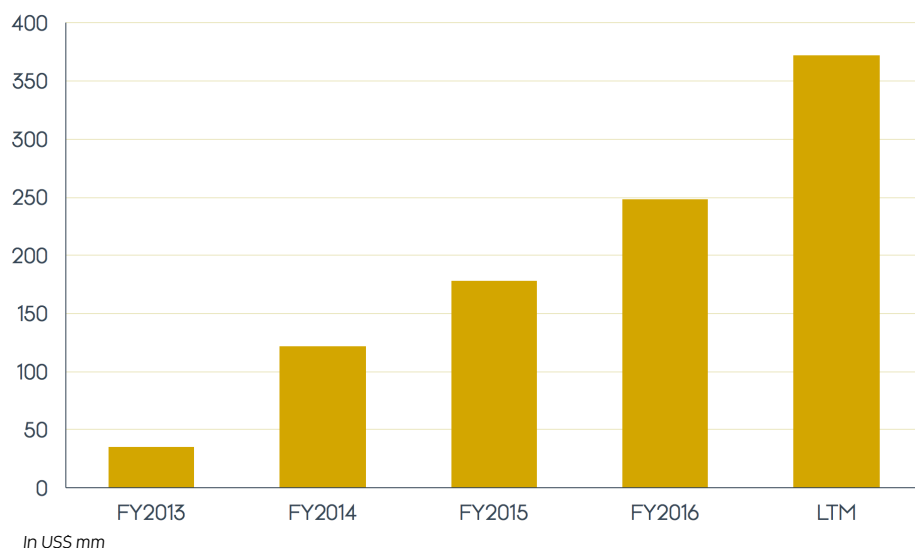
In 2010, Ubiquiti entered the enterprise market selling Wi-Fi (UniFi HD) access points. An access point is similar to the router you have in your home and is used to provide Wi-Fi in coffee shops, hotels and universities.

Revenue from this business has grown from \$35 million in 2013 to almost \$400 million today with

Service Provider Revenue

In US\$ mm





Enterprise Technology Revenue

consolidated EBIT margins remaining above 30%. This success resulted from a second business model innovation. While Ubiquiti was solving a previously unmet problem for its WISP customers, it was simultaneously using low-end disruption to provide less expensive solutions for Enterprise customers that were otherwise overpaying for expensive, over-engineered products and unnecessary service contracts.

Business Model Sustainability

Investors are often skeptical of the sustainability of business model disruption as they assume competitors will copy the model. For example, why can Cisco Systems, Inc. ("Cisco") not attack Ubiquiti with lower prices?

One answer is Ubiquiti's low cost structure, which is due, in part, to a unique customer service model. Rather than rely on expensive sales technicians, Ubiquiti has built a strong online forum community of over four million reg-

istered (and unpaid) users and distributors who act as evangelists for the company's products and help troubleshoot technical issues. In addition to the community, Ubiquiti also offers email and 24/7 chat support. A horizontal income statement comparison shows how Ubiquiti's cost structure protects them from competition:

	Ubiquiti	Cisco Systems, Inc.
Sales	100%	100%
COGS	51%	37%
Gross Margin	49%	63%
SG&A	14%	37%
Operating Income	35%	26%

If Cisco dropped prices to Ubiquiti's level, its operating income would fall by 50% barring a major restructuring of overhead. Public companies rarely pursue strategies that require so much short-term pain which explains why incumbents facing low-end disruption rarely emerge victorious.

Risk Factors

"Real investment risk is measured not by the percent that a stock may decline in price...but by the danger of a loss in earning power through economic changes or deterioration in management."

Ben Graham

When we analyze a business, the most important question we must answer is, "what could go wrong?" The bulk of our analysis is focused on risk assessment and the research process attempts to identify and avoid situations with a material risk of permanent capital loss. With stocks, there are three common causes of permanent loss: overvaluation, industry change and excessive debt. We felt comfortable with the main risk factors in this case.

We think the most significant risk facing Ubiquiti is loss of focus and execution. Execution has not been flawless (nor did we expect it would be), but we believe that Pera is very competitive, highly motivated (it helps to own 70% of the company) and is still only 39 years old.

Valuation

As mentioned previously, business model disruptors tend to be discounted by the market (at least in the early phases) and are often priced attractively relative to their current earning power and especially relative to their future earning potential.

Ubiquiti is such an example. The

company has \$320 million of net cash and a recent market capitalization of \$3.8 billion. It trades at 12x trailing EBIT (not EBITDA) and approximately 16x its trailing earnings per share. Recently, the company has been making substantial investments in its working capital, but over time, we would expect accounting earnings and cash flows to track closely. Unlike most technology companies, Ubiquiti rarely grants options, which are a real economic ex-

pense often excluded from earnings of comparable companies.

Conclusion

This valuation is surprisingly low for a company that has compounded revenue over the past five years at 27% and operating profit at 31%, while growing its net cash balance by close to \$300 million and reducing the number of shares outstanding by

12%. Not only is the historic track record impressive, but we believe the company's prospects over the next five years are more exciting than they have been at any point over the last five. In our view, Ubiquiti is clearly a Great Business.

Disclosure: The author and the author's fund have a long position in this security at the time of posting.

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