SYMMETRY INVEST A/S

FRANKLIN COVEY (FC)

DATE	04/02/2021
TARGET:	80 USD
Price:	25 USD
UPSIDE:	220 %

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SAAS business with impressive unit economics at a huge discount valuation

Ticker	FC
ISIN	US3534691098

Currency	USD
Target	80
Latest	25
Shares outstanding (mil.)	14
Market cap (mil. USD)	345

- FC has over the last 5 years undergone a transition from an on-premises business to a subscription business. We think the market severely underappreciate the outcome of this.

- Covid-19 has severely hit the headline numbers but accelerated the underlying business appreciation.

- As Covid quarters start to lap we think the market will finally realize the underlying strength of the subscription business.

- Current valuation implies only low single-digit sales multiples for the subscription business. With impressive unit economics, we think it should be valued significantly higher.

- Unlike most subscription models that burn money, FC is highly cash flow positive with the stock trading at single-digit forward FCF multiples.

- The business is built around unique content with high IP ownership. In a world where “content is king”, the ability to monetize this content should be viewed as an upside.

- Management has a long tenure with decent insider ownership and a track record of good capital allocation.

We think the market has failed to appreciate Franklin Covey's transformation from a low growth cyclical ad-hoc business to a high growth high-margin subscription business. There are many reasons for this. The main one is that the optics on the business still don't look good. This reminds us well of our other successful recommendations like Naked Wines or Where Food Comes From where the business didn't look to be doing well on the surface but where true value was created beneath.

Like most other investors Symmetry loves subscription businesses. We just don't want to pay nosebleed valuations for money-losing SAAS businesses with extremely long payback on CAC spend. Instead, we have done well with subscription-like businesses that have gone below the radar. Naked Wines is a subscription-based E-commerce, Where Food Comes From has annual recurring auditing revenue, Kambi has recurring revenue-share on operator GGR etc. The only pure SAAS business we own today is Getbusy that is trading at 2,5 x recurring revenue, a long way from the +10 that has become common in the market. At the same time, those companies are also either cash flow positive or operating at breakeven, far away from the big cash burners that are favored at the moment.

We think Franklin Covey fits perfect into this space:

	2021	2022	2023	2024
EBITDA	22.476	33.755	50.147	65.979
EBITDA growth		50%	49%	32%
EBITDA margin	9,8%	12,9%	17,1%	20,3%
Net cash	20.000	44.700	83.400	134.500
Free cash flow	15.900	24.700	38.700	51.100
Enterprise value	327.100	318.300	304.300	291.900
EV / FCF	**20,6**	**12,9**	**7,9**	**5,7**
FCF yield	**4,9%**	**7,8%**	**12,7%**	**17,5%**

While the main driver for the value creation is the subscription business growing at a +20 % CAGR, the big differentiator to other SAAS names is the positive cash flow. Because the initial purchase price is so high, and the payback time low, FC remains a positive cash generator despite investing heavily into growing the subscription business.

FC is already showing high (+50 %) incremental EBITDA margins on incremental revenue despite growing +20 %. We think it is rare to find a company trading at single-digit forward FCF multiples while:

1) Growing fast
2) Improving Unit Economics
3) Expand moat.

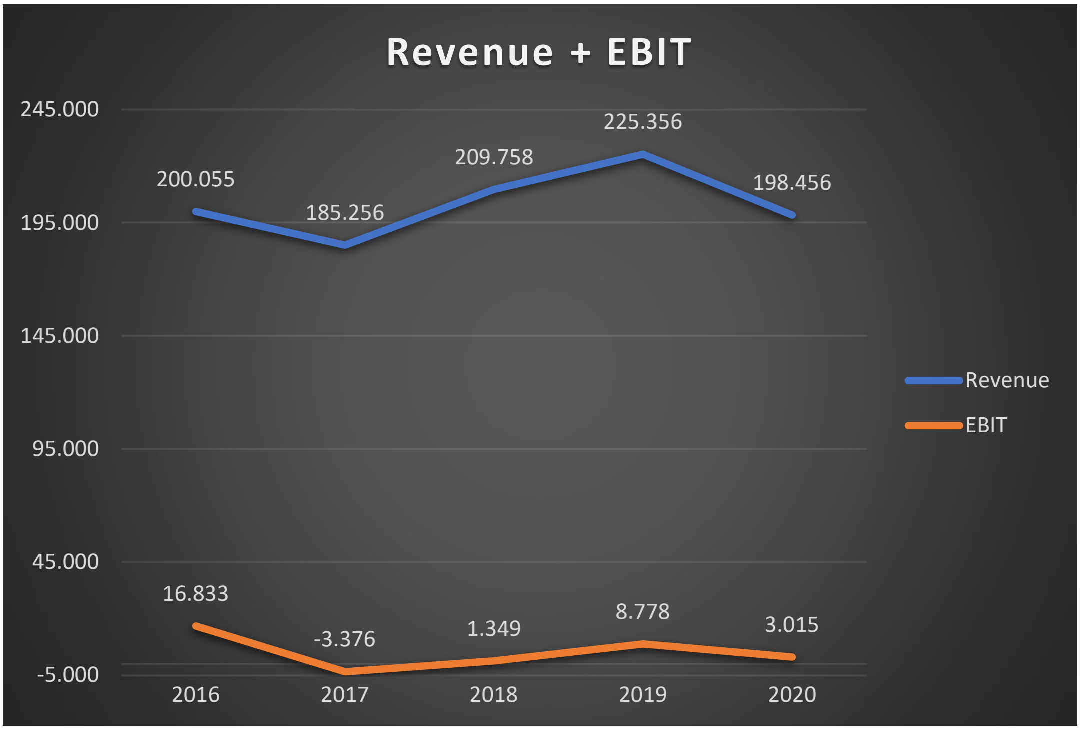
It is worth mentioning that our 2024 estimates above only imply a 20 % EBITDA multiple, way below our 25-30 % EBITDA at maturity target.

Content

Why does the opportunity exist?

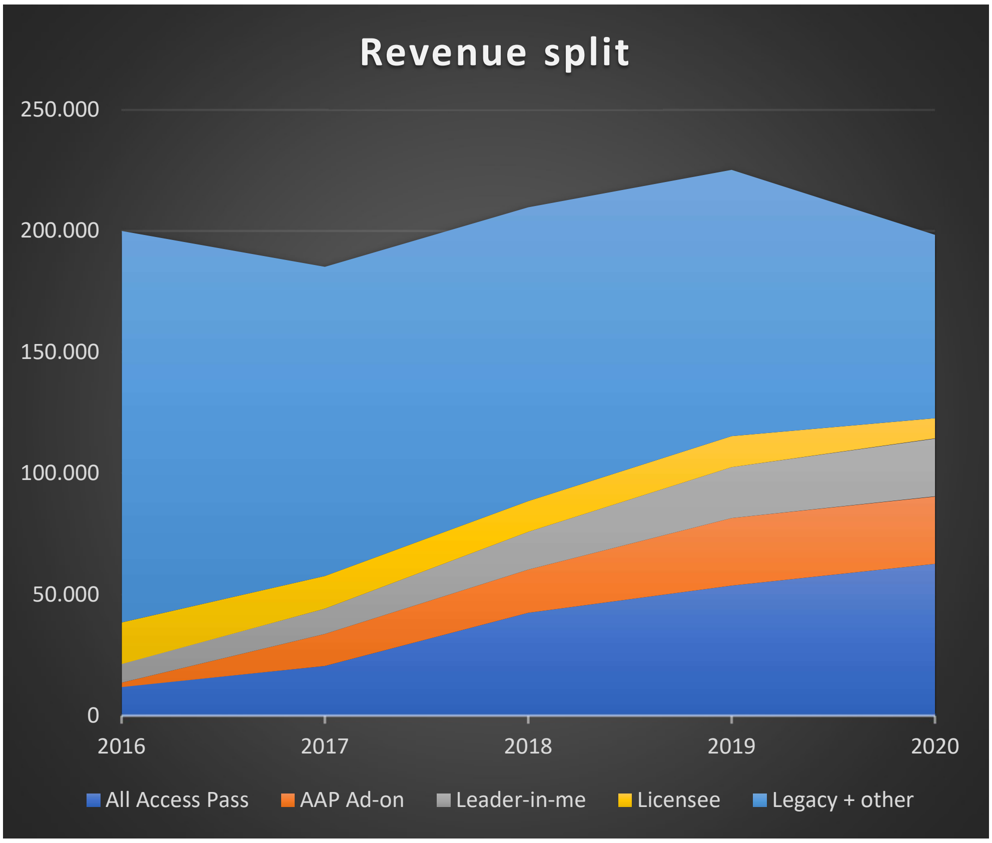
As always when we find an attractive new investment, we ask ourselves why the opportunity exists. What are other people missing?

With FC it's fairly easy to understand why. The optics of the business does not look good:



As can be seen, this is a business that is not growing a lot on the topline. There was some growth before Covid, but not a lot. At the same time, the EBIT was barely flat for 5 years straight. Not something that will get most investors excited about this business.

But what if we split out the revenue on the different segments?



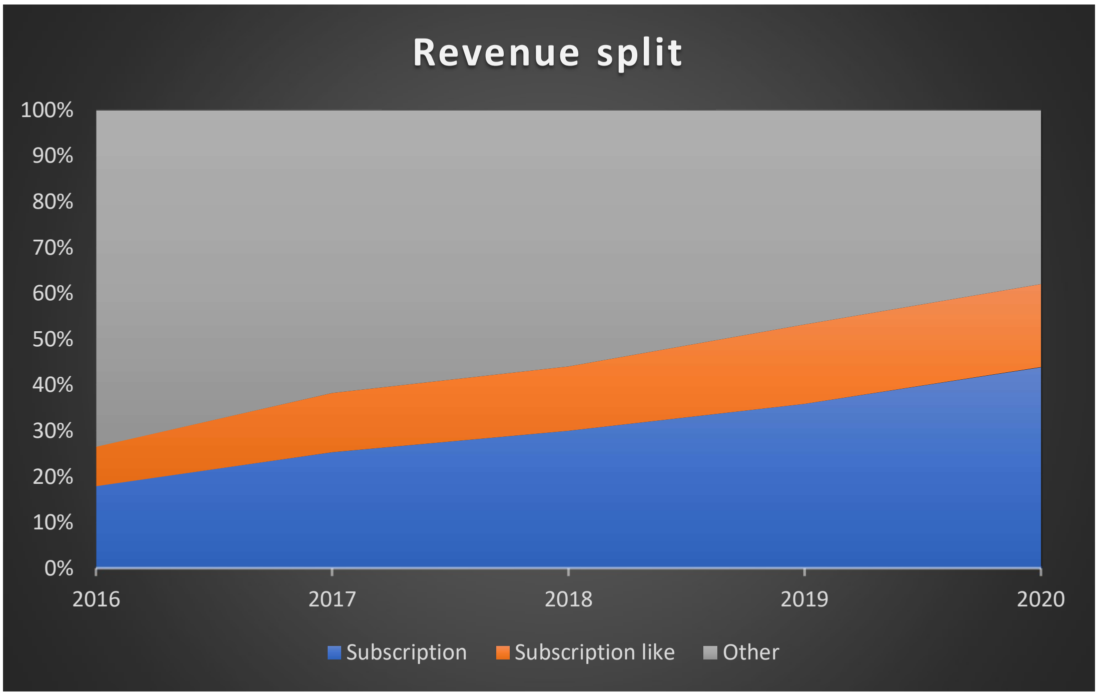
As one can see, while the legacy business has declined steadily over time the subscription business has been growing steadily. In the accounting year 2021 (ends in august 2021), we think we will start to see this transition on the topline starting from Q3.

Both the All-Access Pass and Leader-In-Me are true subscription businesses with strong +90 % gross margins that are billed annually and sometimes contracted for multi-year periods. The retention rate is +90 %.

The AAP add-on sales have some subscription-like characteristics as the add-on sales are recurring in nature, as it follows the growth of the subscription base. The licensee income is a high margin (95 % gross margin and +50 % EBITDA margin) royalty income from the international licensee holders. As those international licensee partners transition to the All-Access Pass that high margin revenue will also become subscription-like.

But the underlying reality is even better. As people that understand subscriptions businesses know, a lot of revenue is deferred to the balance sheet and recognized over time. That is the main reason why Franklin Covey has not shown any topline growth over the last several years. FC has built a deferred revenue base of $60m. That is revenue that is already invoiced and paid for but not yet recognized in the reported numbers.

If we look at the invoiced sales to end customers, the revenue split in percentage would look something like this:



As can be seen above, the subscription part of the business is now closer to 60 % at the end of FY20 and we estimate closer to 70 % at the end of FY21. As this percentage grows, the business will become much less cyclical, more predictable, and trade at a higher multiple.

A relevant question some of you probably have now is: Isn't they just cannibalizing themselves, i.e., changing revenue mix without growing topline?

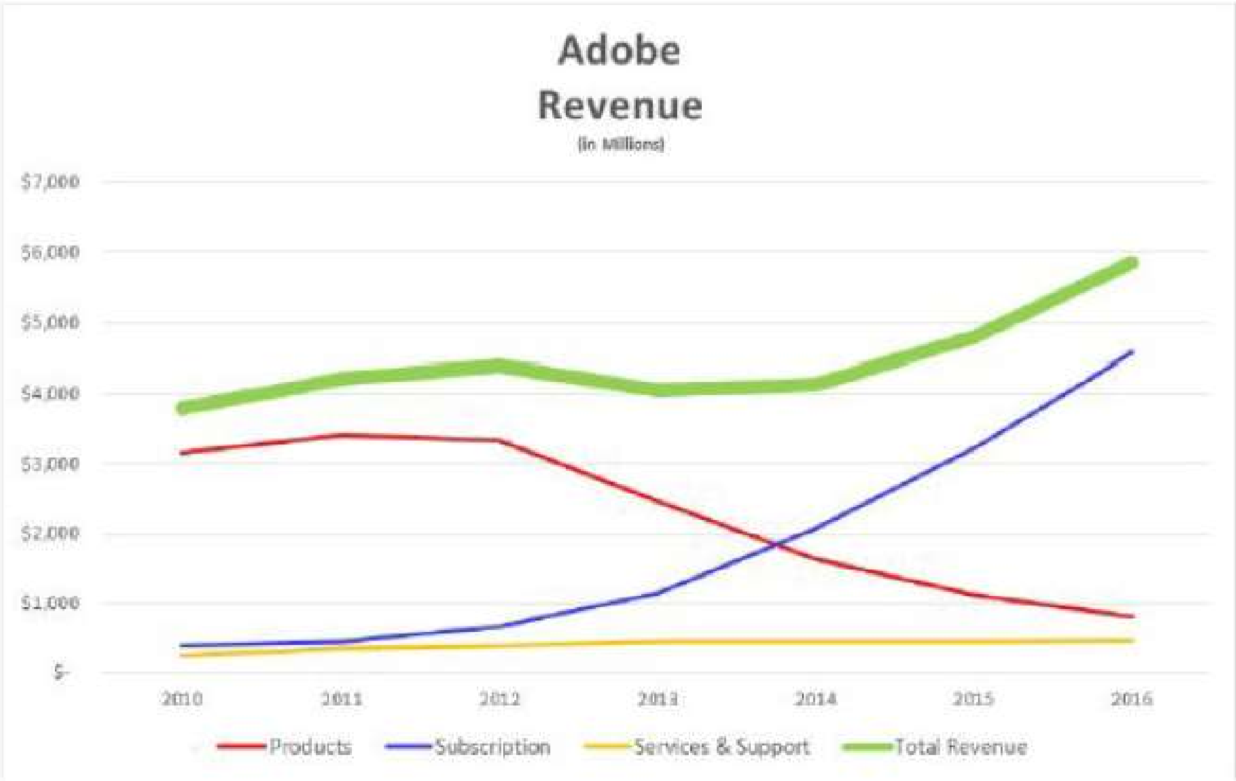
The short answer here: Only to a limited extent. First, as mentioned above, the invoiced revenue growth is higher than the reported growth due to the build-up of deferred revenue. Second, a lot of the legacy decline recently has been in international markets like China and Japan. If one were to open the 10K and look at the North American revenue, it's easy to see that actual reported revenue is growing double-digit %, despite the roll-off of legacy revenue.

When we asked the company how much of the AAP growth that was ascribed to the conversion of old legacy customers, we found out the figure was fairly low. In the first 2-3 years of AAP, there was of course a lot of legacy customers that changed to AAP customers. But in FY20 it was only about 10 % of the new logos they signed for AAP that had been legacy customers of FC. The rest was new logos.

Adobe example

Most people know about adobe. The company owning the PDF file, the Adobe flash player etc.
Adobe went through the same transition from 2012 to 2014 where they changed from product sales to yearly subscription sales. Now, an Adobe package is probably as usual as a Microsoft office package.

This is how the sales developed in the case of Adobe:



[1]

As one can see the revenue was growing from 2010 to 2012 (and before that). But after the company decided to focus on subscription the company had 2-3 years where the revenue was down to flat while the subscription part grew, and the product's business declined. After 2014 when that transition was mostly behind them, the business started to grow fast again. As the business was now mostly subscription-like, the valuation/multiple of Adobe would rightfully also expand significantly.

[1] Adobe financial statements

Here is how that transition worked out for shareholders buying in 2011-2013 during that transition:

[2]

[2] Google finance

What is Franklin Covey

Franklin Covey is a leading performance management consulting firm. The company was founded by Stephen Covey on the foundation of his famous book “7-habits of highly effective people”. Covey leadership was founded in 1985 and prospered on the back of 7-habits after it was published in 1989. Businesses around the world wanted Covey and his associates to teach the 7-habits and help companies with performance improvement.

In 1997 Covey leadership merged with Franklin Quest to become the FranklinCovey company. It has since had its ups and downs.

In the early 2000s, the company focused on marketing a variety of books and audio products based on Covey's 7 Habits material, as well as numerous titles by other Franklin Covey consultants. The PlanPlus software division, which previously developed software plugins for Microsoft Outlook and standalone cloud-based planning tools, was sold to Complete XRM in 2006.

In 2008, Franklin Covey’s CEO, Bob Whitman, enacted a pivot for the company by selling off its popular paper products business and focusing instead on in-person training solutions and live-online training through the growing World Wide Web. The spinoff of the paper planner business became known as FC Organizational Products and maintains a contract with Franklin Covey as the authorized licensee of the brand name.

In 2015 the company pivoted its business and started to offer the All-Access Pass which, instead of selling training courses one at a time, offered all the content under a single subscription.

Franklin Covey operates primarily in the leadership development space. As can be seen below, the corporate training can be divided into segments:

[3]

At the bottom, there are the more technical skills, such as math, chemics, excel, IT etc. that employees often learn in online courses. Franklin Covey does not compete in those areas. What they specialize in is leadership development. The slogan is “we change human behavior at scale”. We will quote CEO Bob Whitman (a quite long quote) from the conference call from a year ago where he describes the product-market fit well.

[3] FC Q1 2020 slides presentation

“Second, we are playing in what we believe is the most -- is the largest and most strategic and most lucrative space in this market, and we're winning. In Slide 19, just the organizational performance market can generally be captured as shown in that slide. At the bottom of the pyramid is the job of developing skills and capabilities in individual learners. On the left-hand side of the bottom row is developing personal and interpersonal skills. And on the right-hand side, you have technical skills. Currently, the vast majority of training at the bottom of the pyramid, so to speak, is focused on the bottom right-hand side on developing technical skills. Increasingly, enterprises are turning to online and do-it-yourself video content to provide this kind of training, and they should. It's an economically smart way to leverage new technology while engaging individual learners online, especially with an increasingly dispersed workforce.

As you move to the left-hand side of the bottom of the pyramid, beyond technical skills into the train of personal and interpersonal skills, and even more importantly, as you go up the pyramid to developing leaders who can achieve results and engage their people and even higher to the top to help organizations achieve major strategic initiatives that require large-scale change in human behavior, you'll find the very challenges that line leaders and C-level executives value most and have the budgets to address.

These organizations must win challenges, challenges such as closing an operational gap, improving sales performance, measurably increasing trust throughout the organization or improving an organization's key customer loyalty metrics. Leaders not only invest a significant portion of their outsourced learning and development budgets to address these challenges, but also a disproportionate share of their internal learning and development budgets as well as portions of their operating budgets are focused on addressing these problems.

We are winning, retaining and expanding our business to organizational customers seeking to address just these kinds of challenges. In doing so, we're gaining access not only to the large outsourced learning and development budgets, the $90 billion piece, but also to the internal learning and development spend, the $220 billion piece as well as to portions of organizations' operating budgets.

Just 3 quick notes on that. As to winning a bigger portion of clients' outsourced learning and development budgets, there's a large financial services firm which has now been an All Access passholder for nearly 3 years who, during this period, has expanded their pass from 100 users to more than 8,000 users. Additionally, they're contracting for many dozens of training days, what we refer to add-on services, each year. This client has expanded its passholder population rapidly in 3 short years because of the depth and breadth of content in the All Access Pass. Each time they encounter a new need in the organization, they consult with their Franklin Covey implementation specialist to determine how that need might best be met through the content and tools in the All Access Pass, and most often, it can be. As this process has played out again and again, their commitment to All Access Pass has increased significantly.

It's important to note that this client is not investing more money in addressing their needs than they did previously. In fact, they're spending a little bit less than they did traditionally, but they've shifted almost all of their spend away from their other historical providers and toward Franklin Covey and All Access Pass.

Similar things are happening with internal learning and development spend, where we're winning -- where people are recognizing that they can take the content in All Access Pass and weave that content and the tools in All Access Pass throughout their leadership development frameworks. And in that -- in so doing, again, they're displacing a number of their former internal and external offerings. We have one example of a multinational Fortune 100 company who purchased All Access Pass 3 years ago as a pilot with a relatively small population of 200 leaders, who recently increased their pass to cover all 30,000 leaders in their organization and signed a 3-year contract. Again, accessing not only the outsourced spend but also their internal.

And finally, we're also winning, as I noted, in portion of clients' operating budgets. For example, the CEO of a large retail organization you'd know made the decision to implement our 4 Disciplines of Execution solution systematically throughout their hundreds of stores using All Access Pass. As a result, their revenue and profits are at historic highs. They give credit to this whole process to 4 Disciplines, and the organization has gained an increasing capability and tool set to execute strategy. So that's -- so we're winning in all 3 budgets.

And the reason we're winning, finally, is because our -- first, because our well-known, best-in-class branded solutions are focused on and known for their track record in delivering measurable outcomes on exactly these critical challenges that we talked about. Due to the importance of the challenges just outlined, organizations seek out best-in-class solutions that have a track record and credibility for delivering outcomes. And this is absolutely where Franklin Covey shines.

Franklin Covey is known and trusted for being the partner of choice for organizations facing challenges, the solution to which require behavioral change at scale. For its most content in the learning and development space is unbranded and relatively undifferentiated, Franklin Covey solutions and insights are well known, best selling, branded and trusted. They received 9s and 10s NPS scores from participants and buyers and have a great track record and reputation for delivering desired outcomes. And so with this branded content on important problems, that's the first reason we're winning.

To try to quantify that, obviously, those are big numbers. But if we did that, just even a modest amount across our current All Access Pass-holding base, there's 5x or more the All Access Pass seat potential inside our client base. And we know that those examples, that's a lot bigger growth than 5x going from 200 or 300 to 8,000 or even 30,000. So lots of headroom there. The way that we do that is the moment a client becomes an All Access passholder, they are assigned an implementation specialist. And that implementation specialist, along with their client partner, are in there immediately and engage with the client formally, at least quarterly. And it's very much a land-and-expand model for us. We make sure that we're doing a good job with the first job they hired us to do, and our process is set up to uncover additional jobs we can help that client with and additional populations which we can serve, and each of those additional populations represents expansion within that logo. And so lots of opportunity there. We're on that, and we feel good about the momentum and the trajectory there."[4]

What Bob mentions here is exactly why FC is growing their AAP business fast. They are helping companies solve their most important problems and goals. Companies are good at making plans and strategies and they often get help from strategy consultants like McKinsey, Boston Consulting Group, etc. But what FC does is help the companies embed the strategy in the organization. Their training, models and tools help companies make sure all employees work in the right direction.

One thing they have observed since they implemented the all-access pass is that companies direct more and more of their budgets to FC. As companies get access to all the tools and materials within the AAP, they can cut back on other suppliers. And as companies become more involved with AAP, they automatically buy more add-on services like training days, implementations and other projects.

> *Next, so medium-size companies reported that because of the All Access Pass Franklin Covey is now their only content provider and some large organizations are telling us as a result of All Access Pass, they're planning to significantly reduce the number of content providers with whom they do business. Several of these reasons we believe that All Access Pass can be strategically important to Franklin Covey. So hopefully that is helpful for those of you that had questions just on strategically where we see All Access Pass.*[5]

This also helps the companies achieve a high ROI on their AAP investment. Both because of the direct outcome of better leadership and better sales productivity, but also because the company can cut down on other places while doubling down on FC.

[4] FC Q1 2020 conference call
[5] FC Q1 2018 conference call

Prior to Apple and Microsoft, few people could harness computers to their daily lives; there was no easily-accessible user interface—no mouse pointers, friendly icons, or overlapping windows on a screen, much less a touch screen. But with the Macintosh and then Windows, the mass of people could finally tap the power of the microchip behind the screen. Similarly, there had been hundreds of years of accumulated wisdom about personal effectiveness, from Benjamin Franklin to Peter Drucker, but it was never assembled into one coherent, user-friendly framework. Covey created a standard operating system—the "Windows"—for personal effectiveness, and he made it easy to use.

~Foreword to the 25th Anniversary Edition of Stephen Covey's *The 7 Habits of Highly Effective People* By Jim Collins

Content is king

It is becoming ever more obvious in today's world that content is king. The perfect example is if course Netflix. Netflix went from a DVD on-demand mail business to an online subscription business, distributing other people’s content. Then they figured out the value was in the content itself and started to invest heavily in creating unique content. Businesses around the world that are sitting on great content and are able to monetize on it will become winners.

What is unique with Franklin Covey is the depth of its content. It is based on best-selling books that have been sold in millions of examples. What FC does, is they can take the principles from those books and make training materials around them.

[6]

Above are some examples of famous books that have licensed content to FC.

“Fads come and go in the industry, but Franklin Covey content has stood the test of time”. [7]

The quote above is something we heard from different people during our research process. And it's evident in the fact that a lot of content is built around ever-lasting content. The 7 habits and Speed of trust etc. are books that keep selling even today, decades after being written. This has two key benefits to FC. One is that the content is widely recognized as the best of the best in the industry. The other one is from a purely financial perspective. The problem with companies like Netflix (if one can say Netflix has a problem) is that the content depletes extremely fast. Netflix can make great series and movies but the longevity of the content does not last long. The content constantly needs to be refreshed and updated, with new content readily available to the ever-demanding consumer. The fact that FC can rely on ever-lasting content that has “stood the test of time” is of course a big competitive advantage.

Another crucial part is the important IP Franklin Covey has around its content. Even though a competitor, in theory, could download the principles or write content around the same books, they can’t use the names and the brand that

[6] FC Q1 2021 slides presentation

[7] Several people referring to FC in this way during our research process

supports it. Companies buy the content from FC because they trust the outcome of the content. As Franklin Covey connects more and more of the best authors to AAP, they also deepen this IP know-how.

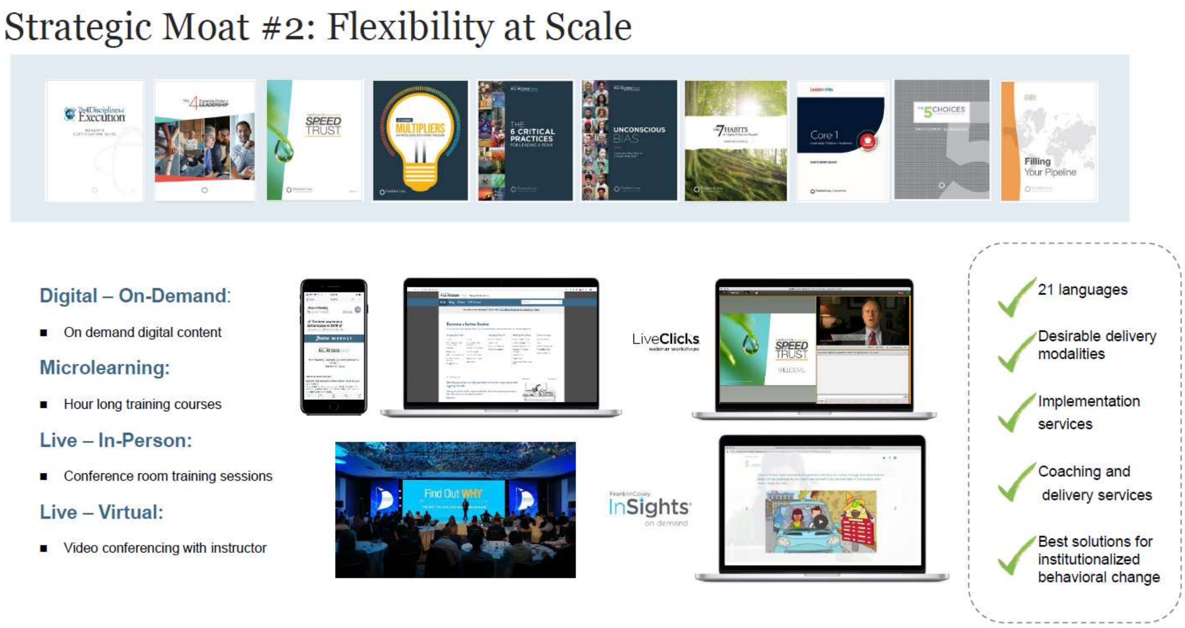
Those authors act as ambassadors for Franklin Covey and help to create references and know-how about the company when they go and speak about the content:

> *As shown in Slide 35, Franklin Covey and its key thought leaders published would often become bestsellers, which present the principles and solutions to help our clients. Our key thought leaders in each solution area also write white papers and articles. They contribute to publications. They deliver podcasts and webinars and they speak at some of the world's most influential events. Franklin Covey's industry-leading thought leadership includes best-selling books as well. And to date, we've sold more than 50 million copies of books worldwide in more than 50 -- in over 50 languages. And to put that $50 million number in perspective, the number of books that we've sold as part of our thought leadership strategy is greater than the amount sold by a large number of our top competitors combined. To achieve best-seller status, a book typically needs to sell a little over 250,000 copies. And so to reach 50 million copies sold and still counting is unprecedented in the industry. These books typically achieve best-seller status, not only in the U.S. and Canada, but also in other countries throughout the world. And in addition, our practice and thought leaders regularly published articles and podcasts in a variety of publications and outlets and speak at client events and on the World Business Forum stage. This strong thought leadership helps to establish our position as a partner of choice for organizations that are truly seeking best-in-class solutions around the world and at scale.*[8]

The way FC normally constructs the agreement with the authors is by a multi-year agreement to use their books as part of the training materials. The authors often help with the actual development of education materials and with implementing the principles from their books. From what we've heard, the actual payments are not based on usage but instead on a fixed amount per year, normally for a multi-year period. This also allows FC to scale those expenses as they grow the subscriber base. FC has increased the gross margin each year for the last few years and is now approaching 80%, even though the subscription business still only makes up half of the business.

[8] FC Q1 2021 conference call

Another important part of FC is their different delivery solutions, which is a source of differentiation. While some competitors with good content normally sell on a course-to-course model, and some lower quality providers mostly sell online tools, FC has taken all their high-quality content and made it available on all different delivery modalities. AAP subscribers can use the content live, online, or as virtual, micro-learning etc. which gives subscribers the ability to make their own impact journeys.



[9]

The quality of the content and the different delivery modalities are also the main reasons why companies chose AAP over the competition:

> *"So, the All-Access Pass wasn't my driving objective though. Most important thing to me was that I had complete access to all of the content, which on their license agreement, allowed me to manipulate, shorten, lengthen, combine, it gave me the authority the permission if you will, to use the content the way that I wanted as opposed to buying a kit and off you go and you teach it."*
>
> *"And I was originally drawn to this product because of the quality and the materials, we use it primarily for classroom and the quality of materials is excellent, the research is excellent. The certification process for trainers is excellent, it's very productive. It's mostly all online.*
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[9] FC Q1 2021 slides presentation
[10] Fortune 150 company using AAP (tegus)

Costumers also recognize the value of the AAP portal compared to the physical delivery.

> *I guess I'll call myself a student of leadership, if you will, and always been a big fan of the Covey content, particularly around 7 Habits. I think that's just timeless content that for years and years and years continues to prove itself useful.*
>
> *And so they've created this to give you access to all the Covey content and I think what differentiates the portal from trying to do some organic stuff like taking pages out of the book and trying to facilitate something, is they have done a nice job modernizing it and packaging it in a way where it speaks more to modern adult theory, learning theory, in terms of bite-size chunks of content, choose your own adventure and let people go and look up what they want to look up.*[11]

Ability to customize content

As AAP grow and FC gets more knowledge about the requirements from the passholders, they can better develop and target the desire for content from future AAP holders. This is also something we have heard in our research, that FC is really good at working with passholders both to customize existing content but also to find new solutions that are in high demand.

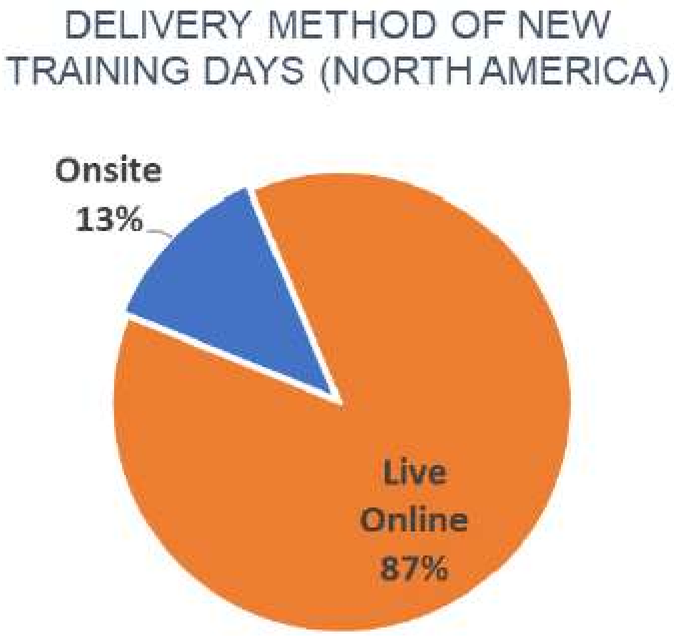
> *We've seen there's some really big ones. We -- because we're focusing on the challenges our -- the organizations that our clients are facing, and because we're always talking to them, we have more than 100,000 hours of sales conversations last year with clients and more than 40,000 conversations from our implementation specialists. That really helps us hone in on exactly what they're looking for. So we're very excited about 2 new offerings that we have coming out this year that we believe will hit things that our clients have needed. They've -- if they don't get it from us, they need to get it from somebody else. And given that they have an All-Access Pass, they would love to just increase their spend with us and have those issues solved.*[12]

One of the new solutions is unconscious bias. It involves important topics like inclusion and how to build trust and accept diversity inside organizations. In the US, where problems with racism and sexism are prominent, these solutions will help companies to create better work environments.

[11] AAP customer transcript (tegus)
[12] FC Q1 2021 conference call

Real network effects

What some people miss about Franklin Covey after the implementation of AAP are the network effects that the business exhibits. First of all, the business has the ability to achieve scale economics now:



[13]

As we can see, after Covid hit, 90% of the business was online based. Some of those sales will of course revert back again, but the fact that the business is capable of shifting between onsite and online is giving it the flexibility it needs.

There are two sides of the business:

1) The content/IP owners

They want to license their content to the platform that is capable of utilizing it best and pay the most money. As FC is by far the biggest platform, they are the de facto choice. Content owners that care about credibility/reputation also want to be associated with other successful authors like Stephen Covey and Clayton Christensen etc.

2) The AAP users

As more and more content become available on the platform it becomes more and more attractive to be a passholder. As FC is giving volume discounts, has been hesitant to raise prices, and is increasing the amount of content, this strengthens their value proposition.

Those two sides complement each other and help strengthen the network effects that build the moat around the business. The management team understands this, based both on the public calls and our conversations with them. They know they have a unique opportunity to build something really valuable here. This is why they are investing a lot in new client partners (salesmen) and more content. They will do everything they can to strengthen the network and support the flywheel.

[13] FC Q1 2021 slides presentation

Over time the company thinks this can create significantly better unit economics. It will be easier to get more passholders if the content library is bigger and better, and it will be easier to convince IP owners to license the content to FC. Management even thinks that one day it could be possible for IP owners to give away content for free or even pay FC for it. As an author builds content on AAP, it normally also leads to higher book sales. I.e., building content on AAP can become a sales tool for new promising authors.

Why is the All-Access Pass winning?

The reason AAP is winning is to some extent obvious. If you give your customers the choice to buy one service at a time or to pay the same amount of money and get the whole buffet, they will choose the latter. As they do so, they will buy more add-on services which will lead to much better retention.

> *but equally important is the fact that it is an auto-renewable subscription, and the entire body of behavioral finance research suggests that changing the default option has a massive impact on human behavior. Simply the fact that the Pass is now part of the budget that auto-renews unless you specifically decide to cancel it, rather than the fact that the previous default option was Franklin Covey content being a discrete cost you had to repeatedly approve every year.*
> *The final question is salesforce productivity, measured in terms of how much new business they knock down relative to the previous year's business. In theory, this should also increase – remember that historically, a large chunk of time was spent selling the same product to the same people year after year, and now that it's on auto-renewal, that would free up a lot of time to go do other things (and FC mgmt has mentioned this several times).* [14]

What my good friend in the investment community wrote above is spot on. This is exactly why the client partners are now ramping at much better rates than before AAP. As most of their books now renew or expand each year, they can focus their efforts on signing new logos instead of selling to old logos.

Building an expanding moat

When AAP helps companies win their most important battles and overcome challenges, they become a trusted partner that companies can rely on in the future. That reputation is important. As they deliver the right solutions, they become the go-to partner next time the company has a big request.

> *As you can see in Slide 26, moat number one is having the best-in-class solutions to our clients' highest impact, must-win opportunities and challenges. At any given time, most organizations have several high-impact opportunities, which have achieved or challenges, which overcome, we have a significantly disproportionate positive impact -- a disproportionately positive impact on their organization's result. These opportunities and challenges include things like successfully and systematically implementing a new or refined strategy. Number two, getting an entire organization to nimbly adjust the necessary changes we've all had this past year; third, achieving a major nonlinear operational breakthrough, such as increasing sales performance or improving customer experience; four, establishing the foundation for winning an engaging culture; five, developing leaders at all levels, leaders who, as Eisenhower suggested, get people to want to do the things that must be done. And so while the rewards for achieving organizational breakthroughs in these areas can be truly significant, even greater organizations often struggle to consistently address and achieve them. These are challenges which can't be solved just by letting people search through a content library and pick topics interesting to them, rather achieving breakthroughs in these areas requires collective organizational and behavioral change at scale. When you step back from this, you recognize that there are certain things like*

[14] US Fund manager

strategic consulting that can have a big impact, they're just not very scalable and doesn't get behavioral change. You've got other things that are really scalable where you can have lots of people take courses, but it doesn't have much impact. Where we're playing is at the intersection of those two. It's high impact with high scalability. And these are the -- exactly the kinds of high-impact challenges on which Franklin Covey has focused its solution development, efforts and budgets for more than a decade. And as a result, we now have the acknowledged best-in-class blockbuster solutions for addressing exactly these kinds of blockbuster challenges.[15]

As we mentioned before, the actual penetration within companies is still very low for AAP. As FC helps companies solve specific problems, they normally broaden the development into a larger and larger population within the company. This also helps FC to get good referrals when client partners go out and approach new targets.

First among those is that we're helping our clients to successfully address some of their most important and intractable organizational challenges. During the third quarter, our clients wrestled through the same historic challenges that each of us here on this call experienced. They moved large populations of employees from their office or school to remote work environments. They narrowed focus to the few critical must-do activities, often with fewer resources than they had pre-pandemic. They had to figure out how to generate sales and retain customers in an extremely difficult selling environment. They had to address culture. And to the extent they had deficiencies in their culture, those get amplified in times like these. And most recently, most every one of our clients is very proactively focused and thoughtfully addressing diversity, inclusion and bias within their organization.

The strength of this value proposition, including the fact that the price per user decreases as the pass-holding population increases, is causing many of our clients right now to make the decision to consolidate providers and double down with Franklin Covey[16]

[15] FC Q1 2021 conference call

[16] Paul Walker FC Q2 2020 conference call

Strong unit economics

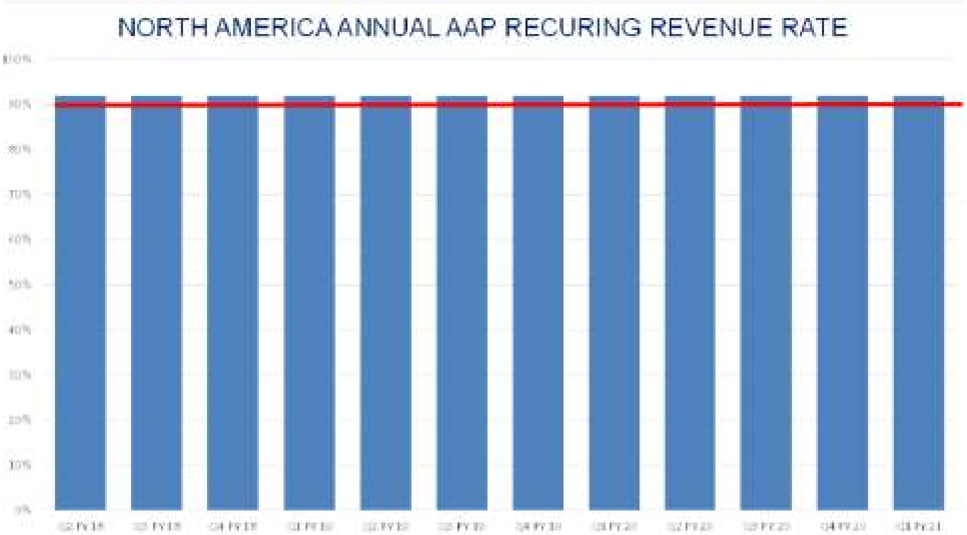
We think Franklin Covey has very solid unit economics. First of all, we severely disagree with the insane focus there seems to be on the "net revenue retention + 100" figure in the investment community these days. At Symmetry, we too like companies with as high revenue retention as possible and as low churn as possible. But we understand that there are many more variables to consider. One of our most successful investments has been in Naked Wines with revenue retention in the 80-90 % range.

Some business models center around paying enormous amounts of CAC in getting freemium users into a platform and then converting them to small initial buyers with the hope of expanding with them over time. Because all the users start really small, those companies can normally disclose extremely high net revenue retention. But the payback time in some of those examples is often very high and in some instances 5+ years.

Two important factors to us are how big the initial purchase is and how fast the payback time on the CAC is. Most people know how fast the world is changing and especially withing software and subscription businesses. The longer the payback time is, the more careful we normally become about a possible investment.

With Franklin Covey we like the unit economics for several reasons:

Retention



[17]

When we first started to dig into FC, we thought this picture was quite odd. We had a hard time understanding why the revenue retention was so stable. We have heard similar questioning from other investors as well. What is underlying this picture (and what we don't think the company has explained well enough) is not the actual revenue retention but the minimum revenue retention. Put another way, the picture just illustrates what FC has said in public; that revenue retention has consistently been above 90 %. Not the actual figures.

Because the actual numbers jump around in different quarters based on the timing of purchase/renewal/expansion etc. FC management doesn't want to spend time explaining to investors and analysts why the figure is 98 % one quarter and 92 % next quarter etc. since it's just normal business variations. But management also understands that if you are a subscription company and you won't disclose your retention, then investors won't trust you. What they want to do is simply to confirm each Q that revenue retention is +90 %.

[17] FC Q1 2021 slides presentation

Based on our research and discussions with them, it's our belief that the ANNUAL net revenue retention varies between 90 % and 105 % each quarter with an average of around 95 %.

This 95 % figure consists of around 15 % net expansion and 20 % logo churn[18]. A 20 % logo-churn each year can seem high, but remember what FC is selling. It's not a highly customized software, deeply embedded into the company's ERP system etc. It's still, to some extent, a discretionary purchase. Another reason for a higher logo-churn is the high growth. As FC invests a lot in growing AAP, they acquire a lot of new logos each year and if your net revenue retention is 95 % and your business is growing 30 %, all else equal, you will have 35 % growth in logos each year. FC has never disclosed actual cohort metrics but it's our understanding that it follows a typical subscription-like nature. High initial logo-churn with declining logo-churn as cohorts mature. As the expansion rates are still high on mature cohorts we believe that the actual revenue retention is +100 % for more mature cohorts (expansion of # of seats + price increases more than offsets the logo churn).

The last factor (and it's an important one) behind the logo churn is that FC uses strict criteria for calculating the metric. If renewal does not take place at the anniversary, right on time, it is calculated as churn. But what actually happens is that companies often just want to "pause" the subscription. The most common reason is that the company just doesn't have any new impact journeys going on where they need AAP.

An example: It could be that a company has a 2-year pass that expires in May. This company would then say to the AAP client partner *"listen we are really happy for our journey with you. We will definitely want to continue with a new 3-year impact journey in a different area of our business. But now with the holidays coming up etc. we want to start that program in August. At that time, we will get into a new AAP contract with you".*

Maybe it sounds improbable, but this happens often. Think about it. How many of you have had a subscription on Netflix, HBO or whatever just to follow one or two series you like (my wife sure has). But if she likes an HBO series and the new episodes will only air 4 months from now, she will unsubscribe from the service and activate it again when she needs it (thankfully for me, as I would probably be too lazy to remember it). Here we are also "churning" even though we actually only take a payment break.

In the case of FC, what we've learned from the company is that they actually reactivate between 25-40 % of the logo churn in the 3-9 months after they "churn". Simply because some companies just don't have a short term need for the service, even though they really like it and want to continue with it after a short pause. One could argue that if the company has a 20 % logo churn per year but 1/3 of those reactivate after a 3-6 month pause the underlying logo-churn is somewhat lower and the underlying net revenue retention somewhat higher (as those reactivations go into new bookings and not retention).

How do they get that retention? Some concerns we hear about FC is that companies will use the content to train their workforce and then move on. It seems plausible. Again, if a company uses AAP for a 2-year project to improve salesforce productivity or to improve trust within the leadership team or to improve customer loyalty etc. at some point they will be "done" and move on? That was truly the case with the old business model where FC sold consulting and training projects one at a time. But what they have learned after introducing the All-Access Pass is that they can work deeply with companies so that they have several impact journeys going on at the same time. FC has learned that if they help companies with actual measurable improvements in some areas, companies will use them in other areas as well. And remember, most companies have churn in their employee base. Especially in the salesforce, leadership etc. If the company is committed to FC there will always be some new recruits or someone being promoted that needs training.

Franklin Covey has what they call implementation specialists. Those are people that are highly trained in using the AAP content and building impact journeys. Those implementation specialists are assigned to the AAP customers to help the companies to get the most out of their pass. Those implementation specialists also make sure that there is an actual usage (if a holder doesn't use the pass, they are not likely to renew it) and they upsell add-on services (consulting days, material sales etc.). By making sure an AAP holder always have an ongoing impact journey it's significantly more

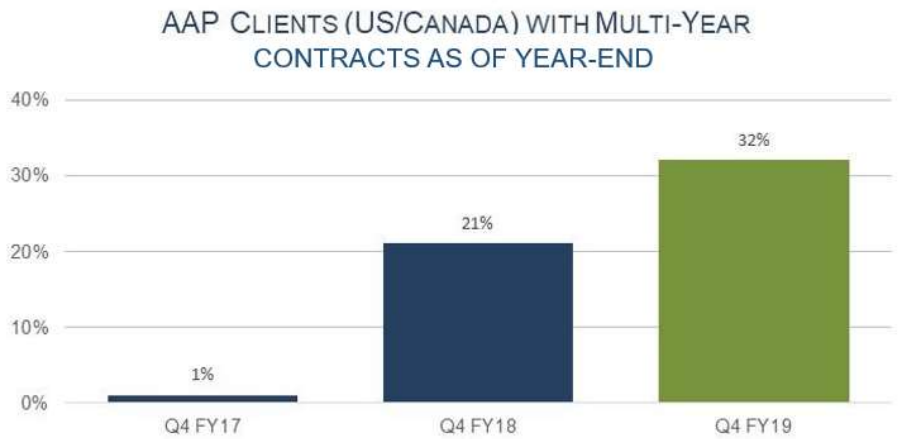
[18] Symmetrys estimates based on our conversations with management etc.

likely that they will renew, or even sign a multi-year pass. Think about it. If a company is 4 months into a 16-month journey but their pass expires in 6 months, you can be quite certain about a renewal as most companies want to complete those journeys.

A Tegus transcript interviewing a current AAP customer digs deep into this retention topic:

> ***Tegus Client***
> *So, maybe to just summarize a little bit of what we talked about, because the thing that I was really concerned about with this business is that repeatable customers, because I didn't really see necessarily why someone would need to continue to consume this content. And it sounds like, at least XXX's case, it's semi-mandatory onboarding. So there is some level of continuity to it, assuming that you continue to hire new multi-unit leaders. Is that kind of a fair statement?*
>
> ***Director of Learning & Program Development at XXX company***
> *"Yeah, yeah I think the challenge there is keeping senior leadership disciplined around reinforcing messages you've already delivered from a leadership development standpoint, is one of the big challenges I know I've had. It's like, "Okay, what's the book of the year this year?" And it's like, "Well we haven't mastered what we deployed last year." So I think there's value in finding a way to stay consistent with something you've already deployed. But that can be challenging because folks are like, "I'm tired of it," and it's like, "Well, have you fully leveraged it? What else can we do with it?" And getting Covey to help you think through what other ways can you get traction or there's something that's only implemented at a top-level but needs to be double-clicked on. I think those are all interesting things to think about to stay the course. Because in my belief, it takes years and years of a consistent approach to how you treat and lead people for the results to start to pan out and that discipline can be tough to obtain from the team. So that would be a long-winded answer of saying, that can be the value of sticking with a particular course of content"*[19]

Another measure of the underlying stickiness of the AAP is the number of passholders that are signing multi-year agreements:



[20]

When FC first launched the pass, they only signed 1-year agreements. But what they quickly learned was that a lot of companies quickly understood it would take a lot more time to accomplish what they were looking for. FC then started to sign multi-year agreements. As we mentioned before, each AAP customer has an implementation specialist assigned to them that makes sure they get the most out of the product. The client partner that makes the initial sale only needs to start focusing on retention 2-4 months before a contract is up for renewal. But if that client partner can

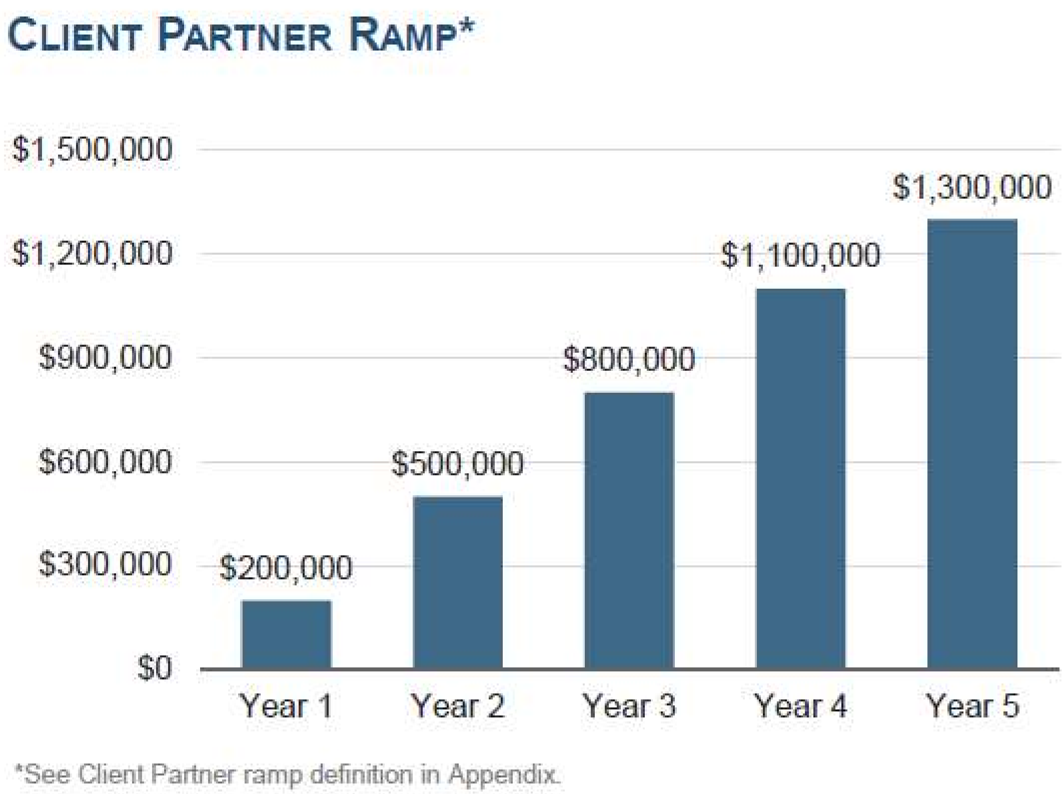
[19] Tegus transcript
[20] FC Q4 2019 presentation

sign a 2-3-4-5-year contract (I think we have even heard about a 7-year contract) it will free up a lot of time to focus on new logos instead of renewals and that will of course lead to much better productivity.

Client partners

The salesforce for FC is called client partners. Client partners normally have a specific geographical area with a lot of targets that they will work on and convince to become AAP clients.

FC have provided the following chart on how a client partner ramp would look like.



This ramp was based mostly on cohorts of client partners hired before the company introduced the all-access pass. The company has since experienced an even steeper ramp for new cohorts of client partners.

> *And Jeff, overall between the -- thanks, Paul and Sean. Overall, if you look at the ramp, the expected ramp, which you know the $200,000, $500,000, it's on Slide 22. The $200,000, $500,000, $800,000, $1.1 million, $1.3 million, the cohorts that we've hired since 2015 -- so '16 on, when All Access Pass has been in place and Leader in Me, we were about 20% ahead for each cohort. And it kind of seems to be about the same for each cohort. And what's happening is, of course, they're retaining substantially all the revenue they generate the first year rather than losing a bunch of it. And that puts them on a higher trajectory. We're keeping the goals the same. So we're at about 20% ahead of those numbers.*[21]

[21] Q4 2019 conference call

And it makes sense. When you can retain +90 % of your prior year sales in the following year it's much easier for you to grow with new logos. In the old days when client partners were selling course by course, they would need to focus much more time and energy on just retaining the prior year's sales numbers.

FC actually provided the following figure on how a client partner ramp could look like after the introduction of AAP:

Building an All Access Pass Book of Business

Year	10 New Passes	20% Add-On Services	90% Revenue Renewal	Total Revenue
1	$300,000	$60,000	-	$360,000
2	$300,000	$114,000	$270,000	$684,000
3	$300,000	$162,600	$513,000	$975,600
4	$300,000	$206,340	$731,700	$1,238,040
5	$300,000	$245,706	$928,530	$1,474,236
6	$300,000	$281,135	$1,105,677	$1,686,812
7	$300,000	$313,022	$1,265,109	$1,878,131
8	$300,000	$341,720	$1,408,598	$2,050,318
9	$300,000	$367,548	$1,537,739	$2,205,286
10	$300,000	$390,793	$1,653,965	$2,344,758

[22]

Those could even prove to be conservative estimates. First, the revenue renewal has proven to be above 90 % each year. And the add-on services attachment has averaged closer to 50 % than the 20 % the company used here back in 2020.

The company actually got a question about this in 2019 from an analyst on the conference call:

Analyst

You talked about the 1-year payback period on new client partner, and obviously the 90% revenue retention and the high incremental margin. Have you guys put that together into an LTV-to-CAC type of metric? It seems like it'd be best-in-class, but you haven't actually disclosed it.

Robert Whitman

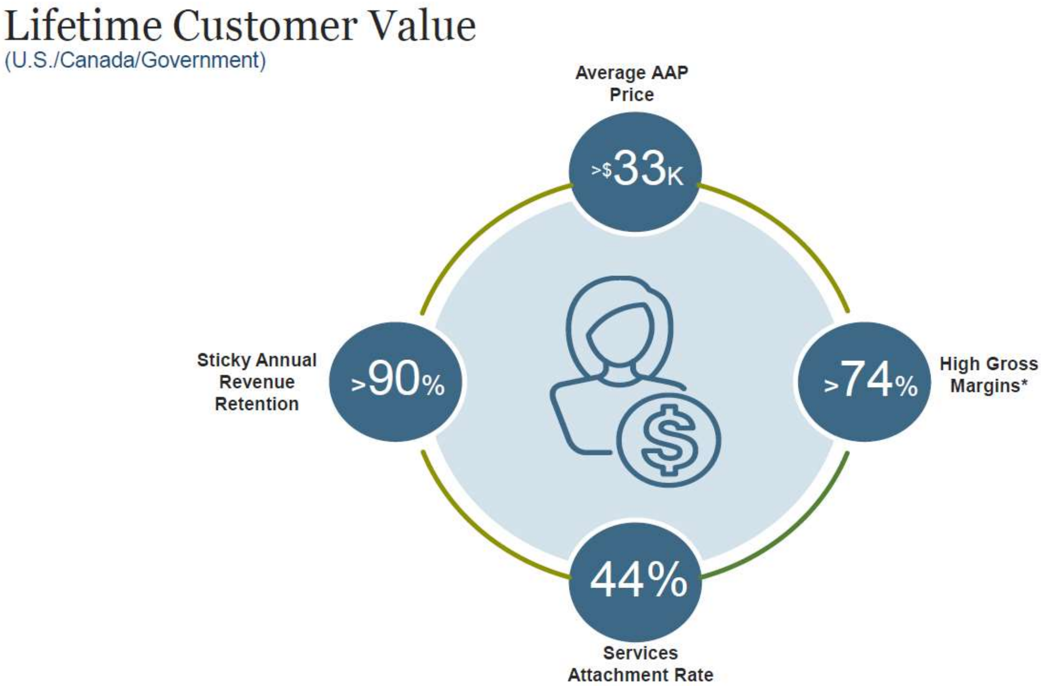
We have. We said it's less than 1-to-1 but I think -- but your point is exactly right. I think it's really the unit economics, are really so compelling that that's why we built this whole infrastructure. It's taken years to build but the sales school is the easier part even though that's not easy. But I mean building the infrastructure of all these managing directors who can mentor and ramp up these people. But yes, it's exactly it. And so that ratio of lifetime customer value to the customer acquisition cost. For us, the combination of the fact that as you say, first our initial

[22] FC Q1 2020 slide presentation

sale price is a pretty substantial amount because of the size of the population, and our costs of acquisition are well less than 1-to-1. So we think that's a compelling metric.[23]

LTV/CAC

One of the main reasons why the LTV/CAC is so compelling is because the CAC spend is variable with low upfront costs. Client partners are paid around 10 % in commission on their revenue. It is not like a subscription company that needs to buy leads or pay for expensive online advertising etc. The only upfront investment FC has is the infrastructure they have built around their client partners, i.e., the initial onboarding, training and coaching they have in place to make sure those new hires ramp as expected.



The other positive with AAP is the high initial sale. In the chart above it says +$33.000. In the last Q1 2021 call they said it's now at $40.200 + add-on services. The AAP business is now +80 % gross margin with high revenue retention as well. Those figures make it extremely compelling for FC to hire and ramp new client partners. And that's the plan. Their current target is to hire at least +30 new client partners each year (a double-digit salesforce expansion).

As you're familiar, 5 years ago, we made the decision to move to a subscription model because we believe it would be the best way for us to fulfill our mission and to serve and build the lifetime value of our clients. We felt that if we made the move, not only would we be better, a better and more strategic partner for our clients, we would also create a more profitable, enduring and high-growth business. And while we've enjoyed high subscriber satisfaction and renewal rates from the beginning, some have asked how resilient we thought our subscription business would be in a downturn. And as you know, we've had a front-row seat watching the answer to that question play out over the past few months, and we are very encouraged, as Bob mentioned, about how resilient our All Access Pass and Leader in Me subscription businesses have been even in the middle of this pandemic.[24]

[23] FC Q4 2019 conference call
[24] Paul Walker: FC Q3 2020 conference call

As FC pays around 10 % in commission to the client partners and will leverage their current sales infrastructure, we think FC will end up with less than 20 % in sales and marketing as a percentage of revenue (it's probably slightly higher today with the upfront investment in client partner onboarding).

Remember FC doesn't need to spend huge amounts on R&D. Most of their R&D is really the content and the actual portals. Most of those expenses are recognized as COGS in the P&L alongside the royalty and license expenses to the IP holders. The only expenses below the gross profit line are therefore mostly SG&A.

But if FC spends 20 % on sales and marketing to get revenue with 80 % gross margin, does that leave incremental margins of 60 % before general and expenses?

As some of the G&A is probably fixed, the company actually thinks the incremental EBITDA to incremental revenue will be 50 % for the next several years.

This is supported by the actual numbers reported over the last 12 quarters:

Incremental revenue	6.710	5.295	5.897	3.809	5.545	347	4.784	3.389	(18.901)	(16.171)	(10.289)
Incremental EBITDA	3.378	122	3.699	2.411	3.065	2.047	1.792	3.092	(6.713)	(4.494)	(1.245)
Flow-through	50,3%	2,3%	62,7%	63,3%	55,3%	589,9%	37,5%	91,2%	35,5%	27,8%	12,1%

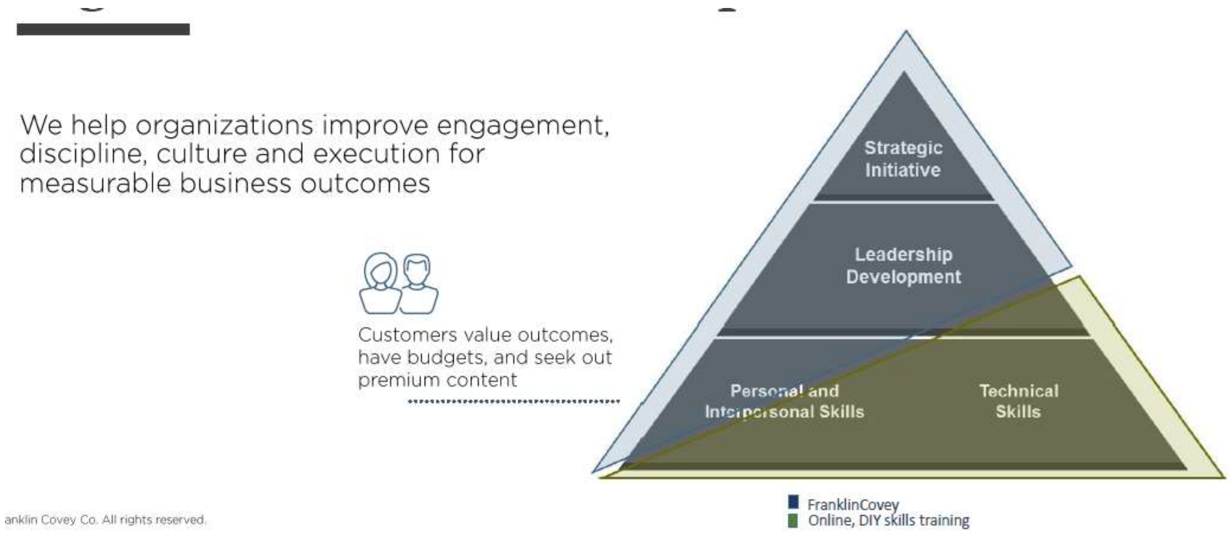
As can be seen above for the 8 quarters going into the pandemic FC had around 60 % incremental EBITDA margins on incremental revenue. This clearly shows the scalability of the business now that they've become a subscription business and sets the foundation for high EBITDA growth when the pandemic numbers start to lapse from Q3 2021 (remember the accounting year ends in August).

Another quite amazing note. Look at how low the EBITDA contraction has been since the pandemic started. Said another way, while the revenue grew before the pandemic the incremental margins were 50-60 %. But when the revenue started to contract a lot during the pandemic, the incremental EBITDA loss was only 12 – 35 %.

The reason? Most of the revenue loss was the lower margin legacy revenue while the subscription business kept delivering good numbers throughout the pandemic.

A big potential TAM

Another metric we look at when we invest is the potential total addressable market (TAM). If we think a company is winning in its industry, there needs to be a huge market to win. We will note that most companies severally exaggerate their TAM, so it’s more important to be directional right than precisely wrong when looking into a potential TAM.



[25]

We have shown this slide before to explain what the market segments looks like. FC competes mostly in the “leadership development” market.

> *Just to say that, first, the market for organizational performance in which we play is huge and expanding. Almost everyone -- when you think about it, almost every organization's largest investment is in its people. Its collective investment is in its people. And therefore, its biggest opportunity for organizational performance improvement most often lies in increasing the collective performance of its people. In pursuit of this improvement, it's estimated that organizations globally spend more than $90 billion on outsourced learning and development solutions and services. They spend an additional approximately $220 billion for their learning and development staff and for internal content development. And then in addition to learning and development, there are countless additional billions spent on consulting and other performance initiatives outside the learning and development spend. So there's a lot of money, effort and time spent on this topic.*[26]

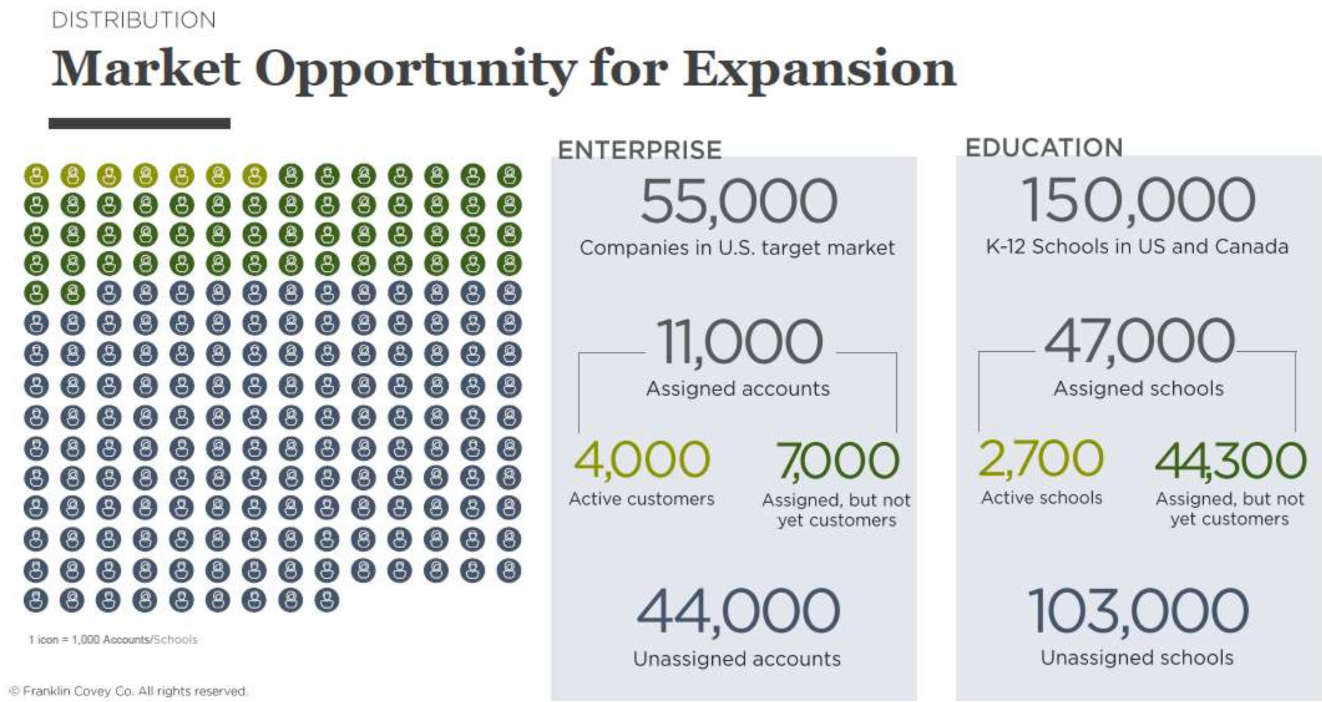
There are two main ways in which FC can grow their revenue. One is to sign on new logos and one is to expand in existing logos. FC has focused on both areas. While client partners have the goal of signing on new logos the implementation specialists help to expand the existing logos.

Management has also tried to quantify the opportunity to expand with existing logos:

[25] FC CMD
[26] FC Q1 2020 conference call

> To try to quantify that, obviously, those are big numbers. But if we did that, just even a modest amount across our current All Access Pass-holding base, there's 5x or more the All Access Pass seat potential inside our client base. And we know that those examples, that's a lot bigger growth than 5x going from 200 or 300 to 8,000 or even 30,000. So lots of headroom there. The way that we do that is the moment a client becomes an All Access passholder, they are assigned an implementation specialist. And that implementation specialist, along with their client partner, are in there immediately and engage with the client formally, at least quarterly. And it's very much a land-and-expand model for us. We make sure that we're doing a good job with the first job they hired us to do, and our process is set up to uncover additional jobs we can help that client with and additional populations which we can serve, and each of those additional populations represents expansion within that logo. And so lots of opportunities there. We're on that, and we feel good about the momentum and the trajectory there."[27]

If we turn to the potential of signing new logos, the company has already initiated a significant investment into new Client Partners. They think they can grow with at least 30 net new client partners per year as the assigned logos to existing client partners is only a fraction of the potential market to go after. In the Leader In Me business, the untapped potential is even higher (but the unit economics is not as good here, so it will be harder to penetrate).



[27] FC Q1 2020 conference call

Management

What we look for in a management team is normally the following characteristics. First, long tenure at the company with a good track record and preferably that the owner still runs the business. The other two are insider ownership (skin in the game) and a history of good capital allocation.

Tenure / culture

As people know we search for companies that are founder-led or with a management team that behave like the founders. The current CEO Robert (Bob) Whitman has been with Franklin Covey since 1999 and is the main reason why the company looks like it does today. He has transformed the business from the original consulting/training/publishing business into the more performance-driven subscription business it is today. He has done so while constantly staying true to the spirit of the company and the seeds Stephen Covey planted there.

Another important part for us is the capability to make hard decisions and execute well. To change the company from its legacy business to the current AAP business was like disrupting the company from the inside. Additionally, management knew it would make the financials look bad for several years while the transformation took place. But management still made the decision that they knew would optimize long-term value.

Before Covid, the company was on track to hit all the goals that were put out before the AAP transformation began. In other words, they executed well on the plan. And even today Covid is merely a 1-1,5-year setback on the original plan and not a heavy blow. On the contrary actually, as Covid can act as an accelerator for the AAP transformation.

Insider ownership

As can be seen below, several of the members of the management team and the board are large shareholders:

Investor Name	Value of Shares Held (MM)	% Of Shares Outstanding Held	# Shares Held	Change in # of Shares Held	% Change in # of Shares Held	This Holding as % of Firm's Portfolio	Holdings Date	Investor Type
BlackRock Institutional Trust Company, N.A.	16,3 US$	6,56 %	920.835	14.313	1,58 %	-	29.9.20	Investment Advisor
Pembroke Management Ltd.	11,9 US$	4,80 %	673.221	(1.679)	(0,25 %)	0,93 %	29.9.20	Investment Advisor
The Vanguard Group, Inc.	11,6 US$	4,65 %	652.173	53.611	8,96 %	-	29.9.20	Investment Advisor/Hedge Fund
Dimensional Fund Advisors, L.P.	10,9 US$	4,37 %	613.756	(9.814)	(1,57 %)	-	29.9.20	Investment Advisor/Hedge Fund
Whitman (Robert A)	14,0 US$	3,99 %	560.648	64.408	12,98 %	99,40 %	11.1.21	Individual Investor
Punch & Associates Investment Management, Inc.	8,4 US$	3,35 %	470.708	(2.369)	(0,50 %)	0,72 %	29.9.20	Investment Advisor/Hedge Fund
McNamara (Donald J)	9,6 US$	3,13 %	439.029	-	-	100,00 %	29.11.20	Individual Investor
Oregon Public Employees Retirement System	7,1 US$	2,85 %	400.028	-	-	0,10 %	29.9.20	Pension Fund
Rice Hall James & Associates, LLC	6,7 US$	2,68 %	376.497	54.702	17,00 %	0,27 %	29.9.20	Investment Advisor/Hedge Fund
Fidelity Management & Research Company LLC	5,9 US$	2,36 %	331.725	(187.385)	(36,10 %)	-	29.9.20	Investment Advisor
Knowledge Capital Investment Group	10,5 US$	2,32 %	325.897	(2.486.908)	(88,41 %)	100,00 %	8.12.19	Corporation
BofA Global Research (US)	4,3 US$	1,72 %	242.071	(12.693)	(4,98 %)	-	29.9.20	Research Firm
Peterson (Joel Clinton)	5,1 US$	1,64 %	230.429	-	-	51,76 %	29.11.20	Individual Investor
State Street Global Advisors (US)	4,0 US$	1,62 %	227.213	(3.244)	(1,41 %)	-	29.9.20	Investment Advisor/Hedge Fund
Renaissance Technologies LLC	4,0 US$	1,60 %	224.703	(59.500)	(20,94 %)	-	29.9.20	Hedge Fund
Silvercrest Asset Management Group LLC	3,6 US$	1,44 %	201.676	61.583	43,96 %	0,03 %	29.9.20	Investment Advisor/Hedge Fund
Covey (Michael Sean Merrill)	4,4 US$	1,43 %	200.634	(301)	(0,15 %)	100,00 %	29.11.20	Individual Investor
Federated Hermes MDTA LLC	3,5 US$	1,42 %	199.355	60.634	43,71 %	0,07 %	29.9.20	Investment Advisor/Hedge Fund
BlackRock Financial Management, Inc.	3,4 US$	1,37 %	192.327	(92)	(0,05 %)	-	29.9.20	Investment Advisor/Hedge Fund
Young (Stephen D)	4,2 US$	1,36 %	190.789	(27.877)	(12,75 %)	100,00 %	29.11.20	Individual Investor

Bob Whitman (chairman and CEO), Sean Covey (head of Education), and Stephen Young (CFO) together control around 7 % of the company. Also, Donald McNamara and Joel Peterson (a member of the board) controls 8 % of the company. Famous author Clayton Christensen was also a board member before his death in early 2020.

The company has also been able to attract Blackrock, Pembroke, Renaissance, Silvercrest etc. as shareholders.

There are still a lot of the Covey family members employed in the business. When we started to research the company several years ago, we were a little spooked by the "related party transactions" section from the Proxy statement. It seemed to us that there were too many brothers, uncles, nephews etc. getting paid quite hefty salaries working there.

This should be an INITIAL concern for most investors. But over time, as we have kept studying the business it has become less of a concern to us.

Related Party Transactions

We previously acquired CoveyLink Worldwide, LLC (CoveyLink). CoveyLink conducts seminars and training courses, and provides consulting based upon the book *The Speed of Trust* by Stephen M.R. Covey, who is the brother of M. Sean Covey. Prior to the acquisition date, CoveyLink granted us a non-exclusive license related to *The Speed of Trust* book and related training courses for which we paid CoveyLink specified royalties. As part of the CoveyLink acquisition, we obtained an amended and restated license of intellectual property that granted us an exclusive, perpetual, worldwide, transferable, royalty-bearing license to use, sell, and perform the licensed material in any format or medium and through any market or distribution channel. The amount expensed for these royalties to Stephen M.R. Covey under the amended and restated license agreement totaled $1.6 million during the fiscal year ended August 31, 2020. In connection with the CoveyLink acquisition, we also signed a speaking services agreement that pays Stephen M.R. Covey a portion of the speaking revenues received for his presentations. During fiscal 2020 we expensed $0.8 million for these presentations.

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We pay M. Sean Covey, who is also an executive officer of the Company, a percentage of the royalty proceeds received from the sales of certain books authored by him in addition to his salary. During the fiscal year ended August 31, 2020, we expensed $0.1 million for these royalty payments.
During fiscal 2020, we employed Joshua M.R. Covey, who is the brother of M. Sean Covey, and paid him compensation totaling $197,787. We also employed Dr. John Covey, an uncle of M. Sean Covey, and paid him compensation totaling $106,967 in fiscal 2020.
We employ John Harding, who is the brother-in-law of Stephen D. Young, and paid him compensation totaling $267,164 during fiscal 2020. We also employed Jonathan Lofgren, who is Scott J. Miller's brother-in-law, and paid him compensation totaling $162,458 in fiscal 2020. [28]

First of all, there is no member of the Covey family on the board. Second, the 3 most senior executives Bob Whitman (CEO), Stephen Young (CFO) and Paul Walker (COO) are not members of the Covey family. At the same time, the Covey family does not have any shareholder control in the company. Said another way, there doesn't seem to be a conflict of interest here. So, while it's hard to know exactly if the Covey members are worth their salary, I have not found any evidence that they aren't.

The second thing is that a lot of the Covey family members are famous authors with prestigious educational backgrounds. Stephen Covey's 3 sons (Stephen Jr, Sean and Joshua) all seem to contribute to the company. Stephen Jr authored the best-selling book "Speed of Trust" and Sean Covey is the co-author of "Leader-in-me". They are credited by a lot of external parties.

To summarize, we trust that Bob and the board is using shareholder money to only pay for employees that are worth it, and so far, we have not seen any evidence against this, and we see no conflicts of interest.

Capital allocation

The last part we look for is good capital allocation. In this case, it's quite easy to judge. Over the last 10 years, FC has run with a fairly simple balance sheet. From time to time a little debt and sometimes (like now) with net cash, but on average only small amounts of debt.

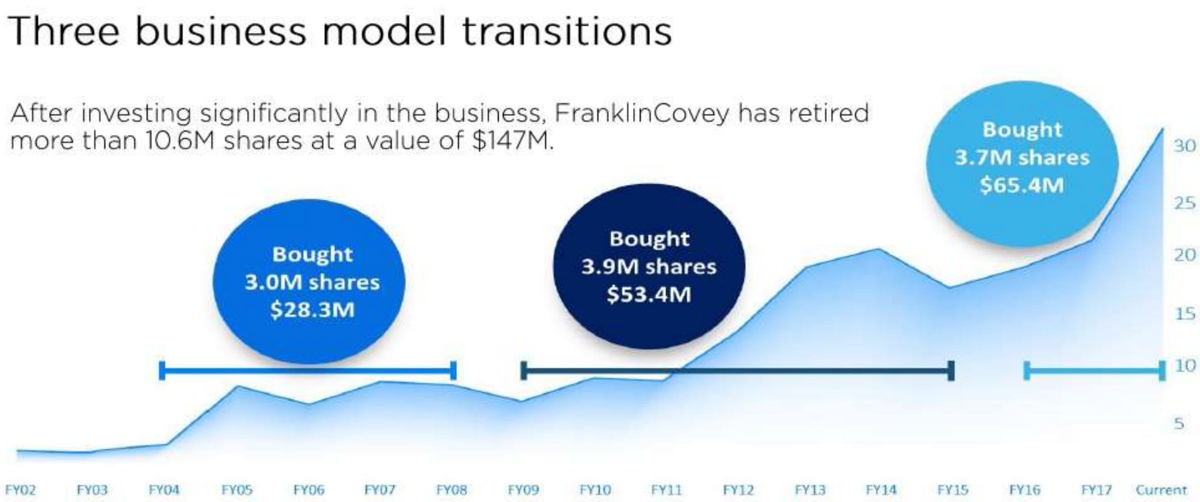
On the M&A front, the company has executed small bolt-on acquisitions. Most of these have been focused on better delivery modalities (like Jhana that gave them micro-learning capabilities) or in other cases where it has been more content-driven. Most of the M&A has been small and strategic additions to the company. In this way, they've been successful. On a standalone basis, it's impossible to judge the ROI because we don't have exact revenue and earnings numbers after they were consolidated into FC. But overall, we think the M&A has been quite good.

Before thinking about M&A or buyback etc. FC makes sure they invest properly into the business. Over the last few years, significant investments have been made in the technology (the portal around AAP), in content, and infrastructure around the client partner ramp-up etc.

But because the business is highly cash flow generative, FC has had excess capital even after those investments.

[28] To small to read it here – but proxy statement can be found on the website of FC

The, by far, most significant spend has been buying back own shares.



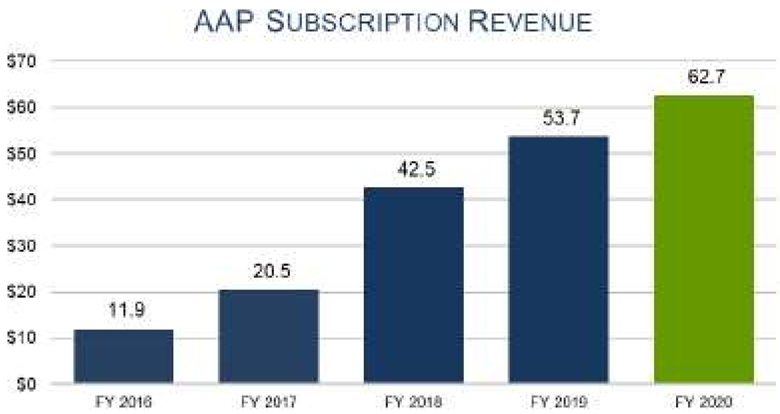
Franklin Covey has bought back close to 50 % of the shares outstanding. The average price paid for the shares has been $13.6. As the stock today stands at $25-30 (and, according to us, is worth significantly more) we think those buybacks have created significant shareholder value.

As the company will be highly cash generative in the future, we think they will keep buying back shares in the market to create shareholder value. We like the setup here, where we can invest in a subscription business growing +20% a year that is still able to buy back its own shares at depressed levels. It's quite the opposite of the money-burning SaaS businesses that constantly need fresh equity raises to keep the momentum going.

Segments:

FC can be divided into 4 different segments, AAP, Education, International, and legacy. The AAP part can be viewed as a pure subscription + add on sales.

AAP

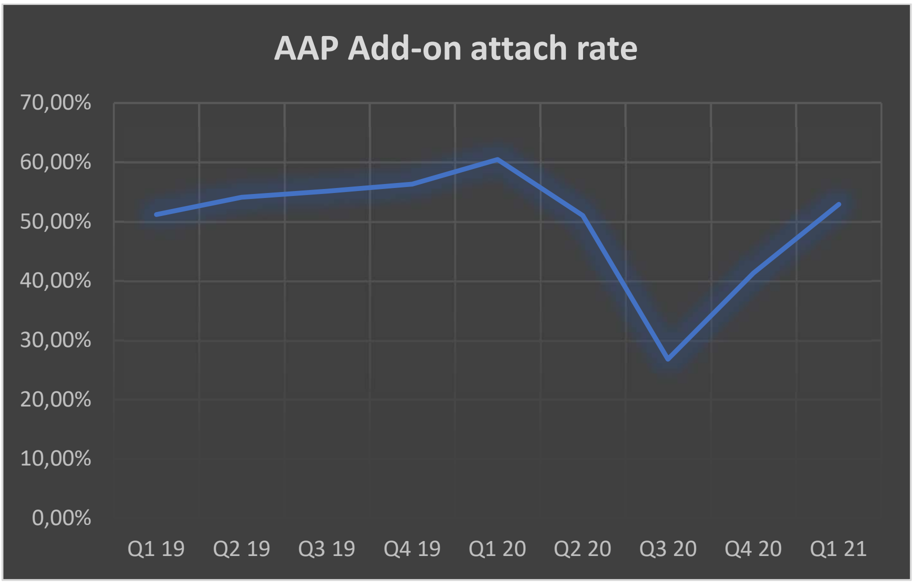


The AAP business is the crown jewel in FC. It's here that we think most of the value is created, and the segment that the market has not appreciated enough. The whole value proposition to end-users is so high and penetration so low that we think it can grow double-digit for decades.

> *The second point related to the value proposition. Our clients tell us that not only are our solutions and flexibility important to them but that All Access Pass and Leader in Me customer value propositions are equally compelling. As shown on Slide 24, and we've reviewed these before, but I think it's helpful to just review them again here. Each All Access Pass client receives the following. They received, one, full -- a full collection of our best-in-class content and solutions. And of course, point two, that's available in all modalities, very, very important right now, which allows them to deliver in virtually any segment of time and on any device. And third, all of this is available in more than 20 languages now worldwide, I think the number is actually 21, and at an addition -- and at no additional cost to them, included in that offering is access to an expert -- the services of an expert implementation specialist who works to ensure that the clients are able to achieve the progress that they're seeking.* ***And then finally, all of this is offered at a price per person trained that is equal to or less than the typical cost of training one person in one content area in just a single modality.***[29]

[29] Paul Walker – FC Q4 2020 conference call

Users of AAP also buy add-on services, such as training days, consulting to help with projects, material sales etc. It is part of the AAP business model to build a large customer base with the AAP, and then upsell services to them.



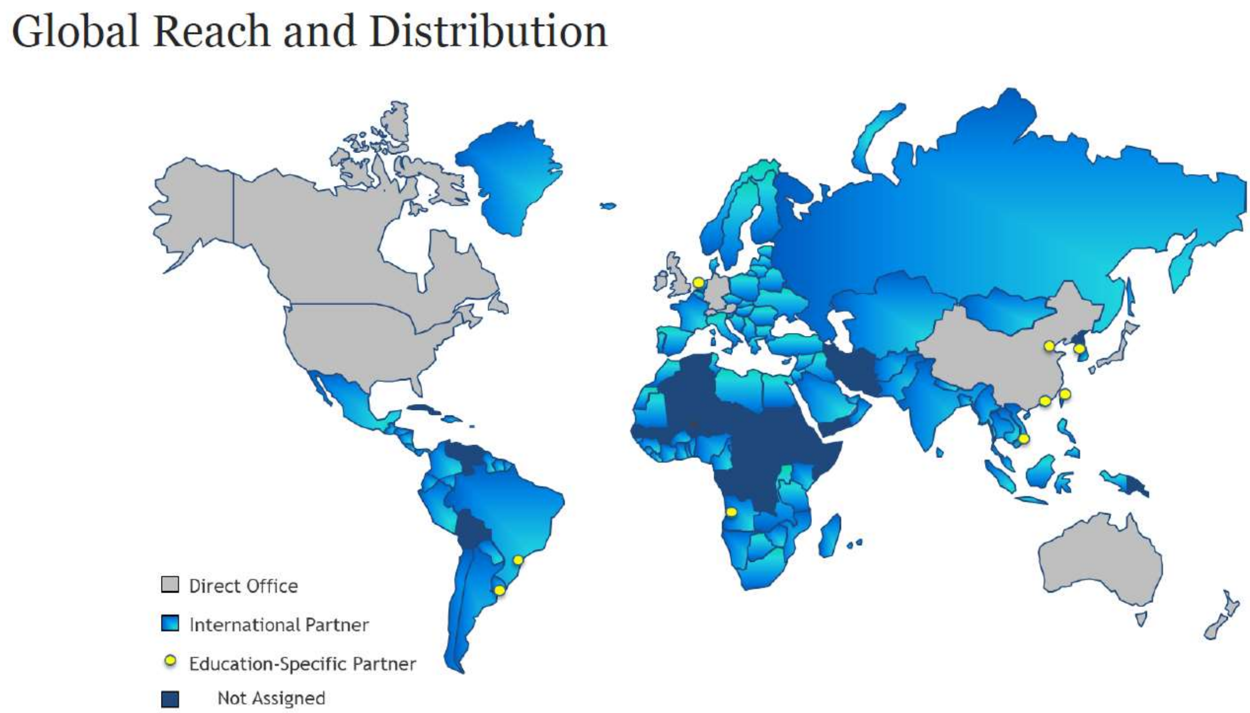
As can be seen on the chart, the AAP add-on attachment rate has fluctuated around 50 % on average. This means that for every $1 of AAP revenue FC receives, they normally earn $0,5 of add-on services. The attachment rate has stayed quite stable around 50-60 % for most quarters, but it dropped to 28 % during Covid. This was not demand-driven but supply-driven, as AAP holders with scheduled on-site training services needed to rebook those as online programs during Covid lockdowns. When passholders that had previously favored on-site training gradually shifted to online delivery the add-on attachment rate picked up again during the last few quarter.

How should one value AAP? In today's environment, we are seeing heavily loss-making SaaS companies with so-so unit economics trading at 10, 15 and even 20x sales multiples. In our view AAP should demand a double-digit P/S multiple due to high organic growth, good unit economics, high gross margins (+90 %), and even more important: It's already cash flow positive and can self-fund the +20% YoY growth. While we think AAP deserves to trade at a double-digit P/S ratio, we are settling with 8x so far as the segment is still quite new (founded in 2015).

The AAP add-on sales we view as sticky revenue attached to the actual AAP sales. As the revenue is lower gross margin revenue (we estimate 50-60 %) we use a 4x multiple on this revenue.

International licensee

Franklin Covey is running their business through direct offices in the USA/Canada, UK, Germany, Austria, Australia, China, and Japan. In the rest of the countries, they have assigned a local licensee partner to run the business. The reported AAP revenue in this report is only the AAP from direct offices.



The licensee partner agreements can be viewed like typical franchise agreements. The licensee partners effectually pay a royalty of around 15 % of their revenue to FC for the usage of the FC brand and content etc. The individual licensee partners are responsible for hiring and training salespeople, localizing the content (and to some extent translating it to different languages). In many cases, the local licensee partner is kind of the national "performance guru" in the individual countries with knowledge of the content and that is in charge of training and consulting around the content.

The licensee network is still early in its AAP transformation. Most of the business is still coming from legacy on-site facilitator courses. Those international licensees were therefore also much harder hit when Covid came as they couldn't rely on a big subscription business. Also, in some of those countries the national lockdowns were harder than in the US, and local government support to businesses much lower (or non-existing). FC management is working actively with the licensee network to leverage the Covid-lockdowns as an opportunity to build their AAP business. As the licensee network becomes more AAP weighted, the royalty payments to FC will also look more like their own AAP business i.e., high margin, growing recurring revenue.

Marco, just to add to that. In many of these countries, our local license partners, and we don't -- licenses happens to be the legal way we do business. We view them as -- really as pullout partners. They really have tremendous stature in their countries. These are people who are well-known in this learning and development space. They may have been senior leaders in organizations and just have a passion for this. And as a consequence, in many of these countries, they are really looked to as the person, the company or their organization where the individual is the one who's asked to speak on issues relating to leadership, who's interviewed on television, if there's a leadership issue in the country, whatever.[30]

As with most franchise-like business models, the royalty stream from the licensee partners is high margin revenue for FC. The only real cost FC has is a support staff that works with the licensee partners and help them grow their business. The typical licensee agreement is a 3–10-year agreement with contracted yearly minimum payments and annual growth targets they need to hit (it's our understanding that FC in many cases waived those minimum payments during Covid or moved down the baseline payments from where they need to grow from). FC wants their licensee partners to be successful and is incentivized to help them become so.

International Licensees Segment

In countries or foreign locations where we do not have a directly owned office, our training and consulting services are delivered through independent licensees. The following comparative information is for our international licensee operations for the periods indicated (in thousands):

	Year Ended August 31, 2020	% of Sales	Year Ended August 31, 2019	% of Sales	Change
Sales	$8,451	100.0	$12,896	100.0	$(4,445)
Cost of sales	1,772	21.0	2,665	20.7	(893)
Gross profit	6,679	79.0	10,231	79.3	(3,552)
SG&A expenses	4,273	50.6	4,159	32.3	114
Adjusted EBITDA	$2,406	28.4	$ 6,072	47.0	$(3,666)

Before Covid, the licensee segment was a 50 % EBITDA margin business. We do not doubt that this will be the case again coming out of the lockdowns. Especially when the licensee partners start to grow their AAP business.

While many "franchise" companies trade at a really high P/S ratio of 10-15-25x this is normally justified because of the high margins those revenue streams have.

We think it's fair to value the international licensee segment at 10 x revenue (or around 20 x cash flow) as we think it will be a durable cash flow stream with good structural growth behind it.

[30] FC Q1 2020 conference call

Education

The education division of Franklin Covey is the one we currently are having the hardest time judging. Within the education segment, FC has a high-margin, high-growth subscription business called "leader-in-me" that is based on the book with the same name. On top of this, the licensee network that is education-related also pays a royalty to the education division of FC.

On the other hand, the segment has seen declining or stagnant revenue for the last few years and has been loss-making. FC has invested for higher growth and has not seen enough productivity out of their salesforce investments here. They have, however, done some restructurings lately that should improve efficiency.

The reason behind this is that they sell to schools and districts. And if they can't get funding, the cost has to be carried by the school budget. As most people in the US know, school budgets are quite tight these days. The hard part is that the upfront investment to implement Leader In Me is high. On the other hand, this makes it quite sticky afterward.

Former Director of Higher Education at FranklinCovey

The investment is based on really the number of adults in the building and then the number of students in the building. The program starts with engaging the adults first. It's transforming them before they touch the kids. And so the adults meaning faculty stuff administrators, goes through pretty extensive training on Franklin Covey's operating system which is based on The 7 Habits of Highly Effective People, by Doctor Stephen Covey. They're trained in the content, they learn how to implement it and they're given guidance about how to integrate it ubiquitously across the school. So that it's not a training program, it's cultural transformation. And so it takes - if the average school was 500 students with 50 faulty stuff administrators I'm making up this numbers. The average implementation which is front loaded because all the training and coaching and implementation happens the first two years, is about $70,000 to get it going. The school had to have skin in the game, otherwise they don't value and treat it - they treat it differently. So they're paying between $7,500 and $10,000 a year as a membership package ongoing each year. It gives them access to ongoing coaching, the online resources intellectual property rise to the content and so forth.[31]

[31] Tegus transcript

FC was "lucky" that in the first several years they could rely mostly on grants for the upfront costs to schools. Leader.org has been instrumental in helping schools pay for the upfront cost of implementing leader in me.

[Grants | (leader.org)]

OUR MISSION IS TO HELP YOU WITH YOURS.

Leader.org offers grants to public schools that have a strong interest and commitment toward long-term implementation of **The Leader In Me**—a whole-school transformation process based on Stephen R. Covey's *The 7 Habits of Highly Effective People.*

GRANT APPLICATIONS – BY INVITATION ONLY.

We are currently accepting grant applications by invitation only.
If you are interested in learning if you meet our grant qualification criteria,
please contact your local FranklinCovey representative.
For further inquiries, please feel free to contact us.

It is our understanding that leader.org had a huge donor in their first years from a wealthy person that loved the Franklin Covey content and wanted to help young people to get a better education. But we also understand that this big commitment ran out 2 years ago, so the total funding level today is lower. It is important for FC to have charities pay for the upfront cost as many schools are reluctant to commit such a big percentage of their budgets.

We think this is one of the reasons that adoption growth has slowed somewhat for Leader in Me. On the other hand, the renewal rate has stayed high during Covid as schools that have already implemented Leader in Me really don't want to leave. As the quote before stated, it's not just a product they buy, it's a cultural transformation within the school and a program everyone involved live by. It's not something that is just turned on or off.

We do think the education business has some valuable parts, but so far, we are not willing to put a high multiple on it as we need to see steady progress and a higher growth rate in the subscription base. For now, we will use a 3x multiple for the education business, but if they can show a consistent double-digit growth with positive cash flow, we do see an upside to that multiple later on.

Legacy

The remaining part of FC is the legacy business. They also have a line called "other" that includes some book sales, material sales, rent income etc. that I have bundled together with the legacy business here as I don't want to assign a high valuation to that business.

Most of the business coming out of China and Japan is also still reported in the legacy line. This is because those two countries are still early in their AAP transformation and have just recently started to sell AAP. This was also the reason why those countries were hit the hardest by Covid lockdowns and work from home.

It's still our belief that we should see continuing revenue declines from the legacy business (although FY22 could see higher revenue due to covid-reversal). We don't believe it will go to 0 as some customers don't want the AAP but would rather pay for services as they go. Some of the other line items, like book sales, etc., will probably also live on.

We think FC is doing a good job getting margins and cash flow out of this segment but it's not a business line we feel particularly excited about. We only value it a 1x revenue.

Valuation

We value FC using 3 different valuation methods. A revenue multiple, an FCF model, and a DCF based approach.

Incremental margins

An important part to understand about FC is the incremental margins the business has on incremental revenue. As we said before in this report, the company is paying its salesforce (with everything included) roughly 20 % to sign 80 % gross margin revenue. This is why the business is seeing 50-60 % incremental EBITDA flowthrough and why we think the EBITDA margin long term will climb towards 25-30 % (before SBC).

Incremental revenue	6.710	5.295	5.897	3.809	5.545	347	4.784	3.389	(18.901)	(16.171)	(10.289)
Incremental EBITDA	3.378	122	3.699	2.411	3.065	2.047	1.792	3.092	(6.713)	(4.494)	(1.245)
Flow-through	50,3%	2,3%	62,7%	63,3%	55,3%	589,9%	37,5%	91,2%	35,5%	27,8%	12,1%

This topic was also something management was asked about in the last earnings call:

> ***Trevor Romeo*** *Okay. Understood. And then just, I guess, a follow-up on the cost side. The margins in the quarter were pretty solid despite the revenue decline year-over-year. You pointed out a number of expenses that were reduced, some of which I'd assume are probably temporary, some of which you said were already in the plan prior to COVID. I just wanted to ask how quickly you'd see or you'd expect to see, I guess, some of those expenses come back online to the extent some of them are temporary. And how much -- or if you see any of those as permanent savings going forward.*
>
> ***Robert Whitman*** *Thanks. Great question. I'd say the majority of these, we think, will be permanent. Here is the reason. We, every year, have been pushing -- we have this goal that Steve spoke about that is to get to an EBITDA margin of 20%. And so every year, we -- well, we don't expect to get there in a year. Every year, we take on projects. And this year, we redid a lot of our IT infrastructure, some supply chain infrastructure. We redid part of our innovation alignment and technology groups. We've challenged, as part of the normal business planning process in February and March, a lot of those costs and millions have been taken out of that, $1.5 million in education, just in permanent cost structure. The part that will come back is that around 10% of our commission -- I mean, the commission expense, let's say, is 15%. About 10% of it is truly variable, the rest being draws and so forth*[32]

As we see AAP continue to grow and the company being able to leverage the cost, we think we will see really high EBITDA growth going forward. Remember the international licensee business is 50-60 % EBITDA margin so for that business just to return to pre-covid levels will give the overall business a solid margin boost.

[32] FC Q4 2020 conference call

P/S multiple

The most typical metric for valuing a subscription business is a P/S multiple. How high the multiple should be dependent on a lot of factors, but most important are the unit economics, retention, growth rate, TAM, etc.
In general, lower quality, higher churn companies can trade at 2-5x revenue, medium to good companies at 5-15x, and the truly exceptional ones at 15+ (although we would argue that some low-quality companies in today's market trade at those multiples). As we said before, we think AAP is a fairly good business and consider an 8-10x multiple to be fair.

	2021	2022	2023	2024
AAP subscription	74	88	106	120
AAP add-on	37	44	53	60
Licensee royalty	12	15	18	20
Education	38	42	45	50
Legacy	67	73	71	75
Total revenue	**228**	**262**	**293**	**325**
EBITDA	**22,4**	**33,7**	**50,1**	**65,9**
EBITDA margin	9,8%	12,9%	17,1%	20,3%
AAP (8x)	592	704	848	960
AAP add-on (4x)	148	176	212	240
License royalty (10x)	120	150	180	200
Euducation (3x)	114	126	135	150
Legacy (1x)	67	73	71	75
Total valuation	**1.041**	**1.229**	**1.446**	**1.625**
Net Cash	20	45	83	135
Net valuation	**1.061**	**1.274**	**1.529**	**1.760**
Shares out	13,9	13,9	13,9	13,9
Per share	**76,3**	**91,6**	**110,0**	**126,6**
Upside to current price	**205%**	**267%**	**340%**	**406%**

Above we have calculated the per-share fair value of FC using the individual segments together. We then calculate a fair value of around $76 per share based on FY2021 numbers (ending august 2021) with further upside in the coming years. That $76 would pose an upside of around 205 % to the current price.

FCF multiple

Another method is to use an FCF multiple. Even though it's not a cash expense, we deduct stock-based compensation to get a more proper figure.

	2021	2022	2023	2024
EBITDA	22,4	33,7	50,1	65,9
Capex	-7,5	-8	-8,4	-8,8
Deferred revenue chance	10	10	10	10
Lease payments	-3	-3	-3	-3
Tax payments	-1	-2	-3	-5
Stock-based comp.	-5	-6	-7	-8
Free Cash flow	**15,9**	**24,7**	**38,7**	**51,1**
Free cash flow growth		**55%**	**57%**	**32%**
Fair FCF multiple	50	40	30	25
Per share valuation	**58,6**	**74,3**	**89,5**	**101,6**
Upside to current prive	**135%**	**197%**	**258%**	**306%**

We use a fairly high FCF multiple in the first years as we expect high FCF growth that justify the valuation, but move the multiple down as the margin goes up. The management team also seem to think they can deliver high EBITDA and cash flow growth and become a +$1 billion company.

> *These targets reflect our expectation that we will achieve at least high single-digit revenue growth each year, growth that's approximately $20 million per year revenue growth. Then on average, approximately 50% of that amount of growth in revenue will flow through to increases in adjusted EBITDA and cash flow, reflecting our high gross margin -- strong gross margins and variable selling costs. We fully expect to achieve an adjusted EBITDA to sales margin of 20% in the coming years and really to become a $1 billion market cap company in the coming years, even at an adjusted EBITDA multiple that's conservative relative to our adjusted EBITDA growth rate and without relying on multiples of revenue, which we should increasingly be able to garner. And then -- but we expect to continue to generate cash flow that's really equivalent more or less to the EBITDA.*[33]

We have also used a DCF based approach that yields a 70-90 $ outcome depending on the kind of input I use and the cost of capital. With this in mind, we believe the stock could trade up to a fair value of around **$80** in the coming 12-18 months.

[33] CEO Bob Whitman Q1 2021 conference call