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Franklin Covey: A Compelling High-Return, Low-Risk Pitch… And I'm Swinging For The Fences

Some investors are attracted to extreme complexity and "exciting" but unpredictable situations – for example, whether a company is an accounting fraud or gaming LIFO for profit. Whether or not an obviously scummy business is actually, under the technical letter of the law, an illegal pyramid scheme. Whether a drug company will be able to outsmart PBMs and raise prices infinitely. Whether one company's ADAS chip is better than another's. Whether the government did or did not literally steal a corporation from shareholders and whether a judge will overturn it even if they did.

Me, I'm not smart enough to figure that stuff out. I like boring, simple things - I'd rather swing at an easy pitch in the minor leagues nobody's paying attention to.

Sadly, ego (and the allure of management fees on billions in AUM) causes most managers who start with this strategy to forget their roots and scale up so big that they can no longer invest in what made them successful to start with. This dynamic makes it perennially profitable to identify underfollowed, illiquid small-caps that large funds can't or won't look at. Often, you don't even have to conduct exhaustive, earth-moving primary research – you just have to be paying attention.

It's within this backdrop that I think Utah-based performance improvement / corporate training company **Franklin Covey** (FC) is an absurdly easy pitch at the current stock price below $15, and have expressed that conviction by swinging hard with a double-digit allocation. Franklin Covey owns durable intellectual property that will never go out of style because it's based on something that doesn't change: fundamental human nature. (If you've ever read late founder Stephen Covey's bestseller *The 7 Habits Of Highly Effective People*, you'll have a good idea of how effective their processes are.) With their new product offering having a per-user cost under $200, their curriculum wouldn't even have to be as good as it is to justify the sale on an ROI basis.

On conservative assumptions, I believe shares will be worth north of $25 three years from today (for 20%+ annualized returns). Larger funds should stop reading here, as it's too small and illiquid to be worth your time – but for PAs, or those of us with more modest AUM who don't have those constraints, it's a fantastic opportunity.

The Market Can't Do Math

When they reported on 6/30, Franklin Covey "lowered" their annual guidance from an original range of $34 - $36 million in Adjusted EBITDA (constant currency) to a new range of $31 - $36 million (also constant currency). On top of a 7.5% reported decline in revenue in the quarter as reported, it's easy to look at the headline numbers and assume the business is struggling – hence the selloff.

Here's the deal, though – Franklin Covey is actually either meeting or potentially even beating their original guidance. How's that?

Earlier this year, Franklin Covey announced a new go-to-market approach called "All Access Pass." To somewhat oversimplify, previously, most clients purchased their content in the form of individual courses – sales performance, customer loyalty, leadership, trust, execution, and so on. All Access Pass changes the game – think of it like a Six Flags season pass. Buy one, get the rest free (via a digital portal). Visit as often as you like, ride all the rides at no extra cost. The business model is largely similar: Franklin Covey has already developed the intellectual property and their incremental gross margin is very high, so why not amortize fixed costs with incremental users who you can profitably upsell?

As I'll discuss in the next section, this business model represents a fantastic value proposition for Franklin Covey clients and is likely to drive substantial value for Franklin Covey shareholders. However, for now, let's focus on the more immediate impact to the reported financials.

Historically, Franklin Covey's sales have been reported substantially as-recognized. Since All Access is a subscription rather than a product sale, it results in a 60/40 split between up-front "license" revenue and deferred revenue that is recognized over the course of the subscription.

More details are available in the company's investor deck here, but the summary is this: while Franklin Covey has lowered their Adjusted EBITDA guidance in constant-currency, as-reported terms, they noted that they expect to exit the year with $5 million (and potentially more) of deferred revenue on their balance sheet. This revenue flows through at a very high gross margin; I believe EBITDA conversion should be 85% but will use 80% for the sake of argument.

So, a couple things here. The first is that from a cash flow perspective, nothing's actually changed – this is purely an accounting issue. The second is that if you add the EBITDA earned but not recognized (stuck in deferred revenue) to even the low end of management's new guidance, you get to ~$35 million – i.e., $31 million guided plus ($5MM deferred revenue x 80% EBITDA margin) = $4 million = $35 total.

This is an overly conservative treatment, as management clarified that the only difference between them achieving $34 million in (constant-currency) EBITDA and $31 million would be increased All Access Pass sales and the consequent deferral of revenue (and EBITDA) into future periods. In other words, this creates a strange dynamic where *more* traction with an exciting new product (i.e. improving business fundamentals) results in *worse* reported financials. If management came in at the low end of the guided range, it would correlate to a higher balance of deferred revenue, such that *actual earned* constant-currency EBITDA should approximate $34 million to $38 million (up from a previous range of $34 - $36 million). In other words, the market determined the business was worth 10% less today than it was yesterday… because they're going to be earning the same (or more) than they originally estimated for this year, with accelerated momentum going into next year.

From a valuation perspective, I choose to treat their headquarters lease as an operating lease (which really isn't the right way to look at it, but is the most conservative). Subtracting stock based comp, currency impact, and this lease, you get to "true" EBITDA of ~$26.5 million. Assuming a $14 stock price, that puts the current EV/EBITDA around 7.5x – which is a bargain multiple for a relatively high-quality business that converts well to FCF. (Normalized FCF should be around $13 - $14 million at current EBITDA levels, implying a P/FCF of ~14x for a business that has a functionally leverage-neutral balance sheet.)

Explaining All Access

Now that we're done with the boring quant work, we can get to the fun stuff: the business model. For the sake of clarity, please note that I'm not really going to go into all of their individual channels (licensees, facilitators, direct office, strategic markets) but rather talk from a high level about how the go-to-market is evolving.

To my knowledge, Franklin Covey has historically been relatively well-regarded by its clients, but they have primarily sold (and competed against) point solutions for individual types of training. When a Franklin Covey salesperson would meet with a corporate Chief Learning Officer or other relevant member of HR, they would attempt to determine which course best met the needs of that company's employees at that point in time – and sell that course. There was nothing explicitly wrong with this solution, but it leaves gaps – sometimes employers won't know exactly what their employees need, and in fact their employees may benefit from a variety of coursework.

Enter All-Access, in which for the price of one, clients now have access to most Franklin Covey content (certain categories are reserved for premium tiers). The logic is as follows: Franklin Covey has already spent plenty of money developing content, and their incremental margins are very high (>60% company-wide gross margin, 25 – 30% incremental EBITDA margin on each additional dollar of revenue). Just as looking at per-caps isn't a particularly helpful way to gauge Six Flags or Cedar Fair's business, looking at Franklin Covey's revenue-per-course is not the right way to evaluate its business. Like any business with largely fixed costs, if they can "put more volume through the box," it becomes quite profitable. All Access is a model that few competitors can replicate, as the highly fragmented corporate training market is dominated by point solutions and most companies are pretty good at one offering (but not at many), whereas Franklin Covey has world-class content in multiple verticals (and is always developing / looking around for more.)

Analysts initially expressed some concern about cannibalization – i.e., what if a client was paying for two courses per user and will now only pay for one? – but the dynamics of corporate training budgets mean that's basically a corner case. Admittedly recent revenue results are rather weak, but I pressed management on this on the call (and in a subsequent offline conversation), and felt satisfied by their answers.

On the other hand, All Access actually represents an opportunity to drive substantial incremental revenues (at high margins) through new users. The value proposition to clients is pretty clear – it's now much easier to justify a subscription even when you're not sure exactly what your employees need, but you know the need something – so without explicitly lowering its prices or harming its revenue, Franklin Covey has substantially improved its (already-robust) value proposition to clients.

To this end, initial indications are that All Access is driving a material uplift in same-client purchase activity. For example, CEO Bob Whitman noted on the 6/30 call that:

> *139 Pass holders who were active facilitator clients in FY15, buying training materials from us, are now All Access Pass holders as of the end of May. In the full FY15, these particular 139 clients spent $3.7 million for the whole year, a median of $17,700 per client, based primarily on facilitator materials.*
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> *These same clients who are now All Access Pass holders have already spent $5.2 million this year, year to date, through the third quarter, a median spend of $25,250. And most of them just became Pass holders recently -- relatively recently.*

Whitman further explained that the All Access value proposition is also leading lapsed historical clients to re-engage with the business:

> *… among our existing Pass holders, half -- almost half have come from new categories that we wouldn't normally -- we'd hoped for, but wouldn't normally know that we'd get. We have certain facilitator organizations that really had bought things from us, but didn't see a strategic path anymore. And 13% of our buyers said, wow, with this, I'd like to re-engage.*
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> *We have 18% coming from new clients, even though our marketing has not primarily been focused there, just people who are -- organizations who have been assigned to client partners, but perhaps they've never even met with, now are raising their hands saying, wow, if we can engage that way, that would be a great thing to do. And then even on-site clients, we call them people, who hire us only to deliver a class or two each year, because they're not fully committed to a rollout, with the All Access Pass providing a way where they can access the content, they're now saying, wait, I'll keep doing more on-site days in the areas where I'm doing those, but I'd really like to add this on.*

There are other ways in which Franklin Covey believes All Access will lead to revenue uplift, although it's hard to quantify given the early stage of the rollout. The recent call transcript and previous commentary from management (as well as the recent slide deck) includes more details. Suffice it to say that the increased traction (relative to their own expectations) suggests that they will indeed see a benefit from this.

Management's internal growth target is high-single-digits to ~10%, but I view this as more of a stretch goal for the long term than a base case model (although it could well be achieved over the next few years if All Access traction continues to be strong). It's not so much that I disbelieve that management can achieve this in good years, but rather, you'll always run into existential factors (currency, the loss of a government contract, and so on) that will depress the long-term CAGR. Just as it's important not to get too excited by a few years of robust growth, it's important to not get too pessimistic after a few years that have fallen short (when the business appears stronger than ever from a fundamental perspective).

My personal base case forecast is as follows:

- 5 – 6% annual revenue growth for the next three years
- Incremental revenue flows through at 25 – 30% Adjusted EBITDA margins
- Stock comp rises with Adjusted EBITDA
- Capex is 2% of revenue
- I treat the lease payment as operating rather than capital (which, from conversations with CFO Steve Young, appears to be the most conservative way to approach valuation)
- I assume 40% taxes and de minimis (<$1 million) interest from the recent term loan
- I assume all incremental free cash flow is directed to share repurchases at a price of $22 (vs. the current price of $14 – again, to be conservative). The company tendered for a large number of shares at $17.75 and recently took out a term loan for the express purpose of having more availability to repurchase shares. However, management is relatively debt-averse and views 1x net debt/EBIDA as a ceiling for leverage. The best of both worlds – aggressive repurchasers but shy borrowers!
- Management has noted that any prospective acquisitions would be relatively small (<10% of the size of their existing business) and they would be unwilling to pay >7x EBITDA (i.e., any deals, outside of perhaps some small technology purchases, would be substantially and immediately accretive.)

Assuming a terminal multiple of ~17x free cash flow – seemingly reasonable, if not cheap, for a business with mid-single-digit growth prospects and potential operating leverage over time – I arrive at a fair value per share of $25 or greater three years from today, good for 20%+ compounded returns with limited downside risk given the strong free cash flow yield and customer acceptance of the new product. Notably, if I assume 8% revenue growth for the next three years (with the same terminal multiple), value increases to nearly $30/share three years from today – implying close to 30% compounded returns.

Ultimately, in an expensive market, Franklin Covey is a rare stock that is both high-quality and cheap. I've spent quite a bit of time talking with management, as well as some time talking to the sales team, and feel comfortable that recent sluggish revenue growth is transitory and that All Access will be a home run. I would also note that this is one of the few public companies with a true "pay for performance" mentality; management's recent commentary around their bonuses being tied to original guidance and proxy/annual report commentary from last year around the currency issue are both a breath of fresh air in the wider pay-me-first-second-and-always corporate governance abyss. I first met CFO Steve Young on a NDR well over a year ago and management has seemed honest and forthright at every juncture since then.

Again, please note that liquidity is limited in the stock, and this idea is likely more usable for smaller funds or PAs. Some liquidity discount is perhaps appropriate (and management certainly seems more focused on value accretion via buybacks than increasing liquidity). However, I believe once the market recognizes just how good a story this is – management is non-promotional and severely, severely undersells the potential here – market interest (and trading volume) will pick up. Even if it doesn't, the prospective returns are more than sufficient for me to not mind having to pay a couple percentage points on the back end when I eventually want to blow out of the position.

Miscellaneous Notes

I approach security selection from the bottom up rather than the top down, but a few brief comments from a macro awareness perspective. The organizational development imperative (see pretty much every article on HBR, Deloitte University Press, etc), focus on productivity/efficiency in a low-growth world, and "free agent" employment model (leading to frequent turnover) seems to underpin the demand for corporate training. Overall, I don't see any existential macro factors that would endanger the future of Franklin Covey's business. (I am of course welcome to different perspectives.)

I don't believe Franklin Covey to be substantially more economically sensitive* than the average B2B services business, and believe that the transition from annual sales to a subscription will substantially improve retention (at least in the sense of not having to dedicate as much sales resources to re-selling, and repositioning that time for higher-touch consultative/solution-oriented work with clients.) Moreover, the current valuation multiple builds in a sufficient margin of safety; even if weak economic conditions offset the revenue growth I expect as a result of All Access, the stock should still compound at a double-digit rate from here.

The major risk I have been thinking about is content piracy, although a) this is a nonunique risk (one that plenty of other companies face), b) it is something FC has always faced (people could copy their DVDs or printed materials), c) developed-world corporations (most of FC's business) are substantially less likely to pirate than emerging-markets businesses or consumers, d) the interactive nature of the portal means pirates would not get full mileage out of the training, e) the per-user cost ($150 - $200 per participant, though it scales with volume) is not particularly high, and f) management is quite focused on this and in fact has not rolled out All Access in certain geographies until they build in more piracy protection with version 2.0 (coming next February). I welcome further discussion of other risks.

*If you look at a long-term revenue chart and notice the plunge, the company used to have a large business selling physical paper planners. This business died a sad death for the obvious reasons. To get a better perspective on the long-term history of the part of the business that's still around and relevant, it's necessary to go back through historical financials and focus on the consulting/training/content results.

Disclosure: I own shares of Franklin Covey (NYSE: FC) in both personal accounts and my fund and stand to personally benefit if the share price rises.

Disclaimer: This is an opinion piece presented for entertainment purposes only and nothing in this document should be construed as investment advice. The future is unpredictable and all projections are just guesses. All of my facts may be wrong and you should double-check them yourself. I disclaim any liability that may arise from you reading this. Etcetera.

Reminder: Franklin Covey is an illiquid stock, which makes it especially important to use limit orders when transacting in it.