Value Investing with Constructive Activism: Potbelly Corporation (PBPB)

At 180 Degree Capital Corp., we are Graham and Dodd value investors with a focus in the publicly traded micro-cap market. We augment our value approach by being activists, and we do so in a constructive and collegial manner. We look to work with our portfolio companies to identify the issues hampering the company's share price. We then seek to help unlock the potential for the company and its stock, and by doing so, we believe our efforts can help to maximize value for shareholders.

While this description seems straightforward, how does it get applied in the real world? We thought it might be helpful to go through one of our current holdings, Potbelly Corporation (PBPB), from the beginning of our process where we first identified it as a potential opportunity to now, where it has become one of our largest holdings.

Founded in 1997, PBPB is a restaurant chain that completed an initial public offering in 2013. The company initially came to our attention in the spring and summer of 2019 when it showed up on a screening tool that we use to identify potential new investments. At the time, the enterprise value had fallen to $80 million despite $300 million in revenues; and the stock was trading at 3.5x enterprise value to EBITDA.

Once a company shows up on one of our screens, it is just the beginning of our process for evaluating investment opportunities; we require a full analysis of the business before we would ever add it to our portfolio. In the case of PBPB, this scrutiny initially took the form of six months of due diligence on the company. We had numerous conversations with the management of the company in order to ascertain their vision for the future. We spoke with private equity investors that specialize in the restaurant industry to understand their views on the restaurant industry in general and PBPB specifically. We interviewed shop owners, franchise owners and other professionals, including the former CEO of PBPB, to gain insights from individuals with operating experience in the restaurant space.

These conversations coupled with the continued attractiveness of the valuation of the stock led us to expand our conversations to include speaking with members of PBPB's Board of Directors; of particular interest to us, were conversations with two Board members who were activists themselves and had taken on an active role as far back as 2017. These discussions provided further insight into the future of the business as well as the strategic direction of the Board. These members of PBPB's Board highlighted the significant changes in management and in the composition of the Board that had taken place since their initial involvement.

Following all of this diligence, we had become convinced in our belief that the franchise value of PBPB far exceeded its enterprise value at the time. We saw PBPB as a real brand, with a quality product, and with what we believed to be real untapped potential. At the same time, we viewed the current management team, led by a CEO with a marketing background rather than experience as a restaurant operator, as needing to be replaced. We were comfortable, however, that the Board had a good vision for the company and as a result, we initiated a position in October of 2019. We grew our position to over 5% of the outstanding voting stock of PBPB and filed a 13D in January 2020, that publicly announced our activist position in the company.

In late 2019 and early 2020, a third activist, who was not a Board member, began threatening a proxy contest unless further changes to the management team and the Board took place. Eventually PBPB and the activist settled their issues and two new members from the activist group were added to the Board. We had made it clear to the Board and management that we agreed with the views of this new activist.

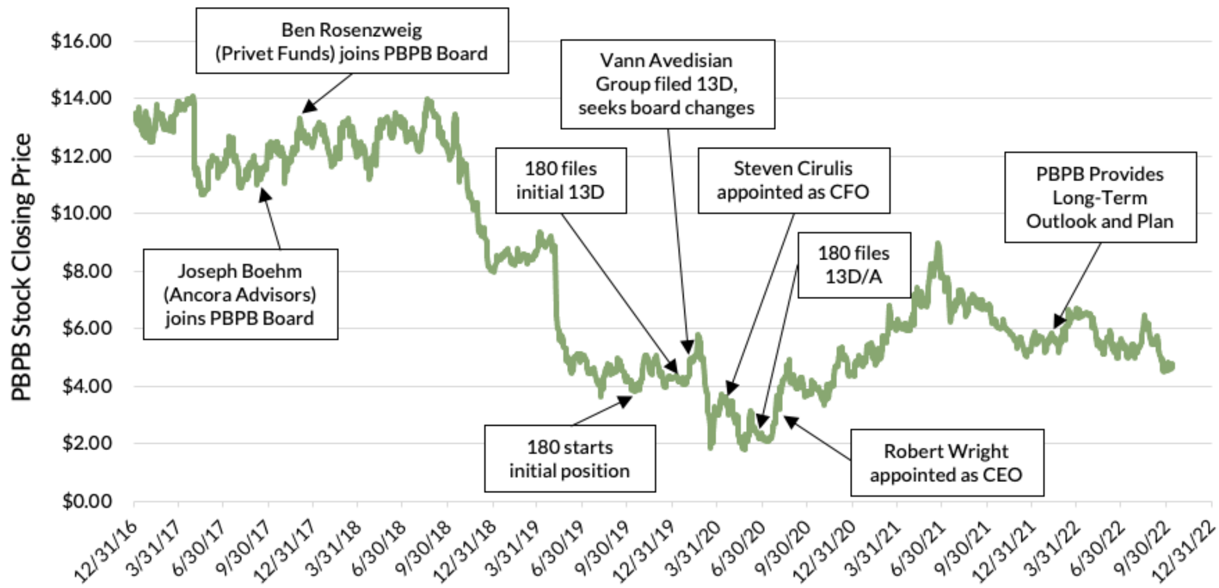
In March 2020, just before the start of the COVID-19 pandemic, we owned 1.42 million shares of PBPB, or approximately 6.0% of the company. Clearly, our timing was less than ideal as restaurants were particularly hard hit by the economic impacts of the COVID-19 pandemic. However, this is where our value approach helps us manage our downside risk, as, given our rigorous application of our Graham and Dodd Value approach, our cost basis for the business we were buying was at a deep discount to PBPB's intrinsic value. During the pandemic-related selloff, we were able to buy more of the company at even better prices as investors sold most of everything, especially restaurant stocks.

As PBPB and other companies continued to navigate through the pandemic, we took steps in June 2020 to fix what we saw as the largest issue holding the company back, i.e, poor management. We amended our 13D filing to explicitly ask for a change of the CEO of the company. Ultimately PBPB's Board agreed with our assessment and replaced the company's former CEO with Bob Wright, who was previously COO of Wendy's and is an experienced restaurant operator. The addition of Bob alongside PBPB's new CFO, Steve Cirulis, a former executive at Panera Bread, established the core of what has become a very strong, restaurant operations-focused management team.

The new team has proven to be as good as we could have hoped. Its initial focus was on getting PBPB's existing stores (90% company owned) to begin showing positive comparable same-store sales; the number-one metric for evaluating a restaurant business. While that may not seem to be a new or novel concept, for years, PBPB had neglected the operating performance at the individual store level and was more consumed with simply building new stores and raising prices. While focusing on fixing the current store base, the new management team also began developing a long-term franchising strategy to drive growth and operating income.

There have been many positive business developments over the past two years due to the efforts of the new management team, including a complete operational turnaround. Comparable same-store sales are at pre-pandemic highs, Average Unit Volumes (AUVs) are at historically record levels, and shop level profitability has been strongly enhanced. Further, on September 27, 2022, PBPB announced the signing of two multi-unit franchising development agreements. Management also reaffirmed its long-term potential for more than 2,000 total units, with approximately 85% as franchised shops. PBPB's management team is doing everything we had hoped they would with regards to enhancing the profitability of the business and setting the stage for significant franchise growth over the ensuing years.

After rising from a pandemic-low price per share of $1.50 in March 2020, PBPB's stock rallied to $9.00 in June 2021. The broader market in 2022 has experienced a significant sell off year-to date driven by inflation, rising interest rates, and the war in Ukraine. Through October 12, 2022, (the date we are writing this piece) the Russell Microcap Index is down 25.6%. Despite all of the headwinds effecting restaurants, PBPB was down 14.7% for the same period. We believe this outperformance to the index is largely due to PBPB's operating improvements since 2020 and its lower starting valuation than its peers. We are currently optimistic on the potential for the company to create value for shareholders moving forward. It is now our second largest holding, and we believe it has the potential to increase in value by 100-200% over the next one-to-three years.



Our process discussed in detail in this white paper helped us to uncover a stock that was trading at a price that we believe was deeply discounted to the company's intrinsic value. Our activism resulted in new management that has positioned the company to achieve strong results over the coming quarters. We currently believe that the public market will recognize these improvements through a material increase in PBPB's stock price, and if that occurs, it would be a significant contributor to growth in 180's net assets.

Note: The information discussed above is solely the opinion of 180 Degree Capital Corp. Any discussion of past performance is not an indication of future results. Investing in financial markets involves a substantial degree of risk. Investors must be able to withstand a total loss of their investment. The information herein is believed to be reliable and has been obtained from sources believed to be reliable, but no representation or warranty is made, expressed or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of the information and opinions.