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PROTECTING DIGITAL DATA

Millions Went Missing – This Company Jumped In
Activist Efforts Are Finally Leading to Change

Protecting Digital Data

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Activist Efforts Are Finally Leading to Change

Her bags were packed, and in her pocket she had a one-way ticket to Russia.

In June 1994, the Philippine National Bank (PNB) discovered it was missing $140,000. The funds had been transferred out of PNB through a payment network called the Citibank Cash Management System, which enabled Citibank's corporate customers to transfer money to any bank account in the world.

PNB managers could see that funds had left – but they couldn't track where the money had gone. It had seemingly vaporized after an unauthorized electronic transfer to an unknown location.

PNB contacted Citibank, and a team inside Citi began to investigate.

At the time, $500 billion a day flowed through this cash-management system run by massive computers at Citibank's New York headquarters at 111 Wall Street. If the system could be hacked and funds redirected so easily, a lot more money could be at risk.

And it was...

Citibank discovered that similar transfers had been made. Large amounts of cash, all from the bank's corporate customers such as PNB, were transferred to unknown accounts around the world – in Israel, Germany, Finland, Russia, the Netherlands, and the U.S.

The damage? $10.7 million.

Someone was using the evolving capabilities of the "worldwide web," as the internet was commonly called in its early days. Citibank didn't know who. Fearful of potentially terrible PR – a bank that loses cash isn't a good look – Citi wanted to keep things quiet.

A few months later, it got a break.

In August, a young woman named Ekaterina Korlokova walked into a Wells Fargo branch in San Francisco. She approached the teller and requested to withdraw some of the $199,000 in cash from accounts she owned with her husband, Evygeny.

Because it was a large amount of cash, the teller sought approval from her manager. The two looked into the account and learned that it had been frozen. The teller informed Ekaterina that she could not make the withdrawal.

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Flustered, Ekaterina hurried out of the bank and headed to her apartment. She packed her belongings, grabbed the one-way airline ticket to Russia that she had purchased in advance, and left for the airport.

Meanwhile, suspicious managers at Wells Fargo flagged the behavior of Ekaterina, a Russian national, to the FBI. Just as Ekaterina was heading out the door of her apartment for the last time – looking to join Yevgeny in the motherland – she was greeted by a phalanx of federal agents.

She was taken into custody, and before long provided the details of an international plan to rob banks electronically. One of the leaders of the operation, a Russian computer programmer named Vladimir Voronin, had recruited Ekaterina and her husband. Voronin illegally accessed the Citibank Cash Management System and hired people all over the world to open bank accounts into which funds were deposited, make cash withdrawals, and bring the cash back to Russia. Ekaterina led the FBI to Voronin, still in the U.S., where he was arrested.

It was a John le Carré thriller come to life.

Voronin talked as well. This led to cooperation between the FBI and Russian officials. The FBI traced 40 transactions totalling at least $10.7 million to a software company in St. Petersburg, Russia, called AO Saturn.

A young software programmer, Vladimir Levin, was identified as the person who orchestrated the entire scheme. From his laptop in St. Petersburg, in Russia, Levin had figured out a way to electronically break into Citibank's computers at 111 Wall Street. His technique evaded the bank’s then-rudimentary electronic security measures.

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Since Russia did not allow for extradition, in 1995, Levin was lured to London where he was arrested and sent to the U.S. (One blogger following this story noted, "he looks like a strange cross between Bill Gates and Stephen Hawking.")

In January 1998, Levin pleaded guilty, and served three years in a U.S. prison, paid a $240,000 fine, and vanished from sight.

And Citibank learned its lesson.

The banking giant overhauled its digital-security system. It began to use a credit-card-size device that, when linked with the bank's security system, displayed a six-digit numeric code. When a bank transfer was initiated, Citibank sent the six-digit code to the device. The banker in possession of the device input the six digits. In order to access the transfer system, this code needed to match that of Citibank's central computers.

This was the start of the cybersecurity and digital authentication industry.

The software company we recommend today provided these then-revolutionary devices to Citibank. Today, they play a critical role in the multibillion-dollar digital-documents and cybersecurity market that creates the hardware and software necessary to keep all of our online financial information protected and away from bad actors like the two Vladimirs – Levin and Voronin – and the Korlokovas.

Cybersecurity products will continue to see strong demand as banking migrates to digital platforms and valuable financial information lives in the cloud.

The company operates through two segments: Digital Agreements and Security Solutions. These divisions develop software and hardware allowing their customers to verify, authenticate, and store critical data.

Its corporate customers include 60 of the top 100 global banks, including Bank of America, Chase Bank, and HSBC. It works with big healthcare companies Oracle Cerner and McKesson. It also counts NASA, the U.S. Postal Service, and the U.S. Department of Agriculture as customers.

While the company has a stable customer base, and generated more than $200 million in annual revenue for the last decade, its stock price has been volatile. The Boston-based firm has slowly been transitioning from an "old school" technology company with products living on hard drives and CD-ROMs to more sophisticated versions of its security software operating in the cloud.

In fact, almost 30 years after it developed those small authentication devices displaying six digits, following the arrest of Ekaterina and others, those devices are still in use – but they are being converted to an online tool.

This slow transition to a tech-savvy company has distorted its accounting, created lumpiness in sales, and left investors confused. Adding to these challenges was a

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board and management team who did not communicate well nor have any sense of urgency to embrace the latest technology.

Seeing tremendous value in the organization, an aggressive (and very persistent) activist investor has been working patiently for more than five years to move things along. Progress has been made, and we believe revenue, earnings, and the stock price are ready to finally move higher.

The Activist Angle

The company we are recommending this month is OneSpan (Nasdaq: OSPN), a $370 million market capitalization technology business specializing in digital documents and cybersecurity. It generates about $235 million in annual revenue, down from a high of $253 million in 2019.

OneSpan has been the target of an activist since 2018 – and we believe steady progress is about to show up in the financials.

Legion Partners Asset Management ("Legion") first invested in OneSpan in April 2018. By 2020, the firm had acquired 2.3 million shares, giving it 5.6% ownership. Legion has consistently added to its holdings and as of December 2023 owned over 3 million shares, or a 7.9% stake, making it the largest institutional shareholder.

Legion's primary complaint is that OneSpan's transition from a 1990s software company to a cutting-edge subscription-based business has been a disaster. And while it has embraced the transition to the online digital world, it continues to embrace some old-school hardware products that are dying on the vine.

That said, OneSpan is a solid company with great products. It serves some of the biggest global companies including banks, insurance companies, and major departments of the U.S. federal government. And Legion is making progress. Over the past five years, Legion has focused on four goals to improve the value of OneSpan and drive shareholder returns.

1. Become a modern, software pure play
2. Improve financial disclosure
3. Overhaul the board and management with fresh faces experienced in cloud-based software solutions.

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4. Regularly review the company's strategic direction including a full sale

Despite the longevity of this campaign, we like the stock today as Legion's considerable efforts to extract shareholder value may finally be finding traction.

In our view, and that of Legion, the stock has only one way to go – up.

Let's get into the story.

Pens Are Out, Digital Signatures Are In…

If you've bought a car, house, or otherwise signed important documents recently, chances are you did not use pen and ink.

Instead, you likely signed all the required documents electronically – on your laptop or digital tablet (like an iPad). OneSpan develops the software that enables this digital signature, as well as the security software and services that protect the signed documents.

Known until recently as VASCO Data Security International, the company had humble beginnings as a small technology consulting firm in the 1980s. In 1991, it moved into early digital security with the purchase of ThumbScan, a manufacturer of early fingerprint scanning devices.

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The company went public in 1998, and changed its name to OneSpan in 2018.

Since then, computing has progressed from giant mainframes taking up entire rooms, to compact desktop computers, to handheld devices that fit easily into our pocket.

Importantly, the software powering these devices has gotten faster and more sophisticated. OneSpan has seen it all.

A Big Market – But That's Not the Story...

Digital-document capture and storage and identity authenticating are all big business. OneSpan and other sources estimate the e-signature and digital-document market at $20 billion, with growth of 30% a year.

But the story with OneSpan is only partially about the software it develops or the devices it sells – this aspect of the business is under control.

The more critical focus is how OneSpan is evolving from a software company that relies on dated technology to a modern firm that uses the latest digital advancements. Legion has been pushing management along this path for years. This is the corporate action providing an investment opportunity to us now.

In explaining this, let's look at a couple examples of how this bumpy transition has derailed profitability and confused investors.

Old Tech to New Tech

The way we consume and use software is always changing. We no longer go to a computer store and buy a glossy box containing a CD-ROM of software that we download to our hard drive.

Our PCs and laptops don't have disk drives anymore. We now download software that miraculously installs itself, and starts to work. Everything is online.

What has also changed is that we don't own software. We subscribe to it.

For a monthly fee, users get access to software applications like video games, Microsoft 365, and complex business programs running massive accounting or HR systems.

Today this is known as software as a service ("SaaS"). It's sold on a subscription basis and all sales and maintenance are handled in the cloud.

The accounting, and investment case, for old-school, 1990s software is different from the new, subscription-based businesses. Not only is it a technological leap from one to the other, but it's a leap in the business model – from changing customers from an upfront buyer of a software bundle, to a regular and ongoing monthly subscriber.

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OneSpan has been dragging its feet on this transition for years, which has added confusion to its financial results – and hurt the performance of its stock.

Perpetual Versus Recurring Revenue

Let's talk about accounting.

Old-school software sales are considered "perpetual." Though it's a one-time purchase, the customer buys the license to use the software in perpetuity. When the sale is made, the product is delivered to the customer and OneSpan recognizes the full amount of the sale on its income statement immediately.

This is different from a subscription-based software payment, which is considered "recurring revenue." Instead of buying software and owning it, a customer signs up for, say, a three-year subscription to OneSpan's software (or hardware). This locks in a consistent, often-monthly revenue stream for three years.

OneSpan does not recognize the full amount of this contract on day one, as it did when simply selling perpetual software. Generally Accepted Accounting Principles ("GAAP") require OneSpan to distribute the revenue over the life of the contract, as it receives the payments. This is called revenue recognition.

Sales of OneSpan's devices add a layer of complexity. These are primarily hardware items connected to software that confirm identity, secure bank transactions, and facilitate two-step authentication. They often look like credit cards or keychains with a window to display a digital code that resets periodically. This regularly-changing code confirms a user is who they say they are. When logging in to a network, the user needs to input the code shown on the device to authenticate identity. Below is an example of a OneSpan device.

Like perpetual-software sales, device sales hit the income statement as soon as they are sold. And like perpetual software itself, these devices are becoming extinct. The same functionality can work on a smartphone or computer. And that is a problem because OneSpan sells a lot of these devices, generating significant revenue every year.

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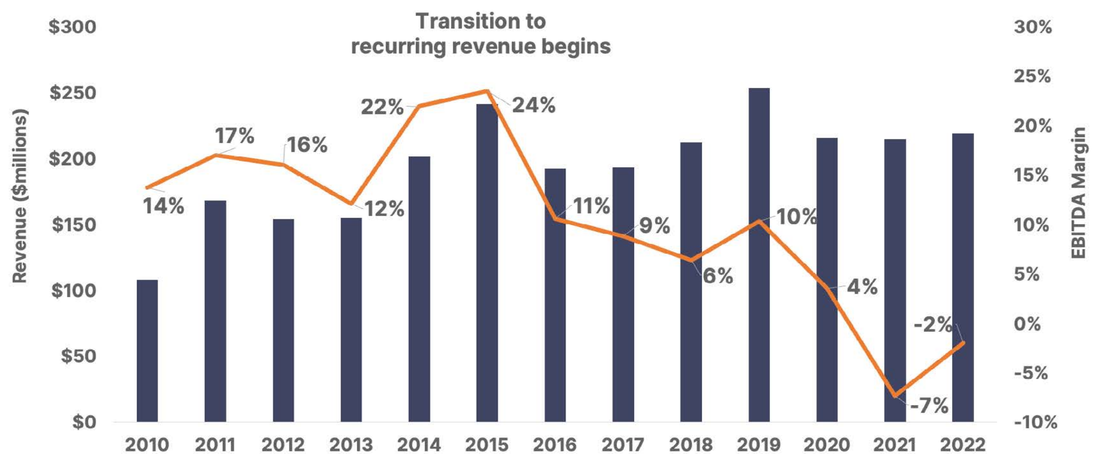
Having to record both recurring sales and perpetual sales makes revenue and earnings look lumpy and inconsistent. This raises questions from investors and drives concern.

The chart below illustrates OneSpan revenue and EBITDA margins from 2010 to 2022 – before improvements began to appear. This helps to tell the story of what happened over the years.



Source: Factset, company reports, Porter & Co. Research

Revenue more than doubled from 2010 to 2015 – from $108 million to $241 million. That is great for any business. However, profitability began to fall in 2015 – from a 24% EBITDA margin to negative 2% in 2022 – and it has yet to recover. In our view, the lumpy revenue and declining EBITDA margin were directly related to management's poor execution of this transition.

Let's look at what was happening at OneSpan from 2014 to 2016 as an example.

Revenue was $202 million in 2014. That was double the revenue number from just four years prior. Revenue grew again in 2015 to $241 million... almost 20% higher than 2014.

However, a couple things were happening.

First, perpetual revenue began to transition to subscription revenue. Rather than being recognized all at once, revenue was now hitting the income statement over time. This can make revenue look weak as revenue recognition is extended throughout the year.

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Second, the company sold $70 million of devices to a customer – this sale was recognized all at once. So, while recurring software revenue was delayed in hitting the income statement, the device revenue added a lump-sum amount. This made 2015 look fantastic… and the stock soared.

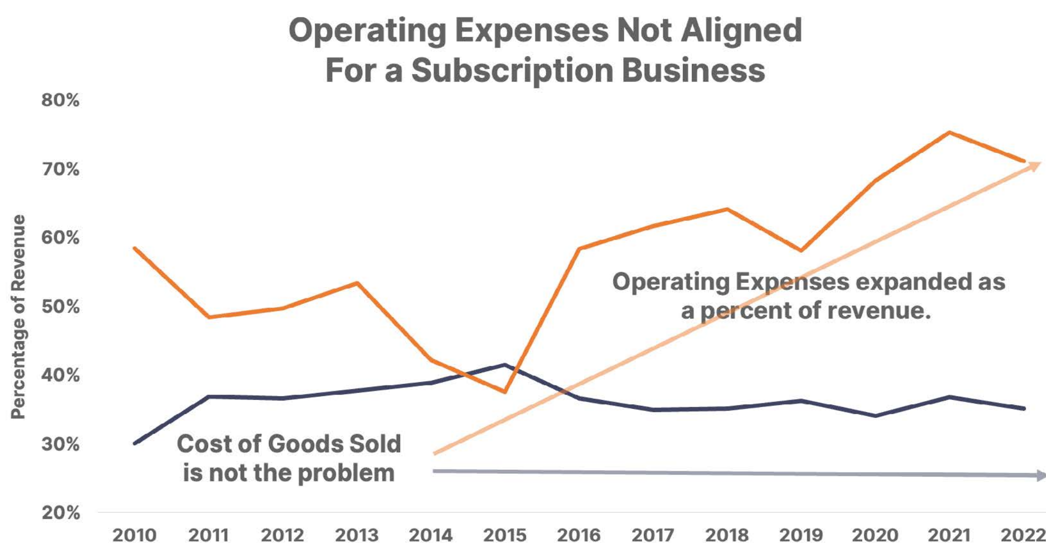
However, in 2016, software revenue continued to transition from perpetual to subscription but there was no large device sale to match the previous year's revenue. As such, revenue fell – from $240 million to about $200 million, leading to a drop in profit margins from 24% to 11%.

Beginning the Bloat…

Moving from perpetual to recurring-revenue accounting also requires managing the business differently – specifically regarding operating costs. We believe management failed to adjust its operating expenses for its new subscription-based business.

For example, OneSpan no longer needs employees that physically travel to customer locations to install, update, and troubleshoot software installations. All of this is handled remotely through the internet.

The chart below illustrates two expense measures: Cost of Goods Sold ("COGS") and Selling, General, and Administrative expenses ("SG&A") as a percentage of total revenue. COGS includes all direct expenses to produce a sold item. SG&A are all the operating expenses that go along with selling and administering the product.



Source: FactSet, Porter & Co. estimates.

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We can easily see that COGS is not the problem, as it remains mostly flat over the entire period shown above. OneSpan was managing the production of its software products effectively.

However, SG&A started to rise in 2015 when the revenue-recognition changes were beginning to kick in. This increase continued through the end of the decade. While revenue was transitioning to a subscription basis, operating costs remained bloated like a software company from the 1990s.

All This Played Out on the Stock Price…

The accounting worked well for the company in 2014 and part of 2015. However, investor confusion led to a drop in the stock price in the second half of 2015 and into 2016.

Source: Factset, Porter & Co. estimates.

The stock tripled from $10 in mid-2014 to more than $30 in mid-2015… but then got cut in half down to $15 as bloated SG&A expenses made the financials look terrible. Investors didn't know what was going on.

This erratic stock performance is based partially on investors not having a clear understanding of the company's transition from perpetual to recurring accounting.

Management and the board did not manage the revenue transition nor underlying operating costs well – nor did it clearly communicate this transition to shareholders.

For example, investors merely saw total revenue and profits declining into 2016. Lacking was an explanation of this changing revenue. If management had

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separated perpetual revenue, subscription revenue, and device revenue – and told investors about what was changing and why – it could have told a much better story.

This entire sequence of events is what, we believe, caught Legion's attention. The investor bought its first shares in 2018 and began a multi-year effort to resurrect the company.

OneSpan Joins the 21st Century

While it's now been six years, many meaningful changes have occurred that should prepare the company for the future.

We highlight two key improvements:

- New management and board refreshment
- A comprehensive strategic restructuring and review

Between the end of 2020 and today, a number of governance changes have been implemented.

This began with the "retirement" of T. Kendall Hunt – the company founder who stepped down after 23 years as board chair and CEO, presiding over some success but mostly mediocre performance.

What ultimately led to his departure from the company was a stock sale the day before OneSpan reported bad second quarter 2020 results.

As CEO, he sold 53,000 shares – a small 3% of his holdings at the time. The following day, the company reported mixed results and withdrew its financial guidance. The stock dropped 40%, from $31.20 to $18.84.

While no scandal was suggested, the timing of the sale certainly seemed questionable.

Legion called for his immediate resignation. The board soon announced that Hunt would retire at the end of the year… and Legion began to sense traction was being made.

They were right.

Between August 2020 and early 2024, several management changes were made. These included:

- September 2020 - The appointment of a new chief technology officer
- April 2021 - Both CEO and CFO resign and interims take over
- November 2021 - New CEO appointed
- January 2022 - New chief human resources officer joins

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- March 2022 - New chief marketing officer appointed
- May 2022 - New chief product officer appointed
- June 2022 - New general counsel appointed
- July 2022 - New chief information officer appointed
- September 2022 - New CFO and customer experience officer appointed
- November 2022 - New chief revenue officer joins
- January 2024 - The new CEO resigns, interim takes over

Legion also targeted changes on the board in early 2021. The investor called for the appointment of a slate of four executives with cloud-based software experience to replace four long-tenured members with no cloud-based recurring-revenue experience.

At the shareholder meeting in 2021, Legion successfully appointed two of its four recommendations while garnering the resignation of three of the four it targeted.

These moves proved successful as the company was about to make another big step aligned with Legion's outlook…

Strategic Review Established and Ongoing

In December 2021, the board approved a multi-year restructuring plan that is aligned with Legion's goals: these include improvements to the operating model, expense reductions, improved efficiency, and a renewed look at how the company spends its cash flow.

Specifically, we point to three items that made a difference:

First, the board and management reorganized the company into two operating segments providing better disclosure to the overall business. These new segments provided clear reporting on the different types of revenue growth as well as operating income for each. They are:

- **Digital Agreements ("DA"**) This segment includes all of the company's cloud-based digital-document products, such as ID verification, user authentication, and digital storage of documents. In 2023, this segment accounted for 22% of revenue.
- **Security Solutions ("SS")** This segment includes broad software and hardware solutions that are on-premise products and not cloud-based. In 2023, these products accounted for 78% of revenue.

The strategic review targets 2025 DA segment revenue growing to 35% to 40% of the total business, with SS falling to 60% to 65%. With this target mix of business, OneSpan expects gross margins above 70% and EBITDA margins at 10% to 12%.

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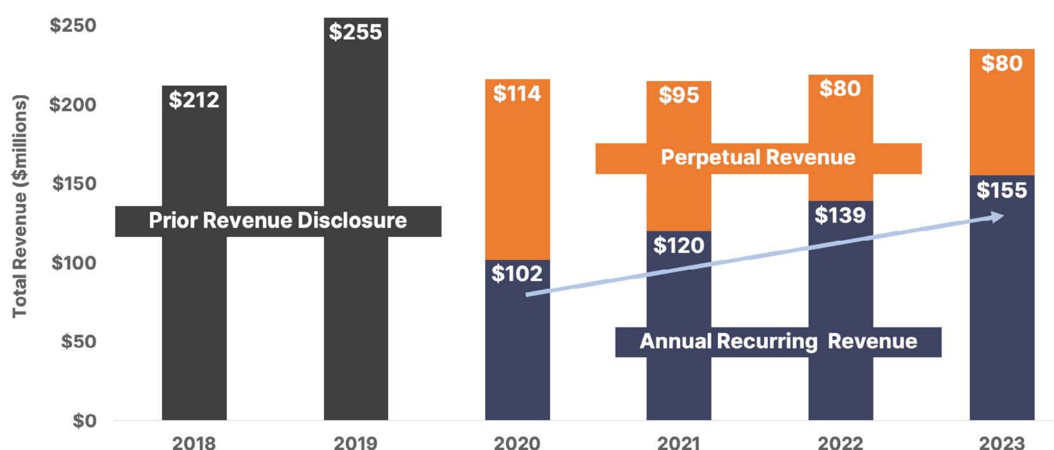
For comparison, these measured 63% and 7% in 2021, respectively, at the start of the corporate review.

DA is growing faster with higher margins than SS, which should be considered a steady-state, cash-cow segment. This is exactly the visibility into the business Legion was calling for in 2018. It allows the market to value the cloud-based subscription business higher than the lower-margin, device and perpetual software sales.

Second, the company started using a more appropriate revenue metric that is very common among SaaS software companies – Annual Recurring Revenue ("ARR"). Because subscription services receive regular monthly revenue, ARR measures expected annual revenue based on this. This gives investors deeper insight into revenue. It differentiates new recurring sales from declining perpetual sales. As ARR rises, investors will place greater value on it, versus legacy revenue sources.

In our view, not previously disclosing this important measure held back the company's valuation. Subscription-based ARR is more highly valued than old-school perpetual revenue given it is the future in all software. Technology investors want to see growing ARR as it smooths out revenue lumpiness and provides longer-term confidence in forecasts.

Along with the increased operating segment disclosure, ARR allows investors to easily see how ARR is growing (a good thing) and perpetual revenue is declining.



Third, the company reduced the number of employees to better align the business with its new operating and reporting segments.

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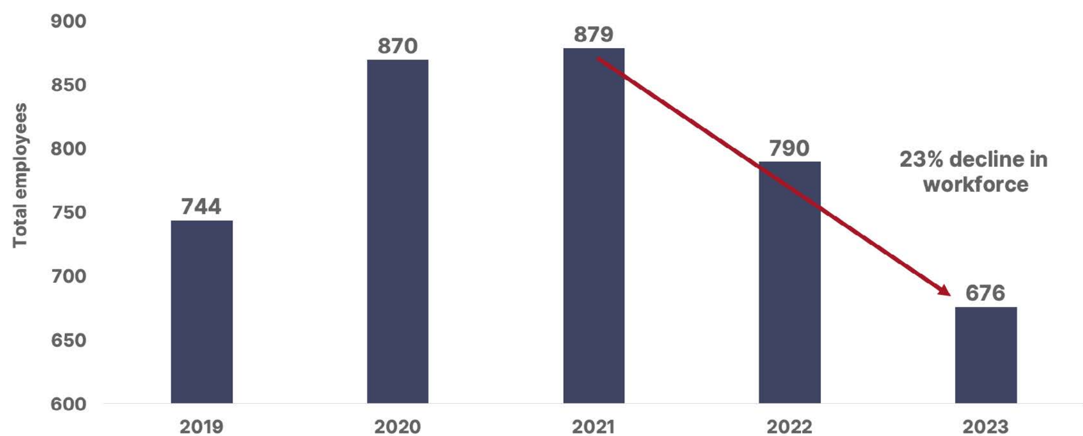
A software company focused on subscription, cloud-based products has very different labor needs than old-school software firms. Management has been slow to make these changes but progress has been made.

In total, the company eliminated over 200 full-time-equivalent positions between 2021 and 2023 – representing 23% of the total.



Despite this effort, we continue to see ample opportunity to cut costs. We believe this is a prominent area of the business where Legion is applying pressure.

For example, let's look at this another way.

Between 2020 and 2022, the company spent $465 million in total on operating expenses during the tenure of the prior CEO, who was growth focused. That is more than 70% of total sales. However, revenue only grew $19 million, or about 8% over three years.

It doesn't make sense for any management team, which says it is focused on growth, to spend so much for so little growth.

As a comparison, look at Docusign – a leading provider of electronic-signature services. During the same timeframe, 2020 to 2022, it spent $3.8 billion on operating expenses and more than doubled revenue, which rose 116%.

There is a lot of spending but not much to show for it. Something needs to change. The growth has not materialized. Therefore, costs need to be cut.

We believe there is a lot more cost cutting to do. This is a source of future earnings power, and we expect to hear more about this at the next earnings report on May 2

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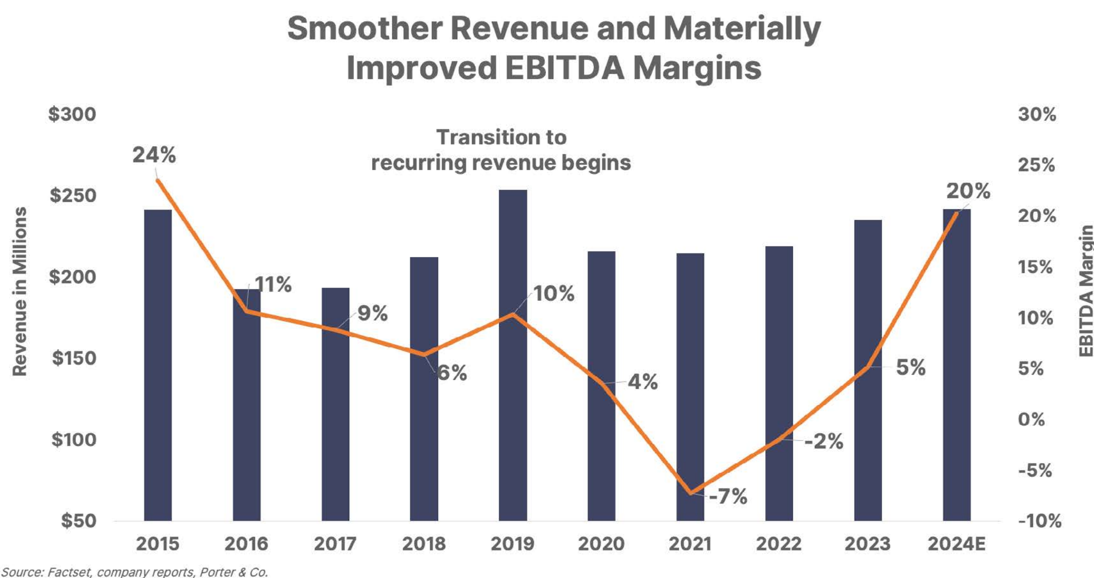
Financial Performance Is Turning the Corner...

Analysts have taken note of governance and operating changes that have been put in place. The chart below illustrates revenue and EBITDA expectations for 2024.



We would make two observations about this chart.

First, revenue has smoothed out since 2020 illustrating fewer inconsistencies and making results simpler to understand. In our view, this is directly related to a maturing level of ARR that investors can now see. Second, EBITDA margins are growing again. They improved significantly from 2021 to 2023 and are expected to jump in 2024.

Furthermore, on March 6, 2024, OneSpan reported financial results for the fourth quarter and full year 2023. Every measure followed by analysts exceeded the same measure in the previous quarter and previous year. In fact, EBITDA was three times higher than expectations.

The company also provided its expectations for 2024. Revenue and ARR are expected to rise modestly but EBITDA is expected to be four times higher than 2023 results – rising from $12 million in 2023 to $50 million in 2024. This would be a great result at half the forecasted amount.

Driving this profitability is success with expense control. SG&A expenses as a percent of revenue fell to 58.5% during Q4 2023.This compares to 69.3% in the fourth quarter of 2022. A significant drop that should continue to fall.

Given the financial update, the stock jumped 23% on the day the company released earnings. The story is beginning to resonate with investors.

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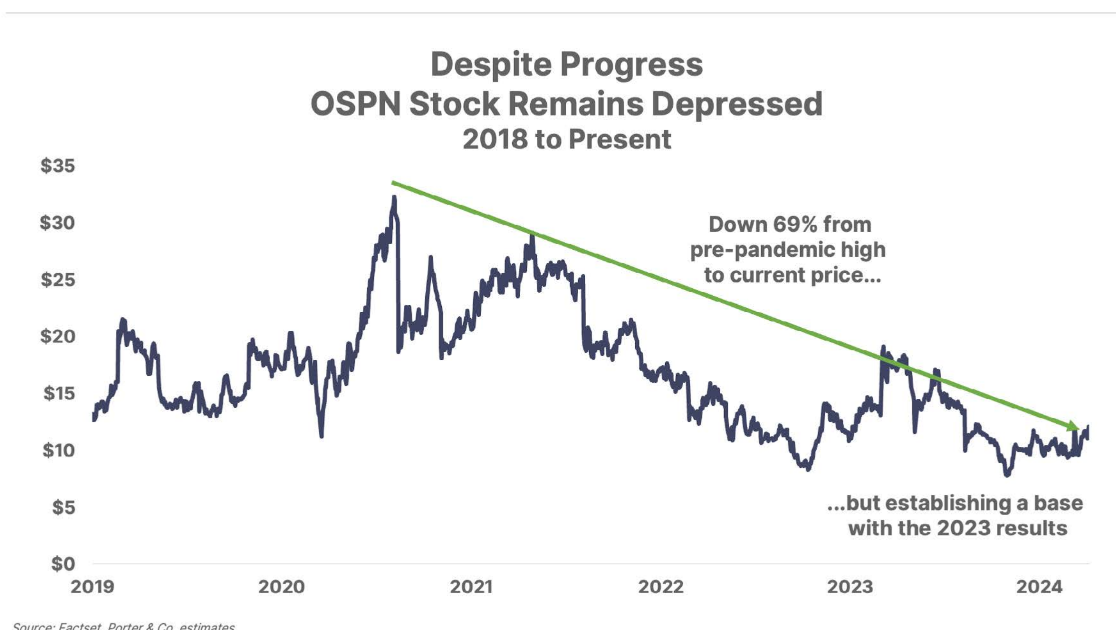
While the activist's focus has been on improved governance and operating results, we should also recognize OneSpan's solid balance sheet. As of year end 2023, the company had $43 million in cash. While not a growing pool of money, this is about 12% of the total market cap of the company. Better yet, the company has no debt.

With all this improvement – including better confidence in revenue and soaring EBITDA – the stock must have reacted, right?

No, it has not. Despite the 23% move following the recent earnings report in March, OneSpan shares remain 70% below their pre-pandemic highs around $30. The stock has mostly been in a downtrend but is showing stability year-to-date. We believe the market is starting to recognize the progress made and is paying attention again.



Source: Factset, Porter & Co. estimates.

But are the shares really cheap? Yes, they are. Consider the following list of 20 technology stocks that focus on cybersecurity, digital documentation, and cloud operations.

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Cybersecurity and Cloud-Based Software Solution Stocks
Sorted Ascending on EV/EBITDA (Enterprise Value to Earnings Before Interest, Taxes, Depreciation, and Amortization)

Company	Ticker	Stock Price	Mkt. Cap ($m)	2025E			Description
				Price per Sales (P/S)	EV/EBITDA	Price per Earnings (P/E)	
OneSpan Inc.	OSPN	$9.86	$373	1.5	6.2	8.9	Digital docs., Cybersecurity
Discount to Median				**-69%**	**-61%**	**-58%**	
Consensus Cloud Solutions	CCSI	$12.51	$240	0.7	4.8	2.4	Data analysis
Digital Turbine	APPS	$1.86	$190	0.3	4.5	3.4	Digital marketing platform
DocuSign	DOCU	$58.06	$11,926	3.8	11.2	16.4	Digital documents
Bandwidth	BAND	$17.16	$463	0.6	11.1	10.8	Communications software
Mitek Systems	MITK	$12.17	$569	3.1	10.4	11.5	Digital identity
Check Point Software	CHKP	$158.09	$17,849	6.6	14.1	15.6	Cybersecurity
NICE Ltd.	NICE	$230.54	$14,494	4.8	13.8	19.2	Broadbased software
Splunk	SPLK	$156.90	$24,216	4.9	14.1	21.5	Broadbased software
American Software	AMSWA	$10.59	$352	3.1	14.8	24.6	Digital supply chain software
Rapid7	RPD	$43.80	$2,715	2.9	16.9	18.3	Cybersecurity
Qualys	QLYS	$162.75	$6,018	9.2	20.6	28.8	Cybersecurity
Radware	RDWR	$16.14	$674	2.4	14.9	20.5	Cybersecurity
Dynatrace	DT	$44.43	$13,151	6.6	21.0	28.3	Cloud-based software
Okta	OKTA	$93.80	$15,702	5.6	24.1	36.4	Digital identity
Tenable Holdings	TENB	$44.38	$5,242	5.3	24.6	34.3	Cybersecurity
Palo Alto Networks	PANW	$277.33	$89,605	9.7	34.9	45.0	Cybersecurity
nCino	NCNO	$29.68	$3,390	5.4	26.9	35.4	Cloud-based software
Domo	DOMO	$7.85	$299	0.9	18.8	na	Data analysis
Zscaler	ZS	$172.96	$25,919	9.8	39.5	53.0	Cybersecurity
CrowdStrike	CRWD	$293.69	$71,034	14.4	50.9	61.4	Cybersecurity
Median				**4.9**	**15.9**	**21.5**	

Source: Factset, Legion Partners, Porter & Co.

Technology stocks are abundant so we have many comparables to consider. At the median, OneSpan valuation multiples trade at considerable discount to this robust group.

Let's break it up a bit and look at the average multiples by market cap size.

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Median Valuation Multiples by Market Capitalization

Market Cap	Number of Stocks	2025E		
		P/S	EV/EBITDA	P/E
OneSpan Inc.		1.5	6.2	8.9
Less than $1 billion	7	0.9	11.1	11.2
$1 billion to $10 billion	4	5.3	22.6	31.6
Greater than $10 billion	9	6.6	21.0	28.3

Source: Factset, Legion Partners, Porter&Co. estimates

OneSpan valuation multiples remain lower than essentially all the peer-group medians by market capitalization except price-to-sales (P/S) of the smaller companies.

What does this say about a OneSpan target price?

We Think Shares Could Double...

Let's look at a handful of ways to consider a target price but focus on enterprise value-to-earnings before interest, taxes, depreciation, and amortization ("EV/EBITDA").

We use this multiple because it is the cleanest, in our view. Enterprise value adjusts for cash and debt levels when comparing one company to another putting companies on an even playing field. EBITDA does the same thing and adds back non-cash expenses providing a cleaner cash earnings measure.

We selected five different target-price scenarios – three based on 2025E EBITDA from our analysis and two from Legion Capital based on its views of 2024 results.

In order of appearance on the chart below, they are:

- **Median EV/EBITDA multiple for peers under $1 billion market cap**. This is the group that OneSpan is part of with a current market cap of $370 million. At the median 11.1x EV/EBITDA of peers, OneSpan shares would trade at $14. This is our most conservative forecast offering a solid 40% upside.

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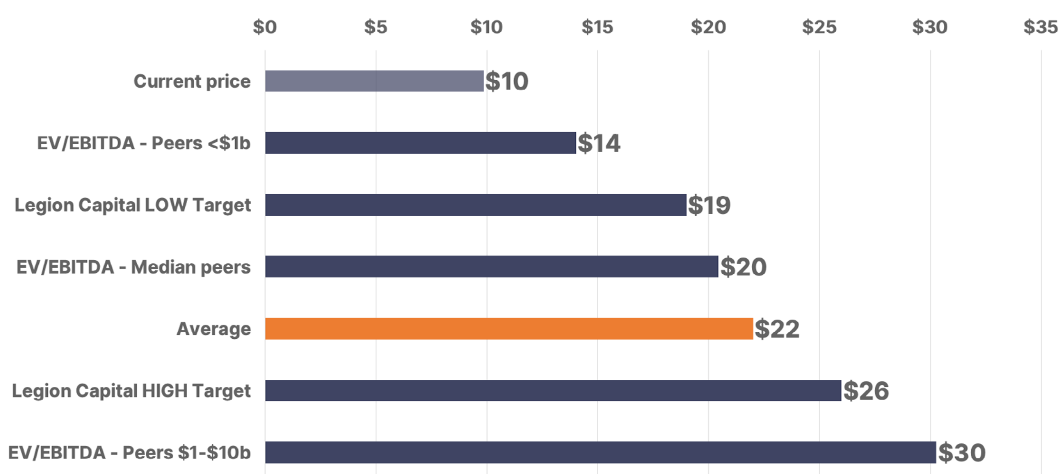
- **Legion's low target price**. In its most recent investor letter about OneSpan (August 2023), activist Legion provided a target-price range based on a sum-of-the-parts analysis. This analysis places a value on the different parts of a business and then adds them up. Important to note, this is now possible because of the new financial disclosure the company provides at the urging of Legion analysts. The low target-price scenario assumes modest assumptions about 2024E EBITDA margin and a lower EV/EBITDA multiple. This yields a $19 target price.
- **Median EV/EBITDA multiple for all 20 peer companies in our table**. With a median 15.9 for all the peers and 6.2 multiple for OneSpan, we derive a $20 target price.
- **Legion Capital's high target price**. This is based on a sum-of-the-parts analysis and uses a better-than-expected EBITDA margin forecast for 2024 and therefore assumes a higher EV/EBITDA multiple. This yields a price of $26 per share.
- **Median EV/EBITDA multiple for peers between $1 billion and $10 billion market cap**. This is the group that OneSpan aspires to be a part of as its operations improve. Should governance and operating improvements keep working, the stock should rise providing a higher market capitalization. At the 22.6x EV/EBITDA median, OneSpan shares would trade at $30, offering substantial upside.

If we average the five results, we arrive at $22 per share. This is 123% higher than the current price.



Source: Factset, Legion Capital, Porter and Co. estimates.

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This Story Is Gaining Steam…

OneSpan has slowly but surely followed the central tenets of Legion's outlook for the company.

There have been significant changes in the makeup of the board and management. The board has moved away from long-tenured members with no modern-software company experience, to a smaller group with industry experience and an outlook more aligned with that of Legion.

Essentially all senior management positions have been replaced. This includes the replacement, with an interim, of the new CEO who started the ball rolling on the restructuring plan. This is a positive sign that the board is *holding management accountable* even after only two years on the job. He wasn't working out and they made a move rather than let him tread water.

The new board has created a formal multi-year restructuring plan with clear targets for 2025. This includes a complete review of operating expenses that has already resulted in a 23% reduction in the workforce. In total, the company is targeting over $60 million in cumulative expense reduction by the end of 2024. As mentioned, we believe management will increase this goal soon (May 2024) helping to drive shares higher.

Additionally, financial disclosure is vastly improved. The company now reports under two operating segments offering greater investor insight into financial results. Importantly, annual recurring revenue is a measure of modern-day subscription-based software business models offered by the company.

A Look at Future Risks

Despite progress, this stock is not without risk and could see some further downside. But downside risk should be very limited.

The company has been slow to change – it's been six years – and continued operating improvements are not guaranteed. There is also no permanent CEO, and a full-time replacement could see things differently. That said, we believe the current interim CEO will be made permanent.

Also, this is a technology stock. Tech stocks tend to underperform in times of rising interest rates. Recent Federal Reserve action tells us there is no clear path to interest rate cuts. In fact, there is a new narrative suggesting that rates could actually increase – rather than be cut – if inflation remains sticky through the summer of 2024. If this gains traction, shares, and the market overall, will likely remain flat or even decline.

Lastly, there are only four equity research analysts that cover the stock and just one of them is positive on the outlook. Six others dropped coverage between 2019

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and 2022. There is clearly not a lot of interest from the Wall Street community. As financials improve, this group may find new interest in the story.

Despite these risks, we believe now is the time to buy the stock. Financial results are turning a positive corner as evidenced by the Q4 2023 results and outlook for the remainder of 2024.

With the board and management seeing that their plan is working, we believe a much bigger effort will be made to cut more costs and drive earnings higher.

As a side note, the company's share repurchase program expires in May. If the repurchase agreement is reauthorized, and the company buys back shares, it would likely support the share price.

Legion has been a consistent activist for over five years. It must be eager for some real upside returns. One of its options for management is the complete sale of the company to a competitor or private equity investor. While we have no knowledge of a potential takeover, that is a common outcome for activist-focused companies – as happened with drug manufacturer Catalent (NYSE: CTLT), which we recommended buying in September 2023 and selling in February for a 31% gain.

We would not be surprised to see that happen with OneSpan.

Action to Take: Buy OneSpan (Nasdaq: OSPN) up to $22 per share

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Portfolio Update

ActivistInvestor PORTFOLIO

Ticker / Latest Update Link	Description	Entry Date	Cost Basis	Latest Close	Total Return	Status
Open Positions						
SPWH Sportsmans Whs H	Sporting Goods Stores	09/22/2023	$3.53	$3.08	-12.75%	Buy Under $15
MRCY Mercury System	Defense Technologies	11/15/2023	$34.78	$27.46	-21.05%	Buy Under $60
OFIX ORTHOFIX MED	Medical Devices	01/17/2024	$13.30	$13.00	-2.26%	Buy Under $22
VFC VF	Apparel & Shoe Brands	02/14/2024	$17.20	$12.25	-28.26%	Buy Under $30
OSPN OneSpan - Registered	Cybersecurity	04/17/2024	$9.86	$9.86	0.00%	Buy Under $22

ActivistInvestor CLOSED POSITIONS

Ticker	Entry Date	Entry Price	Exit Date	Exit Price	Total Return
Closed Positions					
CTLT Catalent	03/25/2023	$45.79	02/05/2024	$59.82	30.64%

Note: This is a model portfolio based on hypothetical holdings. Please consult with a financial advisor before investing. You buy, hold, and sell at your own discretion and your own risk.

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Governance Changes Continue at Orthofix

On April 12, **Orthofix Medical (Nasdaq: OFIX)** announced changes to its board. Stu Essig, PhD, and James Hinrichs will not stand for re-election at the upcoming June shareholders meeting.

Additionally, Catherine Burzik will step down as chair, a position that she's held for three years, overseeing the firing of the prior senior management team. Hinrichs was a member for 10 years while Essig's tenure was just over a year.

These moves are aligned with the cooperation agreement reached between Orthofix and Engine Capital, the primary activist pushing for change.

It is good to see these things come to fruition.

Our expectations for this stock remain the same. We believe operating results will improve throughout the year and the company will be the target of an acquisition at some point.

Action to Take: Buy Orthofix Medical (Nasdaq: OFIX) up to $22 per share

Sportsman's Warehouse Crushed Its Fourth Quarter

You may have noticed...

Sportsman's Warehouse (Nasdaq: SPWH) shares rallied more than 23% on April 4. It was a great day for the stock and likely started a trend that will last all year.

After the market closed on April 3, the sporting-goods retailer reported financial results for its fiscal fourth quarter and full year 2023. The company has made a lot of progress in its turnaround supported by activist Cannell Capital.

Progress was made with its inventory backlog, operating expenses, and repayment of debt. These are all key measures we have cited and are watching for improvement. These improvements even led to positive free cash flow ("FCF") of $60 million in the quarter. This is up from $7 million in the prior year quarter.

Let's look deeper at the company's inventory levels, as this was our biggest positive takeaway.

Inventory levels had grown in prior years. As a general rule of thumb, we want inventory levels to increase roughly in line with revenue. There are exceptions for special events. For example, if the company is expecting a robust hunting season (due to weather forecasts, etc.) it may stock up on inventory quicker to meet expected demand.

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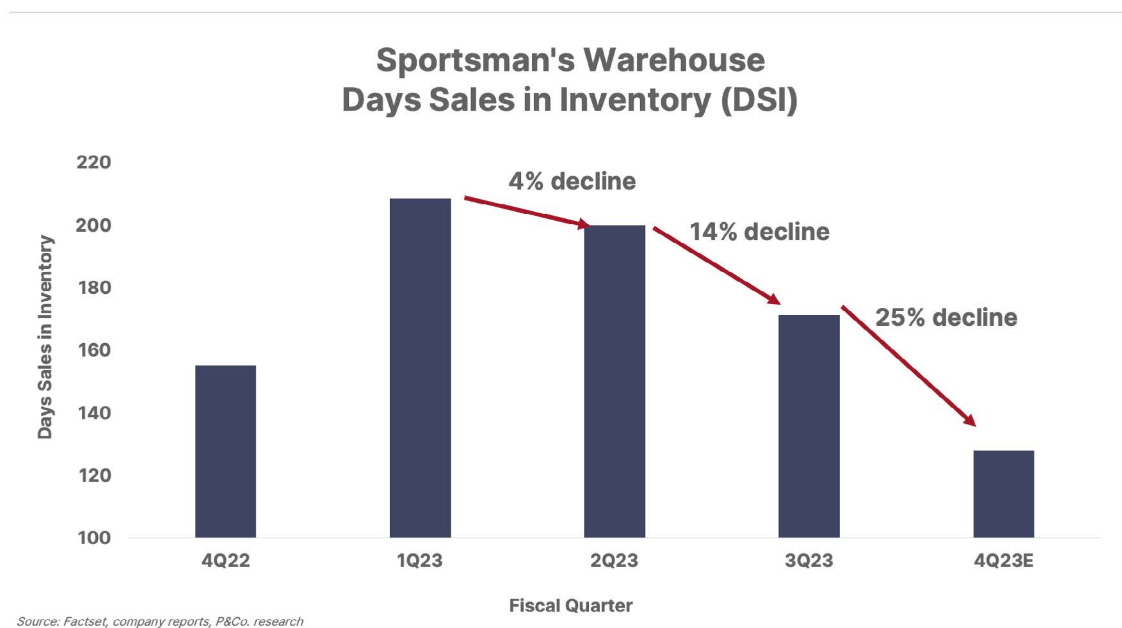
But Sportsman's revenue-to-inventory levels were completely out of whack. From 2013 to 2019, revenue grew at an average annual rate of 6% while inventory levels grew over 20% a year. This has been a big reason for operating underperformance.

But this metric is getting to where it should be. From 2020 to 2023, revenue has grown about 5% annually while inventories have grown about 8%. Inventory growth is still outpacing revenue, but the relationship is much more aligned.

This also shows up in Days Sales in Inventory ("DSI"). DSI is the average number of days it takes to sell all inventory. The goal is to minimize the DSI number as much as possible while not losing sales or keeping products in the store too long. It's a balance.

The chart below illustrates the progress being made. This is the third quarterly decline in DSI and the decline has accelerated. Current DSI numbers are approaching the pandemic years (2019-2022) when revenue grew 30% per year and inventory declined 6%.



Inventory levels are in much better shape than early 2023. This decline is the primary reason FCF swung to a positive $60 million in the quarter.

Why? Inventory is an asset on the balance sheet. If assets increase, that results in a use of cash on the cash-flow statement. This is what was happening year in and year out and much faster than revenue was growing. As inventory has declined in recent quarters, it generated a source of cash as opposed to being a use of cash. That is where the positive operating and FCF came from.

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This report sets a very positive tone in this story. We expect these trends to continue through the year. This will support a rising stock price and perhaps attract another suitor.

Action to Take: Buy Sportsman's Warehouse (Nasdaq: SPWH) up to $15 per share

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