SOULOR

LQDT: Loss Of Government Contracts Highlights Historical Misinterpretation Of Business & Continued Downside

- For the past several years, Liquidity Services (LQDT) has consistently been misunderstood by the market and despite a share price decline of close to 60% over the last 12 months, the risks facing LQDT are still underestimated.

- Founded in 1999, IPO'd in 2006 and based in Washington DC, LQDT operates an online marketplace for liquidation of surplus and salvage assets from commercial and government customers. LQDT operates three transaction models: (1) Consignment (20% of sales); (2) Profit Sharing (14% of sales); and (3) Purchase (66% of sales). Through 2011, US Department of Defense (DoD) represented over 55% of total revenues.

- At first glance, LQDT appears to meet "value" investors key operational criteria: (1) Consistent growth; (2) Stable operating profit margins that translate to stable Net Income margins; (3) Strong and stable ROA, ROE and ROIC; (4) consistently cash generative quarter over quarter since IPO; and (5) consistent net cash position (no leverage). The only potential concern, mitigated by the strong growth, should have been the price paid for ownership.

- Organic growth: Through 2013, the company and wall street professionals led the market to believe LQDT would benefit from 15% organic growth. However, in a capitalistic society, one should consider the fact that such growth and profitability would drive significant competition. In reality, the DoD Scrap contract revenues have been flat since 2008. While the DoD Surplus revenues increased dramatically between 2010 and 2013, in 2014 the DoD allocated its new Surplus contract to IronPlanet instead of LQDT.

- Network Effect: LQDT consistently noted that by increasing the amount of sellers and the GMV, LQDT would increase the number of buyers in turn making its offering more attractive to sellers. If the argument were true, the loss of the US DoD rolling surplus contract would have the exact contrary impact.

- Business Moat: While analysts stated that LQDT benefited from superior and unreplicable products, the loss of the US DoD contract should highlight the only "moat" LQDT benefited from was the DoD contracts.

- At the current price of $15.84, LQDT is priced close to the top end of the fair value range ($18 per share) assuming no significant decline in the 2015 financials. We recommend investors SHORT LQDT should the Mr. Market's emotions for LQDT continue to percolate at a price above $18 per share. We recommend investors BUY LQDT at a price below $8 a share.

June 20, 2014

LIQDUITY SERVICES (LQDT:NASDAQ)
PRICE TARGET: $8
CONSIDERATION: SELL

Market Information

Share Price $	$15.84
52 Week High	$36.58
52 Week Low	$12.17
3M Avg Vol. $mm	$17.31
Mkt Cap $mm	$510
Firm Value $mm	$408

Financials ($mm)	2011	2012	2013
Revenue	327	475	506
EBIT	37	82	68
% Margin	11.4%	17.3%	13.4%
% Growth	34.8%	NM	(17.3%)
Net Income	8.5	48.3	41.1
% Margin	2.6%	10.2%	8,1%
% Growth	(29.1%)	467%	(14.9%)
EPS	0.29	1.47	1.26
% Growth	(33.2%)	403%	(14.6%)
Div. Per Share	0.0	0.0	0.0
Net Debt / (Cash)	(129)	(63)	(95)
Net Debt / EBITDA	(3.0x)	(0.7x)	(1.1x)
ROE	6.2%	23.5%	14.6%
ROIC	6.2%	21.3%	13.5%
5 Yr Avg ROIC			11.6%

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LQDT Investment Thesis

For the past several years, Liquidity Services (LQDT) has consistently been misunderstood by the market and despite a share price decline of close to 60% over the last 12 months, the risks facing LQDT are still underestimated.

Key Risks:

1) Organic growth is substantially below what investors believe(d) and was hidden by acquisitions whose top line revenues are not growing as was predicted
2) LQDT business does not benefit from a network effect
3) LQDT does not benefit from any moat
4) Misunderstanding regarding the total size and penetration of markets served
5) Commodity industry/business where Price is the only differentiator
6) Concentration of customers: Loss of DoD Rolling Stock Surplus Contract in 2015 is not yet fully baked into estimates
7) Concentration of customers: Either the loss of the DoD Scrap contract or renewal on substantially worst terms in 2014 / 2015
8) Concentration of customers: Either the loss of the Wal-Mart business or renewal on substantially worse terms in 2016

Founded in 1999, IPO'd in 2006 and based in Washington DC, LQDT operates an online marketplace for liquidation of surplus and salvage assets from commercial and government customers. LQDT operates three transaction models: (1) Consignment (20% of sales); (2) Profit Sharing (14% of sales); and (3) Purchase (66% of sales). Through 2011, US Department of Defense (DoD) represented over 55% of total revenues. Since 2011, LQDT has reinvested capital through the acquisitions such as GoIndustry and Jacobs to diversify its US DoD concentration and increase exposure to commercial markets.

At first glance, LQDT appears to meet "value" investors key operational criteria: (1) Consistent growth; (2) Stable operating profit margins that translate to stable Net Income margins; (3) Strong and stable ROA, ROE and ROIC; (4) consistently cash generative quarter over quarter since IPO; and (5) consistent net cash position (no leverage). The only potential concern, mitigated by the strong growth, should have been the price paid for ownership.

Organic growth: Through 2013, the company and wall street professionals led the market to believe LQDT would benefit from 15% organic growth. However, in a capitalistic society, one should consider the fact that such growth and profitability would drive significant competition. In reality, the DoD Scrap contract revenues have been flat since 2008. While the DoD Surplus revenues increased dramatically between 2010 and 2013, in 2014 the DoD allocated its new Surplus contract to IronPlanet instead of LQDT. LQDT shortly thereafter noted the loss of the rolling stock contract could reduce Gross Merchandise Value ("GMV" - and revenue) by approximately 30%. In addition, when LQDT announced the Jacobs acquisition, it highlighted Jacobs' 3 year 100% EBITDA CAGR, primarily

driven by an exclusive arrangement with Wal-Mart, as the growth investors should expect going forward. Unfortunately, in the second year after the Jacobs acquisition, Wal-Mart GMV declined by 50% from 20% of GMV to 11% of GMV ($95mm to $56mm of GMV). Moreover, we estimate that the Jacobs EBIT growth is declining significantly.

Network Effect: LQDT consistently noted that by increasing the amount of sellers and the GMV, LQDT would increase the number of buyers in turn making its offering more attractive to sellers. If the argument were true, the loss of the US DoD rolling surplus contract would have the exact contrary impact (i.e. loss of biggest seller would lead to the loss of significant buyers, in turn leading to the loss of more sellers…). However, in reality the US DoD was the key seller attracting buyers on LQDT's platform and in 2014 despite numerous buyers on the LQDT platform, the US DoD moved its rolling surplus contract to IronPlanet which offered to pay 4.35% of Original Acquisition Value (OAV). The prior LQDT / Surplus Stock DoD Contract was on terms of 1.80% of OAV. Ultimately, the "network effect" did not matter to the US DoD as much as the price. In addition, in the second quarter earnings call, the LQDT CEO and founder highlighted that the DoD Scrap contract bidding could head in a similar direction.

Business Moat: While analysts stated that LQDT benefited from superior and unreplicable products, the loss of the US DoD contract should highlight the only "moat" LQDT benefited from was the DoD contracts.

Loss of DoD Surplus contract not yet fully backed into LQDT financials: Shortly after losing the DoD rolling stock surplus contract, LQDT reduced its 2014 FY EBITDA and EPS Guidance by approximately 30%. However, in the quarterly earnings call, the LQDT CEO noted that the material changes in the Surplus contract (i.e. the loss of the rolling stock) would only result in material changes in fiscal year 2015.

In the past, LQDT successfully renewed its DoD surplus contract on several occasions moving from a profit share model to a purchase model in 2009. However, the first cracks started to appear in 2009 when LQDT and the DoD announced that LQDT would pay 3.25% of Original Acquisition Value (OAV) for the DoD surplus assets. Shortly thereafter the amount was reduced to 1.8% of OAV. The new contract the DoD signed with IronPlanet is at 4.35% highlighting the DoD does not want to give away such high profit margins to the vendors (i.e. a commodity service)

Either the loss of the DoD Scrap contract or renewal on substantially worse terms in 2014 / 2015: The DoD is currently reviewing bids for the Scrap contract. Based on the LQDT CEO's comments on the Q2 earnings call, it appears the DoD will focus on pricing as the driver to award the contract. LQDT at best could retain the Scrap contract thereby maintaining and growing the GMV on its platform but at a significantly lower margin and at worse could lose the DoD Scrap contract further destroying its historical network effect description.

Either the loss of the Wal-Mart business or renewal on substantially worst terms in 2016: Wal-Mart's standalone EBIT margin since 2010 is 5.9%, grew at a 2.9% CAGR, and the company has returned $68bn to shareholders (via buyback and dividends) in that period. If the reverse supply chain market is estimated to be over $100bn with a penetration of less than 10% providing a 15% organic growth rate with an operating margin of greater than 10%, why wouldn't Wal-Mart build it's own operations to sell its surplus products as well as potentially seek to become a dominant player in the market? Wal-Mart's significant reduction in GMV sold through the LQDT (Jacobs platform) in 2013 is only the beginning.

LQDT's past wall street support came about as a result of "unrepresentative samples". Charles Munger highlights the importance of obtaining representative data, even if it's approximate. Unfortunately, the market based its

entire LQDT growth predictions assuming LQDT would not only be the US DoD vendor (surplus and scrap) into forever, but also that the terms of the DoD contracts would never be renegotiated to the benefit of the DoD. The loss of the US DoD rolling surplus contract in 2014 highlighted both the LQDT risks as well as the importance of seeking representative data.

The Opportunity or Lack of One: Unfortunately or not, while LQDT's business model has suffered a significant reversal in fortunes in the last 12 months and it's share price has fallen as well, several market participants continue to suffer from the "Psychology of Speculation: Excitement of play causes a certain confusion of mind, and players are prone to do the wrong thing; for instance, double their bets when in an adverse run of luck and "pinch" them when luck is running favorably" (Henry Howard Harper in Psychology of Speculation).

"Although we don't believe in timing the market or panicking over market movements, we do like to keep an eye on big changes -- just in case they're material to our investing thesis… As it stands, with shares down almost 30% over the past three trading days alone, it looks to me like Liquidity Services stock could represent a compelling buy for patient, long-term investors." (Research Analysis published online)

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Additional analysis including in LQDT Investment Presentation.

Source Documentation: All Publicly Available Online

1) LQDT Website
2) LQDT SEC Filings
3) LQDT Investor Relations
4) General Internet

Disclosures and Notices

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