March 11, 2020

Dear Partners,

As you know I prefer to not provide intra-quarter updates, but given the extreme volatility that has roiled markets of late, I thought a brief touchpoint would be appreciated. You are surely aware that this volatility was kicked off by the rapid spread of, and unknown impact of Corona virus, and subsequently exacerbated by an oil price war.

Despite the opinions of many experts - and many more non-experts - the truth is that the near-term impact of these events is entirely unknowable, and a wide range of outcomes is possible. On one hand, warmer weather in the northern hemisphere may be the catalyst that stops the spread of the virus, and planet earth may return to life as usual within a few months. On the other hand, damage already done to global supply chains and investor psychology may be enough to push the world into recession.

Humans are genetically programmed to respond to uncertainty with fear, rather than curiosity. Afterall, those of our paleolithic forefathers who did not run or hide at the first hint of a predator on the savannah millennia ago did not live to pass on their genes. In the stock market, this fear manifests itself as a demand for liquidity, with investors often selling at any price, regardless of fundamentals. What is also true however is that as time marches on, the range of outcomes will narrow, and fear will subside. In the long-term, this current uncertainty will become just a blip in the history books, as has been the case for all of the other calamitous events that have taken place in the past.

As investors however, what is important is getting to the long-term. What this means is that we must focus on what is controllable – our process – rather than what is out of our control – stock prices.

As a reminder, at a high level, my fundamental approach involves searching for good businesses, led by incentivized people, when they are dealing with a temporary problem, and that are well equipped to deal with difficult periods. More succinctly, I *always* generally assume that the next 9-18 months will be difficult, and specifically seek to identify companies that will survive and even thrive during this difficult period. Thus, while I did not specifically envision "risk of global pandemic coupled with oil price war" as a likely scenario when constructing our portfolio, our businesses are broadly speaking well equipped to handle this environment.

However, that says nothing about what can happen to stock *prices* during periods that are defined by a demand for liquidity above all else, and thus over shorter periods of time we are at the mercy of the investor with the weakest hand. The best tool at our disposal to help us ignore the mark to market prices demanded by those less equipped to deal with uncertainty than ourselves is knowledge. As such, I want to just share a few brief thoughts on our companies, many of which have seen nonsensical declines in their prices.

Aimia, Inc (AIM.TO): Aimia is essentially a box of cash and a near 50% interest in Aeromexico's loyalty program (PLM), which is bankruptcy remote to Aeromexico. While shares of Aimia have traded down severely, it should be obvious that the buying power of the company's cash has increased, and Aimia's strategic position vs. Aeromexico in regards to PLM has likely improved as Aeromexico's main business will surely be negatively affected by the global decline in air travel. This may allow for Aimia to extract value from PLM through some form of financial engineering such as a dividend recap, or extending PLM's contract with Aeromexico. In any case, despite the decline in stock price, I believe the value of Aimia has gone up over the last few weeks.

Avid Bioservices (CDMO) – Avid, our large molecule drug manufacturer, largely operates independent of the real economy as demand for pharmaceuticals is recession proof. That being said, the business does not operate independent of bad luck, and the company recently reduced guidance for the next 6 months due to an equipment malfunction that has delayed some previously contracted work. In the real world the value of a private business that experienced a 6 month delay due to equipment malfunction would barely change at all… but during an uncertain time, the stock market often demonstrates no patience, and shares of CDMO have been punished. Beyond this equipment failure, the business has added new customers, grown backlog, and is expanding its salesforce, all of which portend continued future growth that will come with very high incremental margins as the company increases capacity utilization and leverages fixed costs. The market's extreme reaction to what clearly appears to be a temporary problem will almost certainly turn out to be a gift in the quarters and years to come.

Benefytt Technlogies (BFYT): Formerly known as Health Insurance Innovations (HIIQ) and not previously introduced, BFYT is shifting its business away from short-term health insurance and toward online portals that allow Medicare eligible individuals to compare and contrast Medicare Advantage and Supplemental plans. While it is possible that company call centers could be disrupted by corona virus, the vast majority of Medicare revenue is earned in Q4, leaving them adequate time to prepare contingency plans… and hopefully by Q4 the virus will be but a memory anyway. If not, the likely result will be that the company reduces growth spend, and thus fails to meet their more than 100% Medicare growth target this year. Failing to meet this ambitious goal leaves ample room for still impressive growth, and longer term, continued growth in the Medicare eligible population and the need for health insurance will not go away. At present, it is estimated that less than 2% of the eligible population addresses their need online, leaving a long runway for growth that will come with very high incremental margins.

Clear Media (100:HK): Clear Media operates a network of Out Of Home (OOH) advertising panels located at bus shelters throughout China. Corona virus has surely impacted the near-term results for Clear Media, but as the dominant player in the space, Clear Media should be able to take market share from smaller competitors during this difficult period. Further, history has shown that OOH advertising snaps back quickly following difficult periods. Longer term, Clear Media's portfolio is impossible to replicate due to their scale advantages and long-term contracts, and as Chinese urbanization and media spending continue to trend toward Western levels, the business will perform well. ~50% owner Clear Channel Outdoors has also indicated that a sale of this business is possible in the near term. I would imagine any transaction would be delayed while China is in turmoil, but ultimately in a takeover situation Clear Media could be worth double where shares are currently trading hands.

Hill International (HIL): The stock price of our asset light construction management firm has seen a shocking decline in recent days as the company has exposure to the Middle East (~30% of backlog), and investors have seemingly extrapolated a decline in oil prices to a decline in Middle East construction activity. This supposition could certainly prove to be accurate, but the sell-off in shares has resulted in a price that is far below my estimate of the value of the U.S. business alone. The violence of the move can likely be explained by the fact that nearly 50% of the company's shares are in the hands of long-term holders resulting in a limited float, which makes the stock price ultra-sensitive to even one panicked individual seller.

Iteris, Inc (ITI): Iteris, our traffic management business, has no debt and a cash rich balance sheet. It is possible – perhaps even likely – that purchase decisions by customers will be pushed out a few months due to virus fears. However, Iteris has had a market leading position for 30 years, traffic is not a problem that is going away any time soon, and the company has stated its intention to acquire smaller players, who should be more vulnerable than Iteris during any difficult period. Additionally, Iteris is presently at the forefront of replacing traditional analog traffic monitoring technologies with SAAS/cloud products. This evolution has been taking place at a glacial pace due to the inefficiencies inherent to municipal government customers, but perhaps concerns sparked by Corona virus will encourage potential customers to appreciate the value that comes from dealing with cloud products – such as the ability to work from home.

PAR Technologies (PAR): PAR is our restaurant point of sale (POS) business, which at present caters to quick service restaurants (think fast food). While fast food generally performs well in recessionary environments as consumers trade down, it is conceivable that corona virus will negatively impact industry sales, and perhaps slow purchase decisions. That being said, PAR's technology is best in breed, and a newly appointed CEO has laid out clear plans on how to continually improve the offering through additional capabilities, which will lead to higher revenue per user over time. Notably, the company is an acquiror and recently completed a convertible bond offering, leaving it flush with cash. To the extent that the QSR industry does slow down, potential acquisitions will presumably be available at lower prices, meaning that PAR may be able to accelerate their product growth plans, and accomplish them at more favorable prices.

Recro Pharma (REPH): Recro is our small molecule drug manufacturer. Similar to Avid, Recro is largely insulated from the real economy. Also similar to Avid, Recro has traded down violently on news that is unrelated to global pandemics or oil. In the case of Recro, management issued forward revenue guidance that is puzzlingly soft, as they indicated they want to be conservative in the face of a competitor that has been absent from the market potentially returning. I say "puzzlingly soft" because according to the FDA, this competitor has permanently left the market. It would be foolish to question management's view that this competitor may return because I am certain they are more knowledgeable on this front than I am, but at the same time, management has a long track record of extreme conservatism. Regardless, the disappointing guidance against a backdrop of global uncertainty and a share price that was admittedly full has resulted in a severe decline for shares. However, despite conservatively guiding to flat growth next year, industry growth trends remain strong, the competitive position is sound, and management has indicated that looking out a few quarters, growth should resume. Given that the company is presently operating at 66% capacity on one shift and incremental margins are very high, I think our patience here will be rewarded.

USA Technologies (USAT): Not previously introduced, USAT is the largest player in electronic payment systems for vending machines and other unattended retail. Vending machines are generally recession resistant as a soft economy does not prevent people from snacking, although presumably they are not pandemic resistant; if the school where a vending machine is located is closed, that machine won't be doing much business. The company generally collects a monthly base fee and a percentage of revenue from vending machine owners, who are happy to enter into this arrangement as vending machines that are credit card and e-wallet enabled are vastly more profitable than cash only vending machines. As the largest player, USAT can offer the best service and the lowest prices, which are a difficult tandem to compete with. The real story here however is that an activist investor has put forth an all-star slate of candidates to replace the existing board, who have historically mismanaged the company. A large part of USAT's expenses are tied to credit card transaction processing fees, which are collected by JP Morgan (JPM). It is thus notable that the activist in question is the former CFO of JP Morgan, who together with his team likely know more about the payments industry than almost anyone else on earth. They have bet heavily that they can improve this historically mismanaged business, and are likely to take control in late April when the company holds its annual meeting.

Universal Technical Institute (UTI) – Not previously introduced, UTI operates trade schools that train individuals to become automotive or similar industrial technicians. This is a counter cyclical business that thrives during recessionary periods as difficult job markets prompt people to improve their skill set through education. For example, through the Great Recession revenue grew by nearly 30%. It is not clear at this point if classes will need to be halted due to virus fears, and what impact that will have on short term revenue (if any), but the company has a strong balance sheet following a recent capital raise, and should weather any storm well. If the economy does indeed tip into recession, this business will likely be a prime beneficiary.

In sum, while our stocks have not been immune from the panic sweeping the markets, our businesses are generally well positioned. That does not mean we are married to these businesses, and as there are multiple instances of babies who have been thrown out with the bathwater at present, I am hopeful that the quality of our portfolio will be upgraded in the near future. I realize that these statements likely offer little comfort when the inducements to join the panic are seemingly everywhere, but history has shown time and again that periods like these are the time to remain calm and focus on the long-term prospects of businesses, not the liquidity needs of fellow shareholders. It may add an additional measure of comfort to know that as of this writing our year to date performance, while negative, has been substantially better than the small cap indexes and a touch worse than the large cap indexes. This is in no small measure due to hedging activity which has protected the portfolio from some of the extreme price declines that our stocks have suffered. I caution you however that our performance could easily change in the days, weeks and months ahead, as over shorter periods of time we are at the mercy of the most panicked seller, and our hedges could go against us if the market unexpectedly roars higher. Regardless, I remain confident that at some point in the not too distant future the world will return to normal, and we will be handsomely rewarded for stoically enduring the recent volatility.

If you have any questions, or would like to take advantage of recent volatility, please do not hesitate to reach out.

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