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January 15th, 2022

Our strategy composite returned 2.64% net of fees in the fourth quarter (2.94% gross), bringing our 2021 return to 28.5% net (29.9% gross). This performance was achieved in a year of dramatic asset price volatility, inflation, heightening geopolitical tensions, and worsening supply chain problems.

In this letter, we will discuss issues around inflation and give an update on our Georgia Capital thesis discussed in our Q1 2021 letter.

Effects of inflation and how Cornerstone Building Brands is weathering it

The sharp increase in inflation in the US and many other economies (especially in emerging markets) has been a common topic of conversation in financial media lately. For the twelve months ending in December 2021, the CPI annual inflation rate was 7.1%. It is important to remember that when we discuss aggregate statistics such as inflation, we are producing a piece of economic fiction for the sake of convenient discussion. In reality, every economic participant is going to experience a different rate of inflation from their perspective based on the basket of goods and services that they wish to purchase. It's even possible for someone to experience deflation in their purchases while another person sees rising prices.

Two common points of debate regarding inflation calculations are the composition of the baskets of goods and services used to calculate inflation and the adjustments made to inflation calculations for hedonic adjustments to account for quality improvements. Hedonic quality adjustment refers to the price adjustments economists make to account for the fact that new products or services may be more expensive because they are now higher quality than they were in the past and not merely due to inflation. Automobiles and consumer electronics are two categories of goods that have had large quality improvements due to innovation and technological improvement. Some argue that this practice of quality adjustment is a cynical ploy by government officials to decrease the reported rate of inflation by including technological innovation which is not directly related to the money supply. The other side of this argument, for including hedonic adjustment, is that it makes price basket comparisons more accurate and more meaningful as the quality of items in the basket changes over time. As a society becomes wealthier, the quality of goods desired by the population will increase and not adjusting for this will give inaccurate measurements. We only bring up this issue to illustrate that inflation calculations will always be an active debate rather than an exact science.

Generally, we believe that most developed countries publish accurate if occasionally flawed inflation statistics. The current CPI calculation in the US is likely operating at a lag due to the rapid increase in shelter costs (especially in owner's equivalent rent) which will lead to an understatement currently and an overstatement in the future. The CPI basket for urban "Rent of

Shelter" increased 3.9% from November 2020 to November 2021. Meanwhile, the Case-Shiller Home Price index is up 19.1% from October 2020 to October 2021. Large residential property managers are reporting rent increases in the range of 15 to 20%. The main reason for this discrepancy is that the rent of shelter CPI calculation mostly includes old renters who are still renting at the prices from when they began their leases. It will take 12 to 18 months for this rapid price change to show up in the CPI measurement. As "Rent of Shelter" makes up a third of the CPI basket of goods and services, this undermeasurement is skewing the entire headline inflation number lower. Therefore, we expect the core CPI basket price increases to remain elevated through 2022 as the measurement catches up to reality.

For countries where official inflation numbers are completely unreliable, a crude way to get a rough measurement of inflation is to put together a price index of a basket of commodities of which you have good market data going back many years. If the commodity prices are connected to a liquid market, it will be difficult for any government to manipulate these improvised price baskets.

Our biggest portfolio position, Cornerstone Building Brands, has navigated the current environment admirably. While they have been victims of the same supply chain problems and labor shortages plaguing most major manufacturers, they have managed to pass on price increases to their customers and keep manufacturing production at record levels for the company. Their considerable investments in automation in previous years have proven prescient as they can now produce far more products per worker than before and with less reliance on workers in a time of labor shortages. The aggregate sales revenues for the company in the first 9 months of 2021 increased 21.6% over 2020 figures driven by a volume increase of 7.9% and price increase of 13.6%. The official CPI inflation for September 2021 year-over-year was 5.4%, quite a difference from the 13.6% price increase experienced by Cornerstone customers.

Cornerstone has centralized pricing decisions for their subsidiary companies in order to better stay abreast of production input prices (especially steel price increases) and be able to increase prices ahead of inflation. The order backlog for Cornerstone remains at extremely high levels and we expect them to maintain high production volumes and sales for the foreseeable future.

This period of heightened inflation will hurt our stocks with significant dollar-denominated financial assets, but may be a benefit to our stocks with net debt in dollars, possessing real assets, and the ability to pass on price increases to customers.

Georgia Capital and Emerging Markets

Georgia Capital is an investment holding company of disparate businesses operating in the Republic of Georgia. The company has skilled management that is well incentivized and aligned with shareholders and well positioned to take advantage of opportunities in this frontier market country. As we already had a deep dive into Georgia Capital in Q1 2021, I will limit this discussion to recent developments at the company. The company continues to trade at a deep discount to their disclosed net asset value per share (most recent share price was £6.70 against a NAV of £14.80).

On Dec 31st 2021, the company reached an agreement to sell 80% of their water utility business at a price valuing the entire business for 225 million USD (equal to 697 million GEL). This is a significantly higher price than the internal valuation estimate used by the company which held the water utility to be worth 620M GEL on June 30th 2021.

We believe that the company-provided NAV for Georgia Capital underestimates its fair value. The Bank of Georgia (LSE:BGEO), publicly traded on the London exchange, makes up over 20% of the NAV of the company and is the only publicly traded business in their portfolio. On Georgia Capital's NAV calculation, this bank's value is held at market price[1] which we believe trades at below fair value. Most of the other businesses are externally valued by a third party. Through this water utility sale, Georgia Capital has demonstrated that they are able to sell their large portfolio companies at prices above the values used for calculating their NAV, and this suggests that the valuation multiples used for calculating NAV are conservative.

This sale allows Georgia Capital to pay down their debt and deleverage the balance sheet. The management has guided in the past that they consider the company's share price to be a hurdle rate for new investments. If the best use of capital is to buyback their own shares, that is where they will deploy capital. This leads to a fairly straightforward catalyst for realizing the value in Georgia Capital. With the company now flush with cash, we predict that they will accelerate buying back shares in the near future and close the gap between share price and calculated NAV.

The cheap valuation of Georgia Capital and the Bank of Georgia is part of a wider issue with frontier market stocks where an outflow of investor capital from funds dedicated to frontier markets accelerated in 2020, forcing fund managers in these markets to sell their holdings. This creates excellent opportunities for strategies like ours with a flexible global mandate.

Market at the Start of 2022

The irrationality of the market of the past few years has reached new extremes in 2021 as seen in the "meme stock" phenomenon. The valuation spread between cheap stocks and expensive stocks is far greater than any time in history, as well as the spread between the US and emerging market equities. The current environment exceeds even the excesses of the dot-com bubble. A chart from AQR[2] succinctly summarizes this situation by showing the dispersion of a composite value factor measure globally over time.

Hypothetical AQR Industry-and-Dollar-Neutral All-Country Value Portfolio

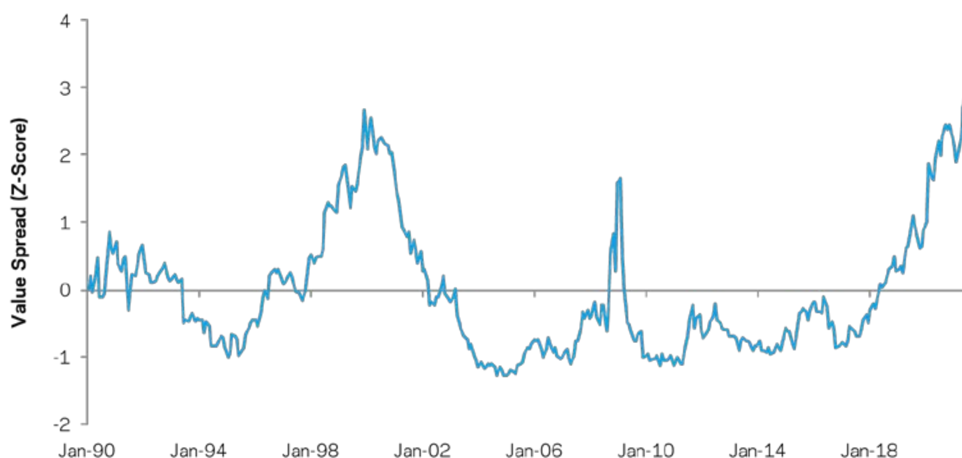

Chart from AQR, data as of 11/30/21, disclosures at footnote link

[1] The Bank of Georgia trades at a Price to Tangible Book Ratio of today is 1.1 and a trailing PE ratio of 4.8. This is a very depressed multiple considering their dominant position within the Republic of Georgia and their growth prospects.

[2] https://www.aqr.com/Insights/Perspectives/Thats-it-Thats-the-Blog

As we enter 2022, there are significant risks. Currently, the market expects four 25-basis point rate hikes from the Federal Reserve for 2022 (based on the spreads in Eurodollar contract trading). These rate increases should slow down USD inflation. However, if rates rise too quickly it could hamper the ability of corporations to refinance debt and harm consumer spending. The pent-up demand from consumers who avoided spending during the pandemic will act to counteract the effects of these rate increases. We believe that the shortage of housing in the US is sufficient to allow significant new housing starts to continue even at higher mortgage rates. A second major risk is the threat of escalation with Russia over the Ukraine crisis. While we continue to believe that a 2022 invasion and occupation of Ukraine is unlikely, there would be significant harm to our portfolio companies in Russia and the European Union if that were to happen. Our Russian equities are already down significantly from their late-2021 peak, so we should expect a significant gain if this situation is resolved diplomatically. In the meantime, our two Russian companies will continue to grow organically and pay significant dividends.

For the past eight years, we have faced a strong headwind for our strategy as foreign equity stocks have underperformed against the US and “value” stocks have underperformed against more expensive high-multiple stocks. Despite this, we have managed to achieve satisfactory investment results through our security selection. We believe that this headwind will soon turn into a tailwind and that the best years are ahead of us. We begin this year with a portfolio of good businesses at great prices. We hope that 2022 will see an end, in most countries, to most pandemic restrictions currently in place and a return to normalcy.

We appreciate the trust our investors have placed in having us steward their capital in these interesting times. Please contact me with any questions you have about financial markets or our strategy.

Best regards,

Andrew Oskoui, CFA

Portfolio Manager