



January 24, 2017

Dear Fellow Investors,

In the fourth quarter of 2016, we generated positive returns of more than 5%, bringing the full-year 2016 gross return to 18.7%. Please check your individual statements for net returns, as they will vary by class. This compares to 12% for the S&P 500 and 21.3% for the Russell 2000 over the same period. We continue to believe that shorter-term (quarterly or single-year) relative performance measurements are largely irrelevant, whether favorable and unfavorable. While we are pleased to have outperformed the S&P 500 in each of the last four years, we consider it more meaningful that, over the last three years, five years, and since inception, we have outperformed the major indices.

As we go on this journey investing together, I try to keep you informed of how I am approaching investments. What are the frameworks that I am using? What am I paying attention to? Clearly, it would be less time consuming to just send statements, but my aspiration is to provide a higher level of understanding and transparency. Not only because this is what I would want as a limited partner, but also because I believe it increases the likelihood that you all will “stick around” when we hit inevitable rough patches. Our concentrated, value-focused, contrarian investment style will inevitably zig when the market zags and zag when it zigs, leading to both outperformance and, at times, underperformance. Knowing what we own and why we own it is your right as an LP, and should provide comfort in difficult times.

WHERE ARE THE BACKHOES? BUY MORE FIAT

In the Q3 letter, I wrote about the attractiveness of “invisible companies” that lay outside the vortex of indexing. I have also written about the benefits of being a small fund, allowing us to pursue the broadest range of investments, and have paid homage to Marc Andreessen’s “Why Software is Eating the World” thesis. During the fourth quarter, I found myself thinking a lot about backhoes of all things.

Some people follow Kim Kardashian on Twitter; I follow investors and people who post anything and everything about Charlie Munger, Mohnish Pabrai lectures, and links to Howard Marks and Murray Stahl essays the moment they drop. It was through Twitter (I wish I could give better attribution) that I came across a 1996 column by venture capitalist Bill Gurley, “Backhoes Don’t Obey Moore’s Law: A Story of Convergence.”¹ I had never read this 20-year-old article before, but it instantly resonated. In the age of dial-up internet, people could see the future of connected computers and the benefits of the broad availability of high speed internet, but Gurley effectively diagnosed that the bottleneck to realizing the utopia of computers connected with broadband would not be the computers, but rather the ability to lay

¹ Moore’s Law refers to the observation by Intel co-founder Gordon Moore that the number of transistors per square inch in a dense integrated circuit had doubled every 1-2 years since their invention (i.e., technological advancement shrunk transistor size so that twice as many could fit onto a chip), and the subsequent prediction that this trend will continue into the foreseeable future.

the pipes which would enable the connections. Unfortunately, backhoes only improve at 12% per year, far more slowly than computers.

Obviously, the evolution of the internet and the passage of 20 years answered many of the questions posed in the article, but as I look at new and existing investments, I now try and understand what might be the metaphorical “backhoe” for the given situation that will delay convergence or the demise of an existing product. The common narrative of our times is that virtual reality, 3D printing, self-driving cars, blockchains, and drone delivery will transform industries. Fortunes will be made and fortunes will be lost. Often the mispricings we exploit exist because the market is over-emphasizing the speed at which change will happen, and underestimating the earnings power of the incumbent business.

I believe that one of our holdings – Fiat – is a situation where the market is/was forgetting about the backhoes. Over the course of the fourth quarter, we substantially added to our Fiat position (which we have owned for 3+ years) for two reasons. The first reason was “backhoe” related. Fiat has underinvested in self-driving cars. If that is not “bad” enough, there is a vision of the future in which the model of individually-owned cars will go away as Uber and self-driving cars converge. Why own a car when it is not used 96% of the time? Just hail a self-driving car on your smartphone and avoid the cost of ownership. In this draconian scenario for the legacy of auto manufacturers, fewer cars are sold, and the ones that are sold are made by technology companies, not car companies. For a futurist, Fiat is one of the most disadvantaged auto manufacturers. As a value investor, I don’t think it matters, there are “backhoes.”

The futuristic vision of car ownership being replaced by an Uber-like fleet of self-driving cars has several likely backhoes. One of the best examinations on the issues facing autonomous cars is this presentation by Frank Chen of Andreessen Horowitz (<http://a16z.com/2017/01/06/selfdriving-cars-frank-chen/>). There is a massive leap that has to be made from today’s “assisted driving” cars, which have advanced cruise control and can parallel park, to a “fully autonomous” car that does not even have a steering wheel and will never be driven by a human. Highway driving is relatively easy, but city driving is more complicated; sunny days are relatively easy, but snow-covered roads are more challenging. A self-driving car that works 99% of the time but still relies on occasional human intervention is not the real game changer; 100% reliability is necessary to change the paradigm. To get to 100%, outlier events such as navigating construction and accidents must be overcome. Other challenges/backhoes include contextual challenges of programming a car to drive alongside other humans. There are also cyber security challenges to prevent hackable cars, cost challenges to make them accessible to consumers... I could go on, but suffice it to say, there are many challenges.

Ultimately, I think the real backhoe for fully autonomous cars will be regulatory. Even after all of the technical challenges are overcome, I can hear the well-intentioned regulators and legislators acknowledging the potential of fully autonomous cars while still encouraging caution and taking a “wait and see” approach. Yes, there will be early adopter cities and even states, but a self-driving car that only works in San Jose and Michigan on sunny days is not that valuable, and hardly a death blow to Fiat. Chris



Urmson, who ran the Google autonomous car project, has estimated it could be as long as 30 years before we have fully autonomous cars. When I synthesize all of the potential challenges to self-driving, I am certain that the impact on sales will not be material in the next five years, which I consider our investment horizon.

Another common argument against owning any of the auto manufacturers is that auto sales in the U.S. have reached “peak SAAR” (Seasonally Adjusted Annual Rate). Clearly, a low margin and high fixed cost business will see earnings decline as volumes decline. Current volumes are 18M per year and The Great Recession saw SAAR fall to as low as 9M units per year. Every monthly sales report is probed for weakness and evidence that peak SAAR has been reached. I think the most likely scenario is a plateau. The U.S. auto fleet is as old as it has ever been at 11.6 years, and with 264 million cars registered, even at 18M units per year, the fleet is still aging. When adjusted for population growth and fleet aging, current SAAR looks sustainable. Having driven in a few 12-year-old cars, I am skeptical that SAAR will decline rapidly, barring a very large shock to the economy.

“I AM NOT BELIEVING” – ACTUALLY, I AM

If we put aside the autonomous car threats as substantially outside of our investment time horizon and posit that “peak SAAR” may actually be plateau SAAR, what do we have? Fiat’s CEO Sergio Marchionne laid out an ambitious five-year plan in 2013 that outlined substantial improvements in margins and volumes. The plan was a PowerPoint tour de force which included the revitalization of Alfa Romeo and, more importantly, a road map to profitability, plus a swing from almost \$10B in debt to \$5B in net cash by the end of 2018. My four-year-old daughter has a simple and profound way of speaking. She will often say, “I am not believing,” which is shorthand for completely dismissing what you are saying. No discussion is to be had after she declares that she is “not believing.” Well, the market’s reaction in 2014, 2015, and 2016 has been “I am not believing” to Sergio’s plan. The consensus “cool kids” dismiss the plan despite dozens of changes at the auto manufacturer, which have included spinning off Ferrari, gaining access to Chrysler cash, improving margins, changing the vehicle mix to emphasize more profitable SUVs made under the Jeep brand, and a joint venture in China.

Ultimately, the decision to double down on Fiat was driven by the fact that 2018 is just around the corner. Most investors think about “forward earnings” where they are looking at the current year or the following year – only a minority of investors look two years out. Thus 2017 marks the point where the majority of investors and analysts stop ignoring 2018. Fiat was trading at less than 1.5X 2018 plan numbers last fall. Something had to give. Real companies that are debt-free don’t trade for 1.5X earnings – even if the earnings are a year away. I know I am supposed to say something conservative like, “I think we can earn an attractive return on our investment,” but the reality is that if Marchionne and team continue to execute and the new car market does not fall off a cliff, I think we can earn multiples on our investment and, as a result, made Fiat a 10+% position. I am believing.

TOP 5 POSITIONS

The fund's top 5 holdings as of December 31 were Fiat, Fortress Investment Group, Videocon, IDW Media, and Gaia. The thesis on Fortress remains the same: it is a quality business with 45% insider ownership trading for a modest premium to cash and investments giving very little credit to future incentive fees. While the share price did nothing in 2016, we did collect almost 10% in dividends, so we are getting paid to wait. The other top five holdings with a little more detail are as follows:

IDW Media (IDWM): The company continues to execute on its plan to use the cash flow from its stable advertising business to fund its entertainment business, which consists of comics, books, games, and television. Long-term economics, and the share price, will be determined by the number of TV shows the company gets on the air. They currently have two shows up with a path to five or more in 2018, and management has a strong track record of identifying content and developing properties. Results will be lumpy and progress episodic, but the long-term prospects appear healthy. An independent publicly traded vertically integrated entertainment company is a rarity. They tend to be gobbled up. If IDW Media has five shows on the air in 2018, there could be \$30M+ in EBITDA. Apply any sort of take out multiple for a strategic acquisition of a unique asset and our patience will be well rewarded.

Gaia (GAIA): The investment thesis was outlined in great detail in the last letter. Gaia's CEO owns 38% of the company and did not sell a single share during a tender offer over the summer. The company has a fully funded business plan to grow subscribers to the video streaming business over the next five years. I had the opportunity to sit with Gaia's Chief Marketing Officer this fall. While they do not disclose customer acquisition costs or churn rates at the level of granularity I would like for modeling purposes, the meeting shed light on the level of targeting they do on platforms like Facebook, as well as the associated tracking methodologies. The landscape may ultimately change, raising customer acquisition costs and increasing churn to make Gaia a less attractive business, but the CEO – who owns multiple of what we own – has sold four previous businesses, so there is reason to believe he would sell again if the business deteriorates.

Videocon DTH (VDTH): This is an Indian satellite TV provider that we have been invested in since 2015. While the company's operating performance has been outstanding, the share price has gone nowhere (well actually down modestly). This is a fundamentally healthy business with revenue growing 20% y/y, rising prices, realizing operating leverage, and lowering churn. During the fourth quarter, a deal was announced to merge with DishTV India, another publicly traded Indian satellite TV provider. We bought more shares when the deal was announced, as the deal provides a number of benefits, including reducing the threat of a price war. Going from four to three major providers does not eliminate the threat of a price war, but it is a step closer to stability. VDTH has been the fastest growing provider because they offer the most channels in each price band – their growth would undoubtedly slow if a competitor decides to change the pricing



paradigm. There is now one less potential disrupter. Fortunately for us, the structure of the deal allows us to participate in the substantial cost savings of the combined entity as we will receive DishTV India shares. Expectations are that 5% or more of costs can be taken out of the business from savings on content and increased scale, and there are additional savings if there is an eventual shift to the same satellites. There will be reduced leverage as well. In effect, we gave up some of our growth to the slower-growing DishTV India holders in exchange for their higher multiple shares and the ability to access the post-deal synergies that benefit both parties. Given that so many benefits should occur post-transaction, I am happy to hold the shares of the new entity. It should be noted that while VDTH is covered by two sell side analysts, to this date, neither has felt compelled to publish research covering the merger deal, which was announced in November. While not completely invisible, not a lot of U.S. investors are focused on the opportunity.

SHORTS

Our “shorts” remain a very modest portion of our overall portfolio with individual shorts being 1-2% positions and index hedges being only modestly larger. Our short of Lands’ End has been moderately profitable. The company’s management situation, which closely resembled a dumpster fire, may be stabilizing as the company announced a new CEO. While short-term operating results will likely be bad, this time the company has hired a CEO who will actually live near the company’s Wisconsin headquarters and has a strong track record at luggage company Tumi. The easy money shorting the shares has likely been made here. We also remain short Tesla for all of the reasons outlined in our last letter, including poor unit economics, the convoluted Solar City deal, increasing crowding in the electric vehicle market, the need for additional cash, and the flawed economics of the Model 3.

NEW HOLDINGS

The investment business can be brutal on the psyche. Any given investment is rarely bought at the true bottom and sold at the true top. Investments that appreciate significantly could almost always have been bigger; investments that lose money could have been smaller. Then there are the errors of omission, which are the investments that were considered but not executed. This is to say there is no shortage of ways for a portfolio manager to beat himself/herself up. In 2016, we made several prescient investment decisions which led to investments appreciating more than 50%, including RMR Group, IDW Media, Diamond Resorts, and Iteris. The steady flow of new funds from new and existing limited partners, as well as our desire to be tax efficient and avoid short-term gains, led to ending the year with almost 20 positions. This is at the very high end of where I feel comfortable. We made three investments (outlined below) in the fourth quarter alone. I would be very happy to slow this pace down and get back to owning approximately 15 positions. This may result in a coming quarter or quarters where we add no additional companies to the portfolio. I think that would be ultimately healthy. For 2017, less is more, fewer is better.

The smallest investment we made in the fourth quarter was in a company called RMG Networks, which I have been studying for almost a year. I went to visit the Dallas headquarters over the summer, but did not invest at the time. RMG is a business in transition. They historically sold the screens that digital advertising is shown on. This is a bad business with little differentiation, low margins, and little recurring revenue. Couple a bad business with the bad strategy of the last CEO who tried to build a media company, and the result is bad financial performance. The stock chart of RMG Networks is a black diamond ski slope with the price declining from more than \$10 to less than \$1 in less than three years. So far, nothing outlined above would have piqued my interest. Why travel to Dallas in July? The primary reason was that Eric Gomberg from Dane Capital had prodded me to meet with the CEO in the spring. Eric described the CEO, Bob Michaelson, as an incredibly high quality leader for a sub-\$50M market cap company. Per usual, Eric's assessment was spot on. The trip to Dallas was to understand if Bob had been able to build a team – or if he was “all hat and no cattle.”

One method I use when evaluating management is imperfect, but it is the “What Would Scott Miller Do” (WWSMD) test. In the case of Bob Michaelson, the only move he has made to date that fails the WWSMD test is accepting the job as CEO, stepping into the top role at a money-losing company pursuing a money-losing strategy with a constrained balance sheet. I would have never taken the job in the first place, but once in the CEO role, he has done everything I would have done and then some. He (and his team) sold the money-losing media business, radically restructured the digital screen business by taking out 30% of the operating costs and lowering the breakeven points, invested in new products, and improved distribution. Bob and his team are de-emphasizing the low-margin hardware and emphasizing the higher-margin recurring revenue software and services. Bob is focusing on what goes on the screens that are sold. Bob has added distribution in specific verticals, giving up some economics in order to leverage their sales forces. Specifically, he partnered with Manhattan Associates, a public company 100X their size, Ragan Associates, a leader in internal communications, and DS-COMM, a unit of Boeing. This is a low-cost, potentially high-reward strategy (nice work, Bob). None of these changes “screen well,” but they matter – the fundamentals matter.

Almost all of Bob's progress outlined above (except the partnerships) was evident in our July visit when the shares were trading at just over \$1, but I still decided to wait and watch as I am not a fan of the hardware business. This waiting and watching ended in December, when two other factors drove the investment decision. First, there appeared to be an indiscriminate seller – the portfolio manager at the second largest stockholder had turned over, and whoever inherited the position wanted out of what effectively amounted to a rounding error in their overall portfolio. An indiscriminate “seller of size” in an illiquid stock creates an opportunity. The second and final piece to the puzzle was RMG's fully backstopped rights offering. In plainer English, in order to strengthen the balance sheet, the company raised \$4M in additional capital by offering every existing shareholder the right to buy shares at \$0.62 (for every five shares an investor owned, s/he could buy an additional share). The largest shareholder, who has a board seat and is presumably quite informed, indicated that he would participate on his pro rata basis



and would backstop the offering by taking additional shares, if necessary, to sell the full \$4M. A fully backstopped rights offering can be a way for existing investors to buy more shares on favorable terms. As a point of reference, our IDW Media shares, which we bought in their fully backstopped rights offering, are up more than 100% in less than a year. While RMG Networks shares will likely not perform as well, the stock is trading at a depressed valuation and is at an inflection point where the product investments and partnerships will begin showing up in the financials. I was thus happy to participate in the rights offering alongside the largest shareholder who was committing additional capital as the long-term opportunity had improved while the stock had gotten cheaper. Over time, improved profitability should come from the distribution partnerships and reduced cost base. We may also benefit from multiple expansion as the company emphasizes software with recurring revenue and services over hardware.

INVESTORS ARE BAD AT MATH

The other two investments that we made in the fourth quarter are detailed in my 30+ page presentation for The Manual of Ideas' Best Ideas Conference 2017. The presentation is up on our website (www.greenhavenroad.com) under the Investor Letters tab. The abbreviated version is as follows: investors are bad at math and underestimate the power of compounding. As you will see if you go to the deck, there is a very large difference between money that grows at 10% vs. 20% over a long period of time. The example I used was 100,000 growing at 10% vs. 100,000 growing at 20% for 30 years. At the end of Year 1, 10% growth gives you \$110,000, while the 20% pile is now \$120,000 – a \$10,000 difference. How big will that difference be after 30 years? For the answer, you can 1) use Excel, 2) go to the presentation on slide 7, or 3) see the postscript at the end of this letter. Bigger than you thought?

The second theme of the presentation and the new investments this quarter is that “Boring is Beautiful.” Boring businesses can deliver outstanding returns. The road to wealth is not only paved by discovering oil, finding a cure for cancer, or social media. The presentation profiles a “boring” business, Watsco (WSO), in the air conditioning business. Watsco has executed a “buy and build” strategy. They have acquired dozens of companies at favorable multiples AND improved them. The share price appreciation has been anything but boring. Over the last 30 years, revenues are up 53X but share count is up only 5X, resulting in the stock price being up 60X. The math of using shares that are trading at 15X EBITDA to buy businesses that are trading at 5X EBITDA, and then improving those businesses, is very powerful.

NEW INVESTMENTS IN BORING BUSINESSES - ENVIROSTAR & LIMBACH

We did not invest in Watsco. Instead we made an investment in a “boring” commercial laundry equipment distribution company, EnviroStar, Inc. (EVI). The company has no sell side analysts, no investor presentation, and conducts no conference calls. Adam Wyden of ADW Capital owns more than 5% of the company and was very helpful in connecting the dots here. As outlined in the presentation, EnviroStar is an investment predicated on the “jockey” – in this case second-time CEO Henry Nahmad, who previously spent eight years at Watsco, where he had a front row seat watching his uncle execute the “buy



and build” strategy as CEO. Influenced by this approach, Henry Nahmad raised money from friends and family and invested personally to create two partnerships that bought control of Steiner Atlantic, a publicly traded nanocap commercial laundry distribution company that has subsequently been renamed Envirostar. Commercial laundry is not coin-operated laundromats, but rather specialized, centralized facilities in high-volume laundry environments such as hotels and prisons. The industry is attractive: with five primary manufacturers of equipment, there is a slow rate of technical innovation, but the machines do break, which provides opportunities for a higher-margin service business. The distribution agreements with manufacturers typically call for geographic exclusivity and distributors carry little inventory beyond replacement parts. In summary, you have geographic monopolies in an asset-light business with little risk of technical obsolescence. Henry has completed his first major acquisition and secured debt, both on favorable terms, while also building out his management team. There are plenty of risks with his “buy and build” strategy, including a reliance on a “favorable currency” in the form of a high stock price. The shares have appreciated significantly, as a value investor, buying a stock that is up more than 4X from the lows is not a natural act. However, the current multiple is lower than Watsco on current year EBIT and the company has a clear path to doubling earnings this year through acquisition while increasing share count less than 20%, which will make us yearn for current prices. Run the numbers, if Envirostar can continue to grow earnings with minimal dilution a few times over, boring will not only be beautiful – it will be quite lucrative for all involved. Remember, investors are bad at math.

The second new investment in the Q4 is a similarly “boring” company, Limbach Holdings, Inc. (LMB), which, like Watsco, is primarily in the air conditioning business. Limbach specializes in installing and servicing non-residential HVAC systems, focusing on hospitals, education institutions, and entertainment venues. The company has a centralized engineering staff to assist general contractors and architects with the design of complex systems, which can bring down project costs and increases win rates. My presentation goes into greater detail on Limbach, but at a high level, the company has a strong CEO, a healthy business backlog growing 30% y/y, and is valued at a discount to its peers. There is a clear path to continued organic growth and margin expansion. Limbach also has the opportunity to selectively grow through acquisition, expanding geographies as well as business lines (electrical and fire suppression). Couple this with aligned incentives from the CEO owning 6% of the company and the SPAC sponsors owning more than 40%, and this has an opportunity to be a lucrative investment as well. We own the common stock as well as the long-dated warrants.

Finally, in the last letter, I stated that we are acquiring as many shares as we can of a small Canadian company with 97% customer retention, a large competitor leaving the industry, and a large customer just acquiring 10% of the company. We are still buying. We also exited the long Dell/Short VM Ware position outlined in the last letter as I preferred the long-term opportunities provided by these newer investments.

K-1s

The partnership’s ability to generate K-1 tax forms is dependent upon the receipt of a K-1 from Fortress Investment Group. Our K-1s should be available and distributed in early April.



EXPANDING THE INVESTOR BASE

We added a number of limited partners over the fourth quarter, and like our children, each one is special. I do think two are worth discussing for different reasons. The first is a museum, which is the first non-profit limited partner we have. I am thrilled that our efforts at making money, if successful, will support their programmatic work of educating children. I hope it is the first of many non-profits who join the partnership. The second LP of note is a portfolio manager with an enviable track record and a disciplined investment style. He has several 20-plus-year holdings, and really understands investing over a long time horizon. He invested on behalf of his children, making Greenhaven Road the first investment outside of his own fund in more than a decade. We now have over a half dozen LPs who are portfolio managers. Whenever a Chuck Royce or somebody like our most recent LP joins the partnership, I am humbled and reminded that there is no “mailing it in.” An incredibly smart and sophisticated group of LPs just got even smarter.

I would also like to thank one of our limited partners who owns a Marriott hotel. I was doing diligence on a hotel-related investment and he was generous with his time.

OUTLOOK

My outlook for the economy is rather benign. Fortunately, our portfolio is a mix of high-quality companies that should compound earnings over years, despite market gyrations, and ultimately be worth significantly more than our cost. Our special situations investments should “work” regardless of the overall market. With the context that we are not actively timing the market, I am skeptical of the “Trump Rally.” I understand the euphoria around the potential for changes to the corporate tax code. It’s impossible to argue with the math. For profitable companies, when taxes go down, earnings go up and everyone can party on. Given the Republicans have a majority, the likelihood of reform is clearly increased. However, to quote my daughter, “I am not believing.” Our process of checks and balances is unwieldy, and the influence of special interests has not abated with the new administration. Inertia is a powerful force, and legislation by a committee of 600+ people has the ability to stall or bastardize the magnitude of tax reform the Trump bulls are hoping for. So, I don’t believe in the foundation of the most recent leg of our bull market, but the reality is, our investments are made on the fundamentals. Ultimately, volatility is our friend. We will continue to invest with a long time horizon like it is our own money – because it is. Thank you for the opportunity to grow your family capital alongside mine.

Sincerely,

A handwritten signature in blue ink, appearing to read "Scott Miller".

Scott Miller

P.S. the answer to the question on page 7 was \$22M.



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