Dear Investors,

In the third quarter, RF Capital was down 6.98%. Please login to your Interactive Brokers accounts to view your exact returns. While the performance of accounts may differ slightly depending on when funds were available and when investments were made, year-end returns should be roughly the same over time. All accounts are managed the same way. Every account is invested in the same stocks with nearly identical position sizes.

Although we were down in Q3, the stock prices of our investments typically decline first before they go up due to our contrarian and distressed investment strategy. Thus, down months, down quarters, and down years are to be expected. However, we believe the firm will generate outsized returns over full market cycles.

As a review, RF Capital typically invests in 5 to 10 stocks that can double in 2 to 3 years. We focus on distressed companies because they tend to trade at large discounts to intrinsic value. Our investment checklist is: 1) a great business, 2) a great price, and 3) a great management team. While our checklist may seem standard, most fund managers seem to compromise on one, two, or all three of those checklist items. For us, a great business has an after-tax return on capital of over 20%. A great price is a 50% discount to intrinsic value as well as single-digit EV/EBIT, EV/EBITDA, and FCF multiples. Finally, a great management team is one that allocates capital well via share buybacks, dividends, debt repayment, acquisitions, and corporate transactions such as spinoffs.

**CURRENT HOLDINGS**

In our 2018 annual investor letter, we mentioned why we did not reveal or discuss our portfolio holdings. Those reasons included commitment and consistency bias and competition. However, we have decided to provide commentary on our holdings after having discussions with other portfolio managers and investors. We will do so in this letter and future letters on an interim basis.

We hope that talking about current and past holdings in our investor letters will yield similar benefits to our research notes and investment journal. Having our investment theses and thoughts written down in the form of an investor letter will hopefully provide us with clarity when we think about our portfolio. Investors will also have the added benefit of understanding why they own certain stocks in their managed accounts.

Going forward, we will have a “Top 5” section where we will provide brief commentary on our five largest holdings. Also, we will discuss select positions such as new purchases or recent exits.
REPORTING FREQUENCY

We will also be making a change to the number of letters we write each year. Prior to this letter, we told our investors to only expect an annual investor letter each year. Occasionally, we would provide a semi-annual letter if needed. The reason for the lack of quarterly letters is because there isn’t much to report on. We only buy a handful of stocks every year, and we do very little selling. The minimal turnover and activity doesn’t provide us with much to write long, thoughtful letters. However, we hope to put out quarterly letters in the future even if they only end up being a few paragraphs long.

TOP 5 HOLDINGS

Foot Locker (FL) – Foot Locker continues to be a strong business that generates free cash flow and high returns on capital. In the last twelve months, FL has generated a pre-tax return on capital of 40.5%. Furthermore, the balance sheet remains solid with only long-term debt of $123 million versus $2.5 billion of equity. Year-to-date sales and comparable store sales are also up slightly compared to last year. Management guides an EPS percentage increase of high single-digits for 2019.

The stock is down from the 52-week high of $68 per share because FL’s Q2 earnings missed the Street’s consensus. Furthermore, analysts have been slashing price targets because they believe the company’s guidance for the year is too optimistic. Also, Nike (a key Foot Locker supplier) missed the Street’s estimates, which is a rarity. While retail and malls generally continue to struggle, Class A malls are doing well. There is steady foot traffic, few vacancies, and rents continue to go up.

Our average cost was $29.62 per share. Although we should have trimmed our position significantly when the stock reached $60+ per share, we will continue to hold the stock and monitor FL’s progress going forward into the holiday season.

Graftech International (EAF) – Graftech is our newest purchase. We bought shares this month at an average price of $11.14 per share. EAF is currently 10% of the portfolio. We will elaborate more on EAF in our year-end letter.

Aimia (AIM.TO) – Our investment in Aimia has certainly played out differently from our initial investment thesis. Aimia originally generated a lot of free cash flow with its loyalty businesses such as Aeroplan and Nectar. After those businesses were sold, the loyalty business segment started losing money. Now, Aimia has essentially become a holding company with valuable assets like PLM, Cardlytics, and Think Big.

The real issue at the moment is management and the board. Aeroplan and Nectar appeared to have been sold at fire sale prices. Furthermore, the board added two new directors less than a month after the company’s annual meeting without consulting the largest shareholders.

AIM has become an activist play. The company has sued Mittleman Brothers LLC, AIM’s largest shareholder with a ~23% stake, for violating a standstill agreement. Allegedly, Mittleman
Brothers ran a covert campaign to convince other shareholders to shift their support for certain board nominees. Charles Frischer also leads a group of shareholders called Aimia Shareholders for Accountability. The group has filed a formal requisition for a special meeting to replace four directors, including the chairman and CEO.

Our average cost was C$2.78 per share. While we still believe shares are worth C$6-$7 per share, the catalyst for price appreciation is questionable. Management doesn’t seem capable of attracting the highest bids for its assets, activists are in play, and the loyalty business remains challenged. We have trimmed our position accordingly. Although we have sold a meaningful amount of stock, AIM still remains a Top 5 position for us.

**Zagg (ZAGG)** – Smartphone sales have been down this year, and Zagg’s Q2 earnings reflect that. Due to the challenged screen protection and wireless charging businesses, ZAGG has reduced its revenue outlook for the year. However, Q3 and Q4 earnings should help Zagg generate $40 million in free cash flow for 2019.

ZAGG has also retained Bank of America Merrill Lynch to explore strategic alternatives. Several firms have expressed interest in acquiring ZAGG. Potential bidders include Acco Brands and a private equity firm, which sent a letter to the board saying it would be willing to pay $9 per share. ZAGG aims to conclude the bidding process in November.

The company projects $60 million in 2020 EBIT and believes the company is worth 7x EBIT. Our average cost was $7.06 per share. If acquired for $9-$11 per share within the next year, our return on investment would be quite satisfactory.

**Fiat Chrysler (FCAU)** – We believe Fiat Chrysler remains undervalued. The low earnings multiple is due to poor performance in China as well as the US-China trade war. Although Q2 profits were up compared to last year, shipments were down. The Street is concerned about growth in North America and FCAU’s struggles in Europe. Old products in Europe need to be refreshed (the average product age is over 7 years), and there is also regulatory difficulty with 2021 CO2 compliance. However, management reaffirmed their 2019 guidance of $2.98 adjusted diluted EPS and $1.65 billion industrial FCF.

**COMMENTS ON ADDITIONAL INVESTMENTS**

**The Joint Corp. (JYNT)** – The Joint used to be a Top 5 position for us. However, we have trimmed our position considerably. While we still like the business, we believe fundamentals have gotten ahead of the valuation. The stock currently trades at 154.65x P/E and 71.55x EV/EBITDA, which are multiples any value investor would be uncomfortable with.

Despite reducing our position size, we will continue to hold onto our remaining shares until a better investment alternative comes along. Meanwhile, we will ride the positive momentum. We invested in JYNT at $4.95 per share. Shares have since gone up 4X.

**NEW HOLDING – Gamestop (GME)**
Gamestop is a video game retailer with over 5,700 stores across 14 countries. GME offers new and used video gaming consoles, video games (both physical and digital), accessories, collectibles, and other miscellaneous items. Customers are able to trade in consoles, games, and accessories for cash or store credit through GME’s buy-sell-trade program. GME also publishes Game Informer magazine.

The business is currently challenged due to the rise of digital downloads, competition from other retailers, and increased gaming on mobile and computers. Furthermore, earnings will continue to suffer until Q4 2020 because the industry is currently at the end of the console cycle. (Sony and Microsoft will be launching new consoles next year in Q4.) Although sales and earnings have been down significantly, at least we are seeing through earnings or somewhere close to it.

Despite all the negative press around GME, we believe the situation looks worse than it actually is. The company has a strong balance sheet and continues to generate free cash flow. GME currently has $424 million in cash versus $418 million in long-term debt. Management has also projected adjusted diluted EPS of $1.15-$1.30 and adjusted FCF of $225-$250 million for 2019. Thus, GME should be able to stay afloat while waiting for the release of the next-gen consoles.

We made GME a 5% position. Our average cost was $5.30 per share. At this point, GME is difficult to value based on earnings. However, the strong balance sheet provides downside protection, and there will be more visibility when the new consoles and product titles launch next year. We will increase our position size if management continues to do the right things. The new CEO and CFO are off to a good start with 180-200 planned store closures and the completion of the modified Dutch auction tender offer for 12 million shares at $5.20 per share.

**NEW HOLDING – Garrett Motion (GTX)**

Garrett Motion is an automotive supplier that makes turbochargers, electric boosting technology, and automotive software. Long-term customer relationships include Ford, Volkswagen, Daimler, BMW, Hyundai, Renault, and Caterpillar. Currently, the turbocharger market is growing faster than vehicle production due to tougher CO2 regulations. IHS and industry sources project 6% CAGR over the 2018-2022 period versus 1%-2% CAGR for vehicle production. The only other major global player that competes with GTX is BorgWarner. Other competitors are either medium-sized global players or local firms.

GTX is a great business that generates returns on capital north of 100%. The business has low working capital needs with >20x turns and a highly variable cost structure of 80%. Furthermore, CapEx is only 3%-3.5% of net sales. There is also revenue visibility out to 2023. The most recent September 2019 outlook reveals awarded contracts of 100% for 2019E, 93% for 2021E, and 71% for 2023E. Long-term financial targets for 2018-2022 include 4%-6% CAGR for revenue, CapEx of 3%-3.5% of net sales, adjusted EBITDA margin of 18-20%, and net leverage of 2x consolidated EBITDA around EOY 2020.

Shares of GTX are currently cheap because it is a small-cap spinoff in the auto supplier industry. GTX was spun out of Honeywell in 2018. Spinoff dynamics led to a lot of selling, especially
since GTX is too small for many institutions to own. GTX currently has a market cap of $710 million whereas Honeywell, a multinational conglomerate, has a market cap of $120.7 billion.

Auto supplier stocks have also been depressed due to the US-China trade war. Furthermore, there are fears of a possible recession. However, GTX is not your typical auto supplier. GTX essentially operates as a duopoly in the turbocharger market with BorgWarner. GTX is also at the top of the auto supplier chain with a 80% variable cost structure. In the event of a downturn, we believe GTX will perform better than other suppliers. The contracts that have already been awarded provide downside protection as well.

Investors are probably concerned about GTX’s debt load and asbestos liabilities as well. However, GTX should be able to de-lever considerably given its FCF stream. Additionally, there are no debt maturities until 2023 and 2025. The asbestos liability payments are also capped at $175 million every year. In fact, future payments are likely to be lower based on the recent trend of cases.

We made GTX a 5% position at an average cost of $9.97 per share. We believe shares are worth at least $20 per share based on recent transactions in the auto supplier industry and GTX’s low EV/EBITDA and P/E multiples. The only concern at the moment is the departure of Alessandro Gili, the company’s CFO. Gili’s departure is a potential red flag in regards to management’s ability to execute and deliver on its financial targets. We originally liked how Gili previously worked at Ferrari and Fiat under the late Sergio Marchionne. His experience will certainly be missed. However, we will continue to monitor the management team and possibly increase our position size. We initially wanted to make GTX a 10% position, but the departure of the CFO put a hold on additional purchases.

OUTLOOK

In the current economic environment, we will proceed with caution. The probability of a recession is highly likely. The inverted yield curve and low interest rates are a cause for concern. The inverted yield curve is especially troubling because it has been an accurate predictor of recessions historically. Furthermore, freight (air, rail, and over-the-road), manufacturing, and certain real estate markets have taken a hit.

Despite a possible recession occurring in the near future, we do not know when exactly it will take place. It could be in a few months or in the next one or two years. Thus, we will continue to look for new investments that pass all of our investment filters. Just because a recession may be on the horizon does not mean we stop investing, go to cash, or try to time the market. Instead, we will be “playing defense” as opposed to offense. Going forward, we target a 25% cash position. An investment that makes it past the 75% threshold has to be a 3X-5X on our investment or more. Currently, we are well positioned with a 20% cash position across all managed accounts.

Thank you for your support, continued interest, and referrals. Please call me at +1626.623.6012 or email me at roger.fan@rfcapitalmanagement.com if you have any questions, concerns, or comments.
Best regards,

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