

RF Capital Management LLC

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Dear Investors,

In the first quarter, RF Capital was down 27.13%. Please check your individual Interactive Brokers statements for 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.

At first glance, it looks like we had a terrible quarter. However, we believe we had an acceptable quarter given how we adapted and managed our portfolio during the downturn. First, the major market indices were down significantly in Q1. For example, the Russell 2000 and the S&P 500 declined by 30.62% and 20.00%, respectively. Second, we run a concentrated portfolio of 5 to 10 stocks, so it is quite normal to experience volatility. Third, February and March were actually great months for us. Starting in February, we started “value trading.” In other words, trading around our positions. As a result, we were down less than the markets by a few percentage points in both of those months. Although we aren’t benchmarked, the small sample size of monthly returns is encouraging.

In this letter, we will first provide an overview of how our firm thinks about portfolio optimization and trading. Next, we will discuss our top 5 holdings. Finally, we will comment on a couple of our closed positions and provide our Q2 2020 outlook.

PORTFOLIO OPTIMIZATION

Value investors aren’t trained to actively trade stocks or focus on short-term price movements. Value investing typically means buying a stock with a low P/B or P/E multiple, holding the stock, and selling when the stock reaches intrinsic value. As a result, value investors tend to “buy and hold” stocks for many years with low turnover.

Since inception, we have followed the traditional value approach of holding stocks for the long term. When we identified an undervalued company, we would purchase the stock with its intrinsic value in mind. Instead of building our position over time, we would buy all at once. For example, if we decided on making an investment a 10% position, we would buy the entire 10% on the same day. Similarly, we would sell all at once when the price reached 90% to 100% of intrinsic value instead of spacing out our orders and averaging up.

Although there is nothing wrong with our previous method, we decided to change our approach in order to improve our investment process. Instead of minimal to no activity, we now trade around our positions based on short-term price movements. Although we trade around our positions now, we still select companies and value them with the same investment criteria and

time horizons as before. We are simply trying to maximize our gains and minimize our losses by taking advantage of short-term volatility. In recent weeks, value trading has been quite profitable due to the markets making new lows in March and subsequently recovering by more than 22% across all major market indices.

Starting in February, we adopted our current portfolio optimization framework. Although the sample size is small, value trading seems to work. In both February and March, we were down less than the market indices by several percentage points. More specifically, the Russell 2000 and S&P 500 were down 8.42% and 8.41%, respectively, in February while RF Capital was only down 5.27%. For March, the Russell 2000 and S&P 500 suffered losses of 21.73% and 12.51%, respectively, while RF Capital only declined by 9.24%. Despite the outperformance, we aren't satisfied with being down less than the markets. Our firm is not benchmarked and we are focused on absolute returns. We merely bring up the relative outperformance because the monthly results provide reinforcement and justification for our new trading approach.

We changed our views on trading around positions because we suffered a small loss on our investment in Stage Stores. To learn from our mistake, we studied all of our investments since inception and their price actions. Everything in hindsight is 20/20. However, we concluded that had we implemented our current value trading approach since inception, our net returns to investors most likely would have been higher. There were multiple cases of companies doubling in value where we did nothing. Similarly, there were several situations where cheap stocks only got cheaper and we failed to exit. It is difficult to put a precise number on what the outperformance would have been had we traded around our positions. However, we believe value trading is likely to help us generate better annualized returns going forward.

Our trading framework has multiple facets to it. Primarily, we focus on building our positions over time, trimming to lock in gains, and selling when there are significant price drops and negative momentum. Prior to implementing our value trading system, we only looked at stock prices once a week after the market close on Fridays. Now, we check prices once a day after the market close. We still put in orders outside of market hours though. While that isn't optimal from a trader's perspective, we do our best to remain detached from the markets. Behavioral psychology and cognitive biases affect investing performance more than most people realize. On balance, not much has changed for us except for increased trading activity and more frequent price checking. Compared to other traders and institutions, our activity level is still quite low.

TOP 5 HOLDINGS

GrafTech International (EAF) – Global crude steel production (ex-China) was down ~2% in 2019 and customers had an excess supply of graphite electrodes. As a result, net sales, sales volumes, production, and free cash flow in 2019 were all slightly down compared to the previous year. While contract prices remained at ~\$9,900 in 2019, there was a 25% decline in spot prices. Management expects spot prices to decline further in 2020.

In addition to reduced global steel demand, market participants are concerned about the viability of Graftech's long-term agreements (LTAs) and spot prices. Spot prices have declined in Q1 2020 and the downward trend is likely to continue given the current global environment.

However, EAF generates most of its revenues from the LTAs. For example, 80% of sales in Q4 2019 were from existing contracts. Thus, EAF is better positioned than its competitors when spot prices are down drastically. With the LTAs, the company has locked in prices with its customers. Those contracts also provide some stability and earnings visibility over the next three years.

Understandably, the take-or-pay contracts themselves are a concern. Although management hasn't provided much detail, the Street is concerned that customers are trying to renegotiate their agreements. Customers might also be looking to get out of those contracts entirely since many companies are experiencing financial difficulty and the risk of insolvency at the moment. According to management on the most recent conference call, a solution they have offered to customers is an extension of their current contracts. Purportedly, major terms such as pricing have not been materially altered.

Going forward, we will monitor the situation with Graftech's customers and their LTAs. At the moment, we aren't too concerned yet. As with most companies in the current environment, there is a lot of uncertainty. However, we believe Graftech is well-positioned to handle this difficult environment. Not only is Graftech the only company in the industry that employs LTAs, but they also produce ~70% of the required needle coke through Seadrift, their subsidiary. Graftech's competitors have to buy all of their needle coke on the spot market, thus creating greater variability in input costs. Given its vertical integration with needle coke, Graftech provides more earnings visibility and stability than its competitors.

We exited the position at an average price of \$9.75 per share in February due to negative momentum. Since then, we have reinitiated an ~8% position in EAF at an average price of \$7.48 per share. We are looking to increase our position if we are able to average down.

Aimia (AIM.TO) – Earnings improved in the fourth quarter. Net earnings were \$4.9 million compared to a \$126.2 million loss in the previous year. Although the cash burn continues, management expects positive adjusted EBITDA and breakeven FCF in 2020. If the company achieves those targets, it would certainly help move the stock price. However, the value in Aimia continues to be its cash and assets. The company still trades at a large discount to NAV.

As with all other travel-related companies, the stock price dropped significantly due to the COVID-19 outbreak. We aren't sure what PLM's earnings will look like this year, but gross billings and EBITDA were on an upward trajectory prior to the market-wide selloff. For 2019, PLM's adjusted EBITDA was \$85 million. If we use Virgin Australia's purchase of Velocity as a comparable transaction, Aimia's 48.9% stake in PLM continues to be quite valuable.

If the current board and management team is able to unlock value, the stock might be able to double or triple from current prices. The net cash position and the PLM stake alone far exceed the current market cap. Additionally, the stock price is likely recover when air travel gets back to normal.

We added to our position in Q1 at an average price of \$2.15 per share.

Undisclosed Top Holding – We initiated a ~5% position in this company. Our average purchase price was \$21.75 per share. We will provide an overview of this company in a future letter after we have finished purchasing shares. Currently, we target a 10% allocation and will buy more if we can average down. So far, averaging down has been an issue. At one point, the stock traded as high as \$39.70 per share. Nevertheless, we will remain patient and wait for a more favorable price.

Foot Locker (FL) – The company experienced softer than expected demand during the holiday season. As a result, fourth quarter comparable store sales were down 1.6% and total sales were down 2.2% compared to 2018. However, FL achieved a new company record with \$8 billion in annual sales for 2019.

Due to COVID-19, stores have been temporarily closed since March 17. Thus, the share price has been affected significantly. Fortunately for the company, they have a strong balance sheet and are in a better position than most other retailers to weather the storm. The company ended 2019 with \$907 million in cash versus \$122 million of debt on the balance sheet. When stores reopen for business, the share price is likely to recover.

We exited this position in February due to negative momentum at an average price of \$33.43 per share. After the market selloff, we reinitiated a position in FL at an average price of \$22.73 per share. Currently, FL is a 5% position for us.

Undisclosed Top Holding – We initiated a ~5% position in this company. Our average purchase price was \$16.32 per share. Like the other undisclosed holding, we have not finished buying shares yet. We are also targeting a 10% position size for this company. Despite the market being down as a whole, this company has performed well. Thus, averaging down has been difficult because there hasn't been much volatility in the share price. We will provide an overview of this company in a future investor letter.

CLOSED POSITIONS

Stage Stores (SSI) – The stock price declined significantly in January due to bankruptcy rumors. Although comparable sales were up 1.4% for the nine weeks ended in January 4, management completely missed their guidance and appeared to have no answers for why that was the case. Furthermore, Debtwire reported that SSI had retained P.J. Solomon and Kirkland & Ellis to explore restructuring options. The article sent the share price crashing. The Wall Street Journal compounded the problem by reporting that SSI was likely to file for bankruptcy. SSI is also currently behind on vendor payments. They now expect to close around 200 stores, reducing their initial planned Gordmans store count from 700 to about 500.

We sold our shares at an average price of \$0.72 per share to cut our losses. Although SSI was one of our biggest losers for the quarter, we were able to mitigate our losses by sizing the position at 5% initially. We don't like to lose money on our investments, but SSI could be a blessing in disguise for investors. Again, SSI changed our views on value trading and portfolio management. Thus, investors are likely to benefit from this mistake for many years to come.

Zagg (ZAGG) – The share price of ZAGG dropped significantly because the company suspended its strategic review process. Furthermore, Q4 and 2019 full-year earnings were underwhelming. Zagg abandoned the sale process because it wasn't able to attract a high enough bid. According to management, getting an acceptable sale price was difficult because of soft demand for smartphones, the impact of tariffs, and the difficult holiday season in 2019.

We exited our position at an average price of \$2.90 per share. We decided to sell due to the negative momentum. In this case, a cheap stock only got cheaper. However, ZAGG is on our “potential acquisitions” list and we may reinitiate a position in ZAGG at a later date. We still like the business and its earnings power going forward despite the failed strategic review process and weak 2019 numbers.

OPERATIONAL UPDATE

We are pleased to welcome Pallav Chaturvedi to RF Capital as an Investment Summer Analyst. He will help us generate new ideas, provide coverage on existing holdings, and work on various research projects. Although his internship officially starts in June, he has been working on investments for us since March. So far, we have a starter position in his most recent idea and one of his other ideas made our watchlist as well.

Pallav is an Equity Research Analyst and Vice President of External Affairs at Berkeley Investment Group, the largest student-run investment fund on the UC Berkeley campus. He is currently a first year student at UC Berkeley pursuing a Bachelor's degree in Business Administration.

OUTLOOK

We remain cautious going forward despite the market coming off the lows in March. Unlike many other fund managers, we aren't optimistic that the economy will bounce back immediately after stay-at-home orders are lifted across the country. It will probably take some time for consumers and businesses to get back to where they were prior to the COVID-19 outbreak. Additionally, the spread and threat of COVID-19 hasn't been contained yet. We are still lacking testing kits, ventilators, masks, vaccines, etc. Thus, it is difficult to normalize earnings for many companies given the level of uncertainty.

At the end of the first quarter, we had a cash position of 56%. Despite the large cash position, we remain patient and disciplined. We are in no hurry to put all of our capital to work. Instead, we will continue to build our existing positions slowly, look for new investments, and hopefully add some companies to our “potential acquisitions” list.

Nevertheless, it is an exciting time to be a value investor. Times of distress are what true value investors live for. Currently, our research pipeline and watchlist are filled with names, and we are as busy as we've ever been. We also have had many opportunities to trade around our positions.

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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