RF Capital Management LLC

615 Las Tunas Drive, Suite 203 • Arcadia, California 91007 • Phone: 626-623-6012 • Fax: 626-623-6012

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Dear Investors,

In the first half of 2021, RF Capital returned 55.17% net of all fees. Please check your individual statements for your exact returns.

We have gotten off to a strong start this year – especially in the first quarter where we generated a 42.82% return net of all fees. Due to favorable prices, we have trimmed and exited several positions already. Thus, we ended the first half of 2021 with a 53.58% cash position.

In this letter, we will briefly review our investment strategy and comment on GameStop, Perfect Medical Health Management, and Sprouts Farmers Market. Next, we will provide an operational update and our full-year 2021 outlook.

OUR INVESTMENT STRATEGY

Because we have several new investors, we will take this opportunity to provide a brief review of RF Capital's investment strategy. Our investment firm focuses on investing in publicly-traded equities globally. We are looking to invest in five to ten businesses that satisfy three criteria: 1) high returns on capital, 2) high internal rates of return (IRR) potential, and 3) aligned management teams. Additionally, we invest in special situations, which involve corporate transactions with catalysts. Our objective is to compound capital at above-average rates of return over the long term.

More specifically, we ask our investors to employ the five-year test, which simply means that they should not pass judgment on our performance until a minimum of five years has passed. Additionally, investors ideally should remain invested in the fund for as long as possible – preferably for decades. We can't capture the upside potential of our portfolio companies within the span of a few weeks, months, or even a few years.

In terms of a targeted rate of return, it is hard to forecast our portfolio's IRR. However, we tend to target companies with upside potential of 26% annualized or better. Our firm's returns may or may not mirror this hurdle rate. Timing and market conditions dictate returns and large cash positions could be a drag on performance. However, we adhere to our research process and value investing fundamentals on a daily basis. Additionally, our focus on micro and small cap companies, our willingness to invest globally, and proper judgment when constructing a concentrated portfolio increases the odds that we'll provide great returns for our investors. As long as we execute on our investment strategy and process, our long-term performance will be quite satisfactory.

GAMESTOP (GME)

Although the initial trading frenzy has passed, the stock price continues to remain elevated as we write this letter. We don't profess to understand the mechanics and exact details of what drove GameStop's historic run. However, we did trade around our position in GME as it happened and took full advantage of the price action. Because GME has been well-covered in the media, we'll just provide a brief overview of what happened.

GameStop's stock price started the year at $19/share. Then volume started to increase mid-January, and the stock traded in the $30's and $40's. In the last week of January, the meteoric rise of GME's stock price occurred. GME's stock reached an all-time high of $483 before crashing back down to the $40's. Essentially, the stock price rallied 2,442%, crashed (wiping out almost $30 billion in market cap), and rallied again.

The prevailing narrative was the battle between retail investors versus institutions and hedge funds. Retail investors were participating in forums and social media sites like WallStreetBets on Reddit and Twitter to exchange ideas. Then, they used brokers like Robinhood, TD Ameritrade, and WeBull to execute their trades. As a result, retail investors started getting involved with companies like GameStop, BlackBerry, and AMC Theatres.

Because there was heavy short interest in companies targeted by retail investors, hedge funds and institutions who were short these names started getting squeezed. Hedge funds like Melvin Capital were the first casualties of the short squeeze. Famous and prominent investors and executives such as Mark Cuban, Chamath Palihapitiya, and Elon Musk only added fuel to the fire by tweeting about and commenting on companies like GameStop.

With so much mainstream coverage of GameStop and other companies, Congress and the SEC started getting involved. Congress held hearings and investors like Keith Gill (Roaring Kitty on WallStreetBets) testified. The SEC also became more vigilant with the volatility and trading of certain stocks. For example, trading of GME was halted four times on Thursday in the last week of February, and the SEC suspended trading of fifteen companies the next day.

As of now, it is difficult to tell whether or not retail investors will continue to drive stock prices of select companies significantly in the future. However, this "phenomenon" will most likely be here to stay. Forums such as WallStreetBets have been around for as long as the internet. Unless such forums are regulated in a meaningful way, investors will continue to exchange ideas and analyze companies with one another. Furthermore, the stock market will continue to be more and more accessible to retail investors. Apps like Robinhood will continue to make it easy for individuals to trade stocks with low to zero commissions.

The public's sentiment towards Wall Street, institutions, and our government is unlikely to change either. For many retail traders, participating in the stock market is a way to pass the time as well as a way to "get back" at institutions, hedge funds, and the government. While it is unclear if individuals are targeting hedge funds and companies with heavy short interest intentionally, retail investors will continue to make an impact on market fund flows as they become smarter and more educated about investing.

Aside from GameStop's immense popularity with retail traders and short sellers, the business has undergone several fundamental changes. First, Ryan Cohen is now Chairman of the Board and the company's second largest shareholder with a 12.7% stake. In fact, the entire board has been overhauled. Second, the company has appointed a new COO, CGO, and CTO, and has made senior hires in the brand, merchandising, e-commerce, supply chain, and fulfillment departments. Most of these hires have previously worked at Amazon, Google, and Chewy. Third, Matt Furlong and Mike Recupero have joined GameStop as the new CEO and CFO, respectively. Furlong has also joined the Board after George Sherman, the previous CEO, resigned. Matt Furlong was most recently Country Leader, Australia at Amazon and has held various roles at Amazon including Director and Technical Director at Amazon North America. Mike Recupero is also from Amazon and was most recently CFO of North American Consumer, CFO of Prime Video, and CFO of European Consumer.

GameStop has also focused on debt reduction this year. The company repaid the remaining $73.2 million on the outstanding 6.75% unsecured senior notes due March 2021. Additionally, GameStop voluntarily redeemed the remaining $216.4 million in outstanding 10.0% secured senior notes due 2023. There are also no borrowings under the revolving credit facility currently, $48.1 million in short-term debt, zero long-term debt, and $752.1 million in cash at the end of Q1 2021. Thus, GameStop's balance sheet remains strong despite still operating at a loss.

In addition to paying down debt, GameStop has also taken advantage of the market environment by raising capital twice via "at-the-market" equity offerings. In April, the company sold 3,500,000 shares for net proceeds of $551.7 million. In June, the company sold 5,000,000 shares for gross proceeds of $1.126 billion. Although we would prefer companies to avoid transactions that dilute ownership for current investors, management made the right call given current market conditions. Taking advantage of its elevated stock price provides the company with liquidity and more options going forward as it turns its business around in an uncertain global business environment.

Despite all the positive fundamental changes, GameStop remains a turnaround situation. Net sales increased 25.05% in Q1 2021 compared to the prior year, but the company is still operating at a loss. GameStop has also closed a net total of 118 stores from the global store fleet in Q1. Earnings will only improve if Cohen and Furlong can enhance the customer experience in physical stores and continue shifting and growing the e-commerce business. Improving physical stores could be difficult, but improving the e-commerce business should be doable based on Cohen's experience with Chewy and all the new hires from Amazon, Google, and Chewy.

Currently, GME is only a 1.75% position in the portfolio. GME used to be one of our largest holdings. However, we trimmed our position significantly during the rally at different prices. Our last sale occurred when the stock traded at $470.25/share. We should note that we have been investors in GameStop since 2019, and our average cost basis was $5.28/share. We also didn't purchase any additional shares this year.

Going forward, we will continue to hold shares in GME as we monitor the progress of the company's business fundamentals. Although we believe the current stock price is egregious given the company's negative pre-tax earnings, after-tax earnings, and free cash flow, GME's earnings could improve with the new board and management team in place, the refreshed console cycle, and the growth of the e-commerce business over the next few years.

PERFECT MEDICAL HEALTH MANAGEMENT (1830.HK)

Revenue, operating profit, EBITDA, and net profit for FY2021 all declined year-over-year due to COVID-19 restrictions. For example, closures in Hong Kong amounted to 142 business days, which was 39% of available business days. Thus, revenues being down 12% overall is only a modest decline. Furthermore, the company continues to pay a dividend. In fact, the dividend was increased from HK$0.34/share to HK$0.38/share in FY2021. The balance sheet also remains robust with HK$499 million in cash and no debt at the end March 2021. Also, Dr. Au-Yeung Kong, along with Au-Yeung Wai and Au-Yeung Hung, continues to own 71.6% of the company. In short, we aren't concerned about Perfect Medical's subpar year and future prospects.

Perfect Medical has also made changes to its business this year. First, the company changed its name from "Perfect Shape Medical" to "Perfect Medical Health Management." The change in name is a reflection of the company updating its business model and being added to the MSCI Hong Kong Small Cap Index. In conjunction with changing the lot size from 4000 to 1000, being included in the index will increase investor awareness and drive fund flows. Second, Perfect Medical is transitioning from its focus on beauty services to both healthcare and medical beauty services. Additional specialties include:

- Pain Management (pain relief that avoids medication and surgery)
- Hair Growth (using Regenera Activa technology accredited by the U.S. FDA)
- Preventative Medicine (i.e., health screening)
- Reproductive Medicine (gynecological medical service and gynecological cancer and health management service)

Focusing on healthcare is a smart move by management given the current COVID-19 environment. The general public is more health conscious due to the pandemic, and this awareness is likely to persist in a post-pandemic world. Another benefit for customers is that they can visit Perfect Medical for healthcare services rather than traditional clinics. Building Perfect Medical service centers into one-stop shops makes it convenient for customers to receive multiple treatments in one place and consolidate trips for efficiency.

Perfect Medical's global expansion and growth prospects remain compelling as well. The company continues to open new service centers in prime locations. Before October this year, Perfect Medical will open 14 new centers in Singapore, Melbourne, Sydney, Guangzhou, Shanghai, and Hong Kong. Additionally, Perfect Medical will open new centers in New York and London in the second half of FY2022. The target is 20 new "Healthcare+Medical Beauty" centers for FY2022. Thus, we believe growth prospects remain strong given several factors: organic growth through new service centers, increased local consumption due to restrictions on overseas travel, more disposable income per capita and improved standard of living in Mainland China, and continued GDP growth in China (i.e., 6.5% in Q4 2020 and 18.3% in Q1 2021).

Currently, Perfect Medical is a 10% position for us. Prior to trimming the position in March and July, Perfect Shape was our largest position. However, we sold some shares around HK$5.05/share and HK$10.56/share – making Perfect Medical our third largest position. Our average cost basis was HK$2.50/share.

SPROUTS FARMERS MARKET (SFM)

Sprouts struggled in the second quarter due to the improving COVID-19 situation. Sales, comparable store sales, and earnings were all down QoQ – not surprising given how customers are enjoying traveling and dining out again. Furthermore, several new store openings have been delayed. More specifically, twenty new store openings have been inked this year but may be delayed due to supply chain issues, and seven store openings have been pushed back until 2022. Additionally, management projects that net sales for the year will be down low-single digits and comparable store sales will decline 5% to 7%.

Despite the weak quarter, management remains committed to their goal of 10% unit growth. Their unit growth goal is certainly doable given that there is room for another 300 to 400 new stores in expansion markets (California, Texas, Georgia, Florida, New York, New Jersey, Delaware, and Maryland). Furthermore, new distribution centers can be built in Florida, New York, and Colorado. The addition of new DCs is important operationally, and management targets having DCs within 250 miles of every store.

On top of unit growth, management is also targeting low double-digit earnings growth annually. Through new store openings, it wouldn't be difficult for Sprouts to realize that goal. New store economics remain attractive. Typically, new stores generate 20%-25% sales growth, $16M-$18M in sales, blended 8% EBITDA margins, and cash-on-cash returns of ~40% in year 4. Furthermore, new stores are now smaller (21K-25K sq. ft. compared to 30K historically), which improves CapEx and profitability.

Although SFM's growth opportunity is attractive, analysts are more focused on other issues such as foot traffic, competitors, and promotions at the moment. While these concerns are well-founded, analysts and investors should view SFM's challenges from a different perspective. With foot traffic, SFM targets a specific customer base. Customers who shop at SFM have different priorities and habits than those that shop at Kroger, Albertsons, Walmart, et al. Additionally, the product mix at Sprouts is different from competitors such as Kroger. (SFM's product mix is closer to that of Whole Foods and Trader Joe's.) Thus, it's unrealistic to expect Sprouts to attract shoppers who are not part of the target customer base. While Sprouts could attract more customers through promotions and deals, coupons and lower prices are not a long-term solution. What SFM needs to focus on is extracting more dollars from existing baskets. Existing customers are more likely to continue shopping at Sprouts over the long term. Shoppers that come into the stores just for the coupons and deals are fleeting.

Sprouts remains one of our largest holdings at 15% of the portfolio. Our initial average cost basis was $16.32/share. We continue to maintain our position given new store unit growth, projected double-digit earnings growth, the increasing trend of being more health-conscious and adopting organic/keto/gluten-free foods into one's diet, and the uncertainty of COVID-19 variants and their impact on consumer behavior.

OPERATIONAL UPDATE

Going forward, we will not be publishing letters on a quarterly basis. Often times, nothing of significance happens with any of our portfolio companies. Three months is just too short of a time period for a business to realize meaningful change and progress. Additionally, our trading activity is quite minimal. Thus, future investor letters will be written based on whether or not we think there are significant developments that require reporting. Investors can certainly expect between one to four investor letters per year. Instead of quarterly letters, we will also communicate more frequently via memos and other mediums.

Additionally, there will be a slight change to the formatting of our investor letters. Instead of commenting on our Top 5 holdings, we will only provide updates on one to three of our portfolio companies. Lately, we have gravitated towards more concentration in our portfolio. As our investors know, we typically own five to ten companies. Since inception, we have had closer to ten positions on average. Nowadays, we aim to own five or six of the best companies that we can find based on quality, return potential, and strength of management. Thus, having a "Top 5 Holdings" section would probably constitute a review of the entire portfolio. To continue with the theme of efficiency and material updates, we will only provide commentary on select companies going forward in an effort to keep our letters concise.

OUTLOOK

We believe the markets are likely to remain volatile for the remainder of the year. The emergence of the Delta variant has caused concern for investors globally – leading to volatility in the stock markets in recent weeks. Judging by the increasing restrictions, required proof of vaccination, and returning mask mandates in some countries and states, no country truly has the situation under control. Even countries like China and Taiwan have faced outbreaks despite experiencing minimal to no cases since the pandemic began.

Furthermore, it is highly likely that the world will see new variants of COVID-19 going forward. Vaccination rates continue to be low in many countries, and there is increasing evidence that the vaccines do not prevent new infections in fully-vaccinated people or prevent transmissions to others. As time passes, the vaccines also lose their efficacy drastically and booster shots are needed. Given that governments and officials worldwide have been gripped by fear of COVID-19 and its variants time and time again, it's possible for new lockdowns to occur in the future if the situation ever gets worse. No matter how well government officials handle the ongoing situation, there will always be the uncertainty and the overhang of possible outbreaks going forward. Thus, investors must be ready for the volatility ahead.

At RF Capital, we are looking forward to the second half of the year. Our research pipeline and potential acquisitions list remains filled, and we can't wait to pull the trigger at the right prices. As long as stock prices meet our targets, our cash position will most likely be reduced in the second half of the year. Meanwhile, the large cash position doesn't concern us. We have continued to generate great returns on a risk-adjusted basis despite the cash drag, and we take comfort knowing that we have plenty of dry power available should the markets deteriorate.

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,

Roger Fan
Chief Investment Officer
RF Capital Management LLC
roger.fan@rfcapitalmanagement.com

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