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Letter to investors, Q2 2021

Performance

The Master Account, in which I am personally invested alongside SMA clients, returned 6.6% net in Q2 2021, as reported by our fund administrator. As of June 30th, 2021, the top ten positions comprised approximately 65% of the portfolio, and the portfolio held approximately 9% in cash.

	ACML	S&P500 TR
2019	18.9%	31.5%
2020	4.6%	18.4%
2021 YTD	13.8%	15.3%

ACML performance is net of fees and standard costs.

Hedge and Carry On

At Alphyn, we are fundamental "bottom-up" investors selecting companies on a case-by-case basis and claim no edge in trying to predict macroeconomic outcomes. Nevertheless, we are still aware of the environment in which we find ourselves and will take steps to preserve our hard-earned capital when we feel the situation warrants it. With the continuation of QE, unprecedented amount of money poured into the economy and emergence of inflation, that may or may not be "transitory" as the Fed believes, combined with the potential for serious repercussions if the Fed does decide to raise rates, I have felt it prudent to invest a modest amount of the portfolio into gold. With this long term hedge in effect, I am able to refocus efforts on the primary job of selecting individual stocks and keeping up to date on our portfolio holdings. I have detailed my thinking in the next section of this letter.

Four of our holdings reported significant corporate developments this quarter. First, Crossroads Systems, a small OTC traded banking/real estate development company, surprised everyone by originating approximately $7bn in Paycheck Protection Program (PPP) loans, almost as much as heavyweights Bank of America and JP Morgan. Second, IAC completed the previously announced spin-out of Vimeo, giving the latter independence and increased visibility to continue capturing share in the growing video creation space. Third, Trebia, a SPAC backed by serial deal maker Bill Foley, announced a planned acquisition. Finally, Naspers/Prosus has announced a share swap deal to close the large discount to Tencent. I will wait for the deal to complete before commenting further, which will hopefully happen next quarter.

Discussion on a selection of portfolio positions with an average weight over 1%:

Positions with an average weight over 1% of the portfolio throughout the quarter were: Alphabet Inc., Amazon Inc., Brookfield Asset Management Inc., Burford Capital Ltd., CarMax Inc., Colfax Corp., Crossroads Systems Inc., Exor NV, Fairfax Financial Holdings Ltd., IAC/Interactivecorp, KKR & Co Inc., Liberty Broadband, Naspers Ltd., Oaktree Acquisition Corp. B, Prosus NV, Tencent Holdings Ltd., Trebia Acquisition Corp., VanEck Vectors Gold Miners Etf and Junior Miners Etf, Vimeo Inc., and Wandisco Plc.[1]

[1] There is no assurance that any of the securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any of the securities transactions or holdings discussed were or will prove to be profitable. See "Disclaimers" at the end for more details.

Crossroads Systems – trim in master account / new position in some managed accounts

Crossroads Systems provides a one-stop home buying service to underserved Hispanic clients in Texas through its subsidiary Capital Plus Financial. Crossroads buys and rehabs homes for approximately $127k and then sells them for an average price of $150k, earning 18% margins. It also provides mortgage financing, making a further 5% spread on the loans.

Crossroads is deeply embedded in its local communities. Its marketing team comprises local community members who generate significant awareness of and demand for its homes with minimal use of agents. Its loan officers are trained to verify credentials and incomes of first-time buyers with no credit history and handhold them through the process, resulting in a successful and minimally stressful experience. As a result, Crossroads enjoys a solid reputation and a low level of loan delinquencies (1% vs. 1.7% for the national average). In addition, in the unusual event of a default, Crossroads can repossess and turn around a home in 60-90 days, further mitigating risk.

As you know, I like companies with "synthetic leverage" that utilize cheap sources of external capital to generate high returns. Crossroads is notable for several reasons. Firstly, Crossroads was originally a defunct patent litigation firm with $132m of net operating loss carryforwards (NOLs) when it acquired its operating subsidiary Capital Plus Financial for approximately $40m in 2017. Crossroad's Chairman Robert Alpert is a successful financier with a record of using NOL shells to purchase profitable companies and offset future taxable income. Mr. Alpert's companies include P10 Holdings, Inc. (OTCPink: PIOE), and Elah (OTC; ELLH), both of which have performed strongly over the last year (we do not own the shares).

Second, Capital Plus Financial is a Certified Community Development Financial Institution (CDFI). CDFIs emerged out of the Community Reinvestment Act (CRA) of 1977, which mandated that banks help meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods. Many local and regional banks do not have the skill set or resources to serve these customers and choose to satisfy their CRA requirements by outsourcing a part of their loan book to CDFIs. Capital Plus, in turn, can secure long-term, low-cost funds (costing approximately 5%) with which to originate 30-year mortgages (earning ~10%).

Third, Crossroads has been trying to buy Rice Bankshares, a small community bank with four branches, pending regulatory clearance for the last two years. Should the deal close, Crossroads will use Rice's bank deposits to reduce its financing costs by approximately 3% (from 5-6% currently), which would result in a significant accretion to profit margins. CEO Eric Donnelly has had a long career in banking with deep roots in the Hispanic community. He will use Rice's capital and operating base to expand the type of loans offered beyond mortgages for rehabbed homes. The total addressable market for banking products aimed at the Hispanic community is very large. In Texas alone, there are approximately 2.5m Hispanic households, compared to Crossroads' portfolio of one thousand loans.

In April 2021, much to the market's surprise, Capital Plus Financial (Crossroads' subsidiary) was listed on the SBA website with approximately $6 billion in PPP loan originations.[2] While the company had announced in January a partnership with a fintech firm called Blueacorn to provide PPP loans, by March, Crossroads had only originated $65m in loans. Crossroads later confirmed its blowout numbers in its quarterly results, released on June 13th. It earned $464m in gross origination fees and $150m in operating profits for the quarter ending April 30th due to PPP loans and guided to $1.1bn in gross proceeds for the entire program.

In May, reports emerged of significant delays with loan approvals and funding, as did rumors that Blueacorn would switch partners (which they eventually did, but this did not impact loans already processed). As a result, I decided it was prudent to take some risk off the table, so I trimmed some of the position in the master portfolio.

I run separately managed accounts, and while the vast majority of portfolios are synced to the "master portfolio" (which is a live account funded with my own money), regulations mandate that I take into account each client's

[2] https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/ppp-data

individual situation (including risk tolerance). As Crossroads is an OTC traded microcap, I had not put all clients into the stock. However, given the significantly positive change in the company's situation, I used a dip in the share price following quarterly results to accumulate shares for clients in the mid-$40's. I believe this provides a reasonable margin of safety to the current NAV of $56/share: $48/share[3] in after tax cash from the one-time PPP plus $8/share[4] for the existing operating business. This is before any value is attributed to the purchase of Rice, which could add at least $12/share in value,[5] or the enhanced growth opportunities now available to the management team. I believe management can double the value of the firm over time as they put cash to work.

The main concern with Crossroads is that it is an illiquid OTC traded micro-cap, and high insider ownership of 66% exacerbates this illiquidity. While management upgraded the listing from the OTCQB "Venture Market" to the OTCQX "Best Market" in January (which allowed for better financial disclosure and reporting), a full up-listing would have voided the NOLs. As the PPP profits have now used up all the NOLs, this is no longer an issue.

Our Crossroads investment is a good example of the optionality provided by aligned and capable management teams, as they find ways to capitalize on opportunities, such as with the PPP loans. Moreover, it is a reminder that timing stock movements is hard. The master portfolio was invested in this company for over two years with minimal movement. Often the best we can do is to position for success, monitor, and wait. As investors we do ourselves a service by judging performance over longer time horizons.

Vimeo- new position

Clients will notice a new ticker, VMEO, on your brokerage statements following its spin-out from IAC. I profiled IAC's companies, including Vimeo, in some detail last year. The pandemic accelerated the use of video by both enterprises and small businesses, and I believe this will continue given the high engagement that video generates. The most recent numbers bear this out: May revenues rose 42% from a year earlier while subscriber base and average revenue per user increased 18%. With its comprehensive set of tools to make video creation more accessible, Vimeo has a great opportunity to capture a share of this growth. It further benefits from an attractive customer acquisition funnel – 65% of Fortune 500 enterprises have at least one self-serve Vimeo subscription (with ARPU[6] of $250). The company is building out its sales team to help upsell these into enterprise accounts (with ARPU of $12,000). Finally, by buying IAC shares ahead of the spin, we received a long-term, high-growth SAAS "call option" at a much more palatable valuation than the current 20x price-to-sales. Historically, it has been very rewarding to hold onto IAC spins.

IAC's largest remaining holding is ANGI Inc., which operates in the fragmented $500bn home services market. The opportunity ahead of ANGI is significant, though not straightforward. Traditionally, ANGI has run a listing marketplace business where Service Providers (e.g., plumbers) pay ANGI a fee to be introduced to prospective customers, a suboptimal experience for both sides. Once a connection is made, homeowners have to field calls from 3-5 Service Providers pitching for the business. The process is not much better than searching on google and then comparing offers often from a technical disadvantage (am I paying a fair price?). Meanwhile, Service Providers dislike the fact they lose 3-out-of-4 opportunities having already paid a listing fee. As a result, ANGI has always been more successful in aggregating demand than supply, with many unanswered service requests.

This could improve significantly over the next few years as IAC doubles down on its Fixed Price offering. IAC first introduced Fixed Price following its acquisition of Handy in 2018 and has spent the last two years testing and expanding the number of services it can offer. In recent months IAC has promoted Handy's founder Oisin Hanrahan to CEO and re-hired Handy's former CFO to the same role at ANGI. Under Fixed Price, homeowners order a job

[3] Taking management's guidance of $1.1bn in total gross proceeds and apply a 30% operating margin after fees (which was their fee split in the reported quarterly numbers), apply a 25% tax rate after using up their $120m in NOLs = $290m in after-tax cash. Divide by 6m shares = ~$48/share

[4] Crossroad's approximate share price before PPP news was around $8. With an annual EPS of approximately $0.65, it traded for a quite reasonable P/E ratio of ~12x

[5] Rice has approx. $300m in assets, Crossroads CEO estimates a 2.5% ROA. On approx. 6m shares out that equals $1.25 in incremental EPS. Multiply by a 10x P/E = at least $12.5/share in incremental value

[6] Average Revenue Per User

with the tap of a button, much like ordering an Uber, and a vetted Service Provider shows up to do the work. No more phone calls, comparing offers, or negotiating. Fixed Price connects Service Providers directly to jobs and ANGI takes a small commission. The difference is significant from the Service Provider's viewpoint as they really value receiving a guaranteed job rather than paying for a lead and then pitching homeowners. As a point of reference, Front Door, a smaller ANGI competitor, has approximately 3,000 preferred service providers to whom it provides a guaranteed volume of work. The process works so well that Front Door often accounts for 40% of their business and receives discounts of up to 50% on regular prices.

Unlike ordering an Uber, home services span a wide range of activities, and ANGI will have its work cut out to develop the complex systems to price out projects while allowing for differences in local markets. While success is by no means guaranteed, ANGI's opportunity is significant, and it has the scale and leadership to make it work. Finally, I like having exposure to ANGI's opportunity via parent company IAC, which gives us additional economic interests in MGM and further optionality with a handful of earlier-stage businesses and approximately $3bn in cash.

Trebia Acquisition Corp – update

On June 29th, Trebia announced an agreement to acquire System1, a digital advertising platform that is profitable on a GAAP basis, for $1.4bn, to a resounding snore by the market. For now, at least, the SPAC market seems genuinely dead. The risk to our capital is minimal given the cash NAV supporting the price, at least until the redemption date. Helpfully, Bill Foley has also agreed to a $200m backstop to the transaction against potential investor redemptions. This gives us time to assess the deal further and see if the market warms up to the transaction.

Gold miner ETFs – new positions

As mentioned in my introduction, we find ourselves in unusual times. QE has continued unabated since 2008. The Fed's balance sheet stands at $8tr, and it currently buys $120bn a month in treasury and mortgage bonds. Furthermore, the federal deficit is $3tr, equivalent to 15% of GDP, on the high end of its historical range. While proponents of Modern Monetary Theory believe this is no cause for concern, MMT remains unproven.

Bill Dudley, former president of Federal Reserve Bank of New York from 2009 to 2018, wrote the following in a Bloomberg Opinion piece last year. "By reducing the supply of safe assets and increasing the amount of deposits that the private sector must hold, the Fed generates a demand by the private sector for more risky assets. The result is a rise in financial-asset valuations and an easing of financial conditions. The Fed's asset purchases change the mix of assets available to be held by private investors and this influences asset valuations."[7] There has indeed been an increase in valuations and "risk seeking," such as the increase in margin loans,[8] the performance of "growth," and the recent valuations of multi-million dollar Non-Fungible Tokens (NFTs). Moreover, the expansion of the money supply, if not accompanied by a corresponding increase in output, also has the unfortunate long-term effect of devaluing the currency.

Since the mid-1990s, the Federal Open Market Committee (FOMC) has had an annual inflation target of 2%. This was viewed as the best compromise to serve its dual purposes of maintaining price stability and maximum employment. But with meager rates of inflation persisting (at least in official CPI numbers), the FOMC announced that it would allow short-run inflation moderately exceeding 2% for some time to achieve inflation that averages 2% over the long run. In May of this year, the US Bureau of Labor Statistics reported the all-items CPI index increased 5% before seasonal adjustment,[9] the largest 12-month increase since 2008and higher than expected, even when accounting for the "base effect" (i.e., comparing to abnormally low figures for 2020 from lockdowns).

While the Fed believes these inflationary pressures are only transient, there is a real risk that a combination of unprecedented fiscal spending, monetary stimulus, pent up consumer demand, and supply-side frictions might cause inflation to blow past the Fed's inflation estimates, while they find that the steps required to control inflation have

[7] https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf
[8] FINRA margin debt was $862bn in May 2021, up 56% year-on-year
[9] https://www.bls.gov/news.release/pdf/cpi.pdf

unpalatable consequences. Moreover, the Fed's change in stance positions it "behind the curve," or slower to react, should inflation become an issue, further exacerbating any risk.

On the one hand, very large amounts of money are being pumped into the system as a reaction to the pandemic, with $12tr in the last 13 months alone.[10] Households now have $2.6tr in excess savings, equivalent to 12% of US GDP (globally, the numbers are $5.4tr, equal to 6% of global GDP,[11] which can drive up consumer spending, which makes up 70% of the US economy, as we emerge from COVID lockdowns. In addition, the government's potential $1.2tr in infrastructure spending, equivalent to 6% of GDP, and the President's proposed $6tr 2022 budget proposal will only increase the amount of money and the demand for goods and services.

On the other hand, there are significant supply constraints. For example, the Institute of Supply Management released a report in May, stating "record-long lead times, wide-scale shortages of critical basic materials, rising commodities prices and difficulties in transporting products are continuing to affect all segments of the manufacturing economy. Worker absenteeism, short-term shutdowns due to part shortages, and difficulties in filling open positions continue to be issues that limit manufacturing-growth potential."[12] While many of these effects are likely to be indeed transitory, some may not.

Supply-demand imbalances can lead to inflation, from the cost of raw materials to wages. For example, the Dow Jones Commodity index is up approximately 60% over the last 12 months. With their margins squeezed due to increased supply and labor costs, many companies from Coca-Cola to JM Smucker, to Procter & Gamble, to 3M announced the intention to raise prices over the next year. While companies such as Chipotle, McDonalds, and Amazon are increasing minimum wages, a Morgan Stanley report found that labor shortages and wage inflation has been more concentrated in middle- and high-wage industries like manufacturing, government, wholesale trade, and construction.[13] Wage increases are not easily reversed. Taken collectively, this type of action can increase the cost of living for more extended periods.

I do not claim to have an answer but have felt it prudent to gain some exposure to gold, which could be prudent under several scenarios. If inflation is transitory, we might expect the Fed to continue with QE. Under this scenario, our gold hedge may be unnecessary for some time, but equities, the focus of our portfolio, should continue to do well. However, as the money supply continues to expand, it becomes harder to ignore the potential for long-term devaluation of the currency. Gold's role as a long-term store of value is useful in this scenario. If inflation proves particularly resistant, the Fed has in the past hinted at considering yield curve control,[14] and gold does very well during such times. If inflation becomes an issue, the Fed may have difficulty containing it through interest rate hikes without serious unintended consequences given financial asset valuations and high debt levels. The US has $85tr of debt. Say, a 2% increase in interest rates, to bring them into line with historical averages, would increase interest expenses by $1.7tr, equal to approximately 8% of GDP and 50% of total US tax revenue. Therefore, despite the Fed's signal in June that it might increase in rates in 2023 and eventually taper the bond-buying program, it is difficult to see how the Fed could raise rates significantly without damaging the economy or financial assets. In this case, gold's safe-haven characteristics would be helpful.[15]

I chose the mining ETFs as our indirect gold vehicle, as the miners are companies that generate cash flows and have a better chance of produce a "yield" even if the price of gold does not move. Over the past few years, miners have collectively cleaned up their balance sheets, de-risking them overall. While commodities, in general, have increased 60% over the last five years, and gold 30%, the miners have been near flat. However, given the operating leverage inherent in the mining businesses, a further significant increase in the price of gold will increase the miners' revenues by more than the costs to extract the gold, resulting in expanded profit margins and faster share price appreciation. Finally, a good mid-teens percentage of the GDX ETF coprises companies such as FNV, WPM, OR, and SAND. These are gold royalty companies which, for an upfront investment to finance the startup of a mine, are

[10] Cornerstone Research
[11] https://www.cnn.com/2021/04/19/business/consumer-saving-spending-boom/index.html
[12] https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/may/
[13] https://qz.com/2027852/which-us-workers-benefit-most-from-the-labor-shortage/
[14] https://www.federalreserve.gov/monetarypolicy/fomcminutes20200610.htm
[15] http://aswathdamodaran.blogspot.com/2021/05/inflation-and-investing-false-alarm-or.html

given the right to a percentage of gold production or revenue with no, or minimal operating cost exposure. These business models generate high margins and recurring revenues with minimal operating risks.

Samer Hakoura
Alphyn Capital Management, LLC
July 2021

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