

June 10, 2019

Dear Partners,

Lowell Capital Value Partners, L.P. (the “Partnership”) was (7.5) % in May 2019 vs. (6.5) % for the S&P 500 with dividends reinvested (all returns shown are net to investors). For 2019 year-to-date, the Partnership was (1.8) % vs. 10.7 % for the S&P 500 with dividends reinvested. As of May 31, 2019, the Partnership had 17 long positions (representing about 59% of total capital) and 4 short positions (representing 4% of total capital). The Partnership had no leverage and a 44% cash position giving our portfolio a net long position of about 56%.

Our focus is on increasing the capital accounts in the Partnership in a conservative and prudent manner by taking what we think are intelligent risks. We seek to carefully allocate our capital into investment opportunities where we believe we have an advantage and where we think the risk-reward ratio is asymmetrically in favor of the Partnership.

Our investment results have been achieved with an average net cash position of over 30%. The Partnership has avoided the use of leverage and, on the contrary, maintained a relatively significant net cash position, and we believe this has reduced the risk to its capital.

We are not happy with the Partnership’s results for 2019 to date and we are working hard to improve them. We believe technology has had a much greater impact than we expected on several of our investments and this has hurt our performance.

### **Stock Market, Economy, and Technology Deflation**

The U.S. economy continues to expand steadily but with some risks. We continue to expect modest earnings improvement in 2019. Risks include the obvious addition of a major tariff / trade war between the U.S. and China, which together represent close to 40% of global GDP. Other risks include a large U.S. federal deficit funded at very low interest rates, continuing political struggles in the U.S. and in other parts of the world such as the European Union and the Brexit situation in the U.K. There is also the build-up of corporate, mortgage, and other debts dependent on low interest rates. U.S. equity markets have had several positive years of performance since 2008.

Interest rates continue to remain low globally. Interest rates could continue to remain low for a long time in the future, but we could be surprised. With myriad uncertainties, we continue to invest cautiously and defensively and leave room for surprises. We strongly believe that carefully selected equities provide one of the best options for investors to conservatively protect their purchasing power. We believe fixed income securities offer little value at today’s prices, with ten-year treasuries offering a risk-free yield which has now dropped to almost 2%.

One potential explanation for persistent low inflation and low interest rates is technology. Technological innovations and advances are having a deflationary impact on the U.S. and global economies by reducing the cost of living in many areas of our lives. Whether it is automated check-outs at supermarkets, automated check-ins at airports, overnight delivery of groceries and staples to residential customers, or automation of supply chains and manufacturing processes for companies, all these activities are putting strong downward pressure on wages and prices in the global economy. An article we read recently noted that the Fed has consistently over-estimated inflation over the past several years due to data being used that was already obsolete due to the impact of technology in further reducing living costs. Technology innovations are reducing the cost and increasing the productivity of a significant part of daily activities for consumers and businesses. The downward pressure on inflation cited by Fed Chair Powell driven by technology may not be captured fully in the traditional backward-looking data used by the Federal Reserve to measure inflation. This could be why the Fed has consistently overestimated the inflation rate over the past few years. It also could explain why interest rates have remained so low for such a long period of time and could possibly continue to remain low in the future. It would also lend support to higher stock prices and a more robust and resilient U.S. economy than traditional data pick up. We believe lower prices and low interest rates, if they persist for a long period of time, make businesses that generate strong cash flows in that environment more valuable and could thus support higher stock prices over time and higher price earnings multiples.

We continue to believe most of the Partnership's investments have near 10% or greater unleveraged free cash flow yields. While we have little confidence in our ability to forecast the stock market, we are more confident of the free cash flow yields that support our investments. We do a lot of work to try to maximize our confidence that these free cash flows are sustainable and reliable. This is what keeps us invested in carefully selected equities despite several consecutive years of positive stock market returns. We believe our large free cash flow yields provide a significant margin of safety for our investments, especially when compared to nearly 2% risk-free yields on ten-year treasuries. Our focus with the Partnership is to find companies that can sustainably generate free cash flow over several years. We have found this to be the most reliable and conservative method to drive investment returns for the Partnership.

### **Good Businesses with Low Expectations**

We are focused on investing in good businesses with low expectations (i.e., low valuations). For us, a "good" business is one that earns high returns on invested capital or where you don't have to spend a lot of money to make a lot of money. We look at businesses where the total investment in tangible assets to run the business (i.e., net working capital plus the book value of property, plant, and equipment) are modest relative to the sustainable operating earnings or free cash flows. These businesses are not capital intensive. Businesses with high returns on invested capital tend to be strong generators of free cash flow. These are businesses that we like very much.

In terms of low expectations, our investments generally have valuations which are low and this helps reduce risk. The market does not expect much from the business in the future or is worried about current earnings or free cash flow sharply declining. These may also be situations where a business is simply misunderstood or undiscovered. Our general experience is that if the business is able to exceed these low expectations or generate results that are less bad than expected, the stock price is likely to increase. Also, if expectations are low, when results are disappointing, the stock is likely to decline less than otherwise. We spend a lot of time studying these types of companies to try to get comfortable that their prospects are better than the market believes. Often specific businesses or industries get painted with a very broad brush and their valuations are driven down to what we find to be attractive levels. We think our focus on these out-of-favor companies and industries gives us an opportunity to earn better risk-adjusted returns than the general market.

### **Focus on Smaller Companies**

We focus on smaller companies, searching for “low-risk, high-return” opportunities. We believe a few good ideas can drive the Partnership’s results. We believe the Partnership can generally achieve better risk-adjusted returns by uncovering a few small “gems” than by focusing on larger companies or macro issues which are much more widely covered. Our focus on smaller, less-followed companies represents a potential sustainable competitive advantage for the Partnership relative to larger investment funds that must focus on much larger companies. Our empirical investment experience validates this belief, as our most successful investment positions have consistently been smaller companies.

We are specifically looking for small companies that may appear risky on the surface but are less risky due to characteristics such as: (a) cash-rich, “Ft. Knox” type balance sheets, (b) consistent free cash flows; (c) unique niches or business models; (d) very low valuations with minimal expectations imbedded in the stock price; and (e) honest and intelligent management teams that are highly focused on driving shareholder value. Most small companies do not possess **any** of these characteristics. We focus most of our attention on a handful of companies that we believe possess almost **all** these characteristics.

### **Top Long and Short Positions**

Our top long positions as of May 31, 2019 were as follows:

Global Scape (GSB)  
HCA Healthcare (HCA)  
Ecology & Environment (EEI)  
Character Group plc (CCT.L)  
Calloway’s Nursery (CLWY)  
Lanxess (LXS)  
Reitman’s Class A (RET-A.TO)

CRA International (CRAI)  
Saga Communications (SGA)  
BJ's Restaurants (BJRI)  
Tech Data (TECD)

We believe our long positions have strong competitive niches, large and sustainable free cash flow yields, low-risk balance sheets, recession earnings capability, shareholder-oriented management teams, and attractive risk-reward characteristics as investments. You will find that most of these companies are not household names and that is exactly as we have intended it. We are seeking to maximize our competitive advantage by investing in under-followed companies where we may have a greater opportunity to understand the company and the investment better than other investors.

We had short positions in Brown Forman Class A (BFB) and Omnicom Group (OMC) as of May 31, 2019, among a few other companies.

### **Position Sizes**

The Partnership's investments are diversified across a wide range of businesses. Our goal is generally to have core position sizes in the 3% to 6% of total capital range and limit our exposure to any one specific investment to approximately 10% of capital or less. We think this helps limit our downside exposure to any one investment position while retaining substantial upside for those investment positions that work out as expected. Our investment positions are also diversified across several different industries.

### **Northern Exposure**

We continue to find what we believe are attractive values for good businesses in Canada, our neighbor to the north. Canada has a population of about 35m or about 10% of the U.S. and we believe its economy remains in reasonable shape. Canada's debt to GDP is currently well below U.S. levels. Canadian banks avoided much of the real estate problems in the U.S. by maintaining more disciplined underwriting standards in making real estate loans. Canada is a natural resource-oriented economy with substantial oil and gas reserves. We will continue to carefully monitor the impact of oil price changes upon the Canadian economy.

As of May 31, 2019, the Partnership had one investment in a Canadian company, representing about 4% of the Partnership's total capital. We will continue to evaluate investment opportunities in Canada on a case-by-case basis and closely monitor the overall exposure of the Partnership to Canada.

### **Recent Investments**

Our optimism regarding the future of the Partnership relates directly to our specific investment positions, which we believe are significantly mispriced relative to their intrinsic values. Certain of these are detailed below:

**Global Scope (GSB)** develops and sells managed file transfer (MFT) software that provides secure information exchange, data transfer, and file sharing capabilities for enterprises and consumers worldwide. Its flagship MFT product platform, Enhanced File Transfer (EFT) is its strategic focus and responsible for 97% of 2018 revenue. EFT is highly reliable, easy to install, and is delivered as on-premise software or through cloud and hybrid deployments. GSB's enterprise customers include market leaders in financial services, health care, media and entertainment, and retail. One of the largest broker-dealers in the U.S. depends on GSB's software to securely transmit millions of time-sensitive financial transactions. GSB also serves a cruise ship operator that last year had a market share of over 20%, which trusts GSB to securely transmit point-of-sale data and other transactions generated while at sea. Many customers realize that homegrown or non-enterprise solutions lack scalability, flexibility, and the security architecture necessary to comply with arduous and ever-changing state, federal, and international regulatory mandates.

GSB generates revenue from three sources: software licenses, maintenance and support (M&S), and professional services. In 2018, software license revenue was \$10.5 million and accounted for 30% of total revenue, M&S revenue was \$21.6 million and represented 63% of total revenue while professional services revenue was \$2.3 million, or 7% of total revenue. Close to two-thirds of GSB's revenue is recurring in nature and M&S customers have a very high renewal rate. GSB primarily goes to market using a direct salesforce but also does support a robust partner network. While GSB's growth depends on new software license revenue, GSB is highly focused on its maintenance and support (M&S) business which represents the recurring revenue in its business model. One impressive driver for M&S renewals is its documented ability to deliver customer satisfaction. In 2018, GSB had a customer satisfaction rating of 94%, almost two percentage points better than 2017.

In August 2018, GSB took aggressive actions to improve its profitability and right-size its expense structure. GSB reduced its workforce by 30%, primarily by refocusing selling efforts to its core EFT platform and reducing marketing spending that had failed to yield increased revenue. GSB also targeted product development efforts to more closely align with specific customer requirements. In 2018, GSB also dealt with challenging legal and regulatory matters as a result of previous accounting restatement issues.

Despite the cost reductions in August 2018, GSB's revenues for 2018 Q3 and Q4 were up 13% when compared to Q1 and Q2 of 2018 and up 7% over Q3 and Q4 of 2017. GSB attributed this to its renewed focus on providing EFT platform products that its customers value and avoiding activities that divert from this strategy. While sales in H2 of 2018 improved, operating expenses declined markedly over the same period, in aggregate by 25% when comparing the first half of the year (\$13.4 m) to the second half of 2018 (\$10m). Adjusted EBITDA went from \$1.6m in the first half of 2018 to \$6.6m in the second half of the year, and \$4.6m in the fourth quarter of 2018 alone. We believed GSB had achieved a run-rate level of adjusted EBITDA of close to \$18m by Q4 of 2018.

GSB also optimized its capital allocation strategy in 2018. GSB had about \$28m in net cash at Q2 of 2018 and conducted a modified Dutch auction tender offer and repurchased approximately 18.2% of total shares outstanding. Total shares outstanding were reduced to 17.1m at year-end 2018 or about 22% less than at the end of 2017. At the end of 2018 GSB still had no debt and \$9.2 million in net cash. It also is worth noting that as of year-end 2018, the GSB Board and insiders beneficially owned approximately 36% of the Company's outstanding common stock and, as such, we believe they are strongly aligned with the long-term interests of all shareholders.

We believed GSB's managed file transfer software business was a much better business than the market was valuing it at with its solid growth rate, large base of recurring revenues, and high renewal rates. We have invested in GSB over several years. Most recently, we were invested in GSB at about \$5 per share, for a market cap of about \$85m and an enterprise value (EV) of about \$76m. We believed GSB could generate adjusted EBITDA of \$15m+ and free cash flow of \$10m+ in 2019, which represented attractive multiples of 5x adjusted EBITDA and 8x FCF. Many other software companies trade at significantly higher multiples.

Based on recent results, we believe GSB can generate adjusted EBITDA of close to \$20m in 2019 as non-recurring charges in 2018 are reduced. We believe GSB's recurring, cash generative, and growing MFT software business could trade for well over 10x our estimate of adjusted EBITDA of \$20m in 2019 with a net cash position of about \$20m by year end 2019. This would equate to a market value of about \$220m and, based on 17m shares outstanding, an implied share price of about \$13 per share, or more than 100% above our average price of \$5 per share.

We also think GSB could be very attractive to a strategic or financial acquirer, especially as free cash flow generation continues to grow. We further believe GSB can drive shareholder value through continued share repurchase and/or dividend programs.

**Saga Communications (SGA)** is a radio broadcasting company whose business is devoted to acquiring, developing, and operating radio broadcast properties. SGA owns or operates broadcast properties in 26 markets, including 75 FM, 33 AM radio stations, and 54 metro signals. SGA generally operates radio stations in smaller markets. SGA's five largest markets are Columbus, OH (12% revenues); Milwaukee, WI (12%); Des Moines, IA (8%); Norfolk, VA (6%); and Manchester, NH (5%).

We believe radio is a good, steady business which is highly cash-generative and requires little capital to operate. It is a very locally oriented and therefore harder for new technologies to displace. We believe the bankruptcies of larger radio players like Cumulus and I-Heart have tainted radio, but this is more a problem of excessive leverage than a bad business. Organic growth is likely modest, maybe low single digits over time, but we believe SGA can steadily add incremental revenues and cash flow from small acquisitions.

We believe SGA's management team, led by CEO Ed Christian, who controls SGA through super-voting Class B shares, is one of the best in the radio industry. SGA intimately understands the advantages that radio offers local advertisers in smaller radio markets and does an excellent job controlling operating costs and driving revenues in these smaller markets. SGA is also extremely disciplined about capital allocation and entered the Great Recession as one of the least leveraged broadcasters in the industry. We believe SGA is a great partner for both operating and acquiring small market radio stations in the U.S.

SGA has about 6m shares outstanding at \$28 for a market cap of about \$170m and a net cash position of about \$25m at March 2019 for an enterprise value (EV) of about \$150m. We believe SGA can sustainably generate close to \$20m of free cash flow (FCF) for an unlevered FCF yield of 12%. In 2019, we expect SGA to generate close to adjusted EBITDA of about \$30m, and we believe SGA could end 2018 with net cash of \$35m+. Based on these assumptions, SGA is trading at 5x our adjusted EBITDA for 2019. We believe this is an attractive valuation.

Since the Great Recession in 2008-9, SGA has used its strong free cash flow to steadily reduce its net debt position from about \$130m at year-end 2008 to a current net cash position of about \$25m. We believe SGA will continue to use its strong free cash flow and "Ft. Knox" balance sheet to make small radio acquisitions. We believe SGA's under-leveraged balance sheet is an important strategic advantage.

In 2015, radio stations in Harrisonburg, VA were acquired for \$15m; in 2016, radio stations in Columbus, OH were acquired for \$14m; in 2017, radio stations in Charlottesville, VA were acquired for \$2m and radio stations in Charleston and Hilton Head, SC were acquired for \$23m. SGA sold two small television stations in Missouri and Texas for about \$66m in Sept 2017. In October 2018, SGA acquired four radio stations in the Ocala, Florida market for about \$9m.

We believe SGA's small market radio broadcasting business model is a much better business than the market is giving it credit for today. Other radio broadcasting companies trade at significantly higher multiples. We believe SGA's cash-generative radio broadcasting business could trade for 8x adjusted EBITDA of \$30m with a net cash position of about \$35m by year end 2019. This would equate to a market value of about \$275m and, based on 6m shares outstanding, an implied share price of about \$45 per share, or close to 60% above the current price of \$28 per share.

We also think SGA could be very attractive to a strategic or financial acquirer, especially as free cash flow generation continues to remain. Alternatively, SGA could drive shareholder value through share repurchase and/or dividend programs. We believe there are multiple levers to driver shareholder value over the next few years.

## **Short Positions**

We have sought to protect the Partnership's capital partially by maintaining small short positions (1% or less) on several companies with extremely high valuations and unsustainable business models. We are continuing to research several candidates and as of May 31, 2019, the Partnership had four short positions.

### **Concluding Thoughts**

We think we own an excellent group of businesses with asymmetrical risk-reward characteristics biased in the Partnership's favor. We have long-term confidence in the North American and European economies and believe carefully selected equities remain one of the best ways to participate in their economic growth and protect ones purchasing power from inflation. We have tried to position the portfolio to achieve these objectives.

We focus on detailed research on individual investment opportunities with asymmetrical risk-reward characteristics in the Partnership's favor. We are keeping the Partnership's capital well-diversified in companies with "Fort Knox" balance sheets. We are doing our best to balance well-publicized macro risks against our micro work on specific companies. A "Fort Knox" balance sheet, both at the Partnership level and at our individual investments, helps us sleep better at night. Our first goal is always capital preservation, followed closely by prudent, intelligent growth of capital.

We believe that small cap stocks offer us excellent opportunities for attractive risk-adjusted returns. Most investors on Wall Street simply cannot focus on these smaller companies due to their small size. This should give the Partnership an advantage over time. There are greater opportunities to find a specific business or security which is meaningfully mispriced before it becomes clear to other investors. We do a large amount of research on these individual positions to achieve a high conviction level which allows us to establish and remain committed to a larger position. We often have detailed discussions with the senior management of our investments to better understand these companies and their industries and thereby strive to increase our competitive advantage.

We are one of the largest investors in the Partnership and continue to have a significant investment. We will always maintain a large amount of capital in the Partnership and make sure our interests are closely aligned with our limited partners.

Our goal is to significantly outperform the major indices over a three- to five-year period while taking a conservative approach to risk and we continue to believe we can achieve this goal.

We remain cautiously optimistic on our investments due to our continued ability to find what we believe to be good businesses that are under-valued. We are doing our best to position the Partnership to earn attractive risk-adjusted returns in this environment. We truly appreciate your patience.

Please do not hesitate to call (310-426-2045) or email ([jez@lowellcap.com](mailto:jez@lowellcap.com)) us with any questions. We appreciate your confidence in the Partnership and we will do our best to protect and conservatively grow the Partnership's capital over time.

Sincerely,

Jim Zimmerman

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