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The Global Value strategy returned -2.90% gross (-3.14% net) for Q1 2017. Our performance this quarter was somewhat weak primarily due to three factors: 1) relative weakness in US small-cap equities, 2) a sentiment-driven sell off in EZCORP's stock, 3) a general meltdown in the subprime auto lending sector. In this letter, I will give updates on EZCORP's business and our investments in auto lending.

Relative Weakness in small-caps

Smaller companies had a rougher start to the year than the overall market. The Russell 2000, an index of smaller companies that (as of the most recent reconstitution) have market capitalizations between $3.9 billion and $133 million, had a return of 2.47% in Q1 relative to 6.07% for the S&P 500. If I were to speculate on the origin of the relative weakness of small cap stocks, I believe it is the result of the tremendous post-election rally that small cap stocks had after the election. This post-election bump in small caps was largely due to the belief that US corporate tax reform would be forthcoming (Trump campaigned on lowering the corporate tax rate to 15%). Small companies in the US pay a higher effective tax rate than large caps stocks, with the average for the Russell 2000 and the S&P500 being 30.6% and 25.8% respectively[1]. As hopes for a rapid tax reform process dim, Russell 2000 stocks have pulled back. Due to the Blue Tower Global Value strategy historically being invested mostly in US small cap stocks, the Russell 2000 has been the most correlated of the major indices to the strategy.

EZCORP

EZCORP (EZPW) was the largest detractor to our performance in Q1 2017 with a performance impact of -4.5%. EZCORP has gone through significant changes since we first invested. Late last year, they sold Grupo Finmart, their Mexican government employee payday lending service. The company recently had their annual shareholder meeting in Austin, TX where the company's leadership discussed the growth in pawn loans outstanding and other aspects of the business. Over the past year, the company has grown loans in the US faster than either of their two major competitors. They are also undergoing a major hiring push and switching their workforce towards being fulltime only and phasing out many part time roles. They explained that they believe that fulltime employees will give the company less turnover which will allow them to gain more experience and create a better customer experience.

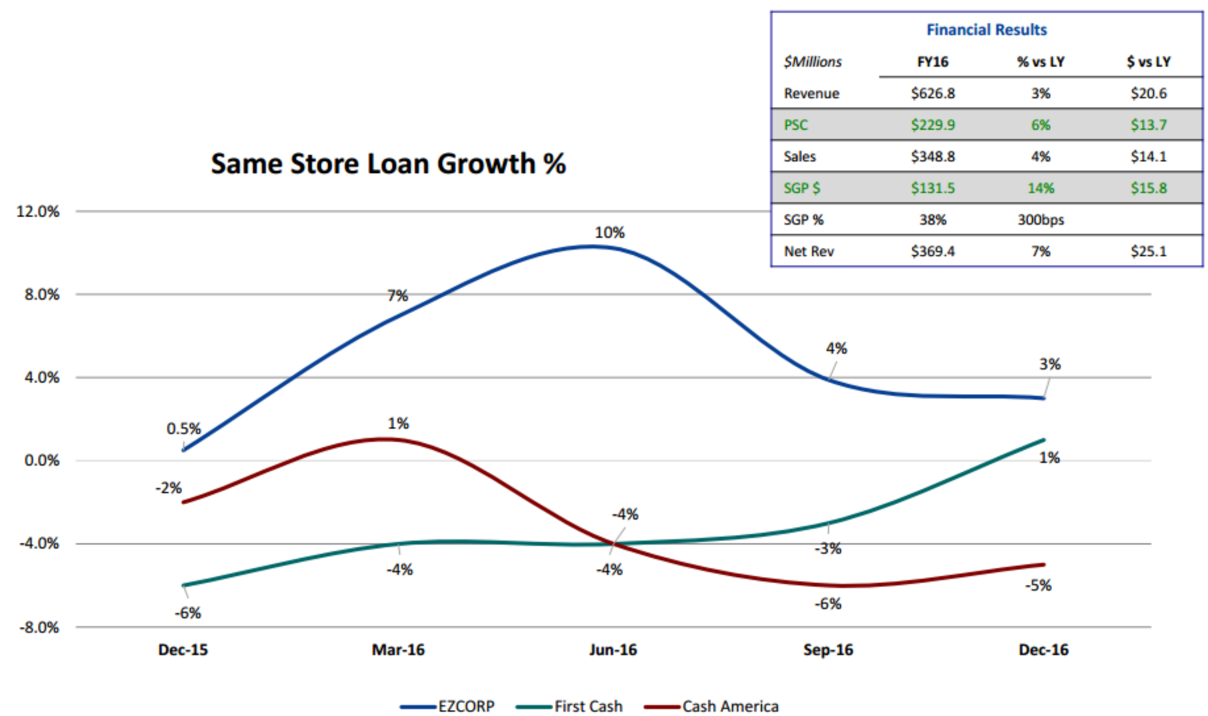
The creation of a new point of sale system for EZPW is a major initiative for the company. EZPW is developing the new system in-house with a software development team in Austin and

[1] Source: Factset, 2016 estimated median effective tax rates

has already invested $3 million into the project. This system will use the individual history of each borrower to determine the relative likelihood that the borrower will repay their pawn loan. For individuals who are more likely to pay back the loan, EZPW can give a larger loan and therefore boost the balance upon which they are collecting interest. For those who are less likely to pay back their loans, EZPW can give a smaller loan and thereby lower the cost of their merchandise and boost their gross margin. The point of sale software will provide store staff with a minimum and maximum loan amount for each item used as collateral allowing them to still make adjustments based on their judgement. If well implemented, such a system could give it a significant advantage over other pawn chains.

The company is also doing a major refurbishment of their stores due to significant deferred maintenance. For example, the company mentioned during the annual meeting that one store had pot holes in its parking lot. This reinvestment should improve the experience for customers and borrowers as well as increase the morale of employees.

Year-over-Year growth in US same store loans by quarter



$Millions	FY16	% vs LY	$ vs LY
Revenue	$626.8	3%	$20.6
PSC	$229.9	6%	$13.7
Sales	$348.8	4%	$14.1
SGP $	$131.5	14%	$15.8
SGP %	38%	300bps	
Net Rev	$369.4	7%	$25.1

In Chart: PSC = Pawn Service Charges, SGP = Sales Gross Profit

Source: EZCORP 2017 annual meeting presentation

Charlie Munger once said in response to a question about the power of incentives: 'I think I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther.' The incentive structure of any company's management is important towards understanding their behavior, and this is certainly true for EZCORP.

It's important to note that several of the senior executives at the company left far larger corporations to work at EZCORP. For example, Stuart Grimshaw, the Executive Chairman, was previously the CEO of the Bank of Queensland, an Australian bank with a market capitalization of $3.5 Billion US Dollars. For them to leave larger companies, they must have seen an opportunity to make more money off of their EZPW equity.

Currently, the restricted stock vesting for the management is based on EBITDA and net debt hurdles (with the great majority based on the former). The incentive period for these hurdles begins starting in September 2017. Therefore, it is reasonable to assume that the management of the company is front-loading business investments and non-recurring expenses to the months before the incentive period in order to make their future numbers look better. We expect that the company's profitability will increase after September and that this improved profitability may be a catalyst towards a higher valuation for the stock in FY2018.

Another aspect that we enjoy with EZCORP is the recession proof nature of the business. Even during the 2008 financial crisis, the company's stores continued to enjoy high profitability. The demand for short-term credit has little connection to the overall business cycle.

Subprime Auto Meltdown

The subprime auto lending space has been under significant pressure so far this year. It has been hit by a perfect storm of several factors: rising interest rates, increased competition between lenders, declining used car prices, and rising defaults by borrowers. The increased competition is both causing lenders to give out loans at lower rates but also to less credit worthy borrowers. According to a report by Morgan Stanley, loans given to borrowers with a FICO score of below 550 now make up 32.5% of all subprime auto loans. Five years ago, that number was 5.1%.

We have three stocks which are in subprime auto lending (NICK, CACC, and CRMT) giving us significant exposure to it. Our thesis is that over a multiyear cycle, the lenders that have structural advantages in underwriting will outperform their competition. Unlike many other lenders, these companies do not securitize their loans and sell them off to third parties, but instead hold them to their maturity. Because of investor fears over declining fundamentals for the subprime auto sector as a whole, the entire sector has sold off. This creates a value opportunity for us over the long-term as these quality companies are now trading at bargain valuations.

The Subprime Credit Cycle

In an interview last year with ValueWalk, I mentioned a description of the subprime auto credit cycle which I will repeat here. The cycle can be broken down into 4 sequential phases. Because this is a repeating cycle, we can begin at any point on it:

High Profitability: With tight access to capital and few competitors, lenders are able to negotiate favorable terms with borrowers. Return on assets is high, financial leverage is lower, and lenders are able to get high net yields and high profitability.

Expanding leverage: Due to the wonderful reports that are coming out of the lenders in the sector, new entrants begin to enter the market. Capital markets are willing to lend more money at more favorable terms. Increased competition causes ROA to fall as borrowers have more options to choose from. Lenders begin to lever up their capital structure in order to boost ROE.

Low profitability: Intense competition forces lenders into a choice of surrendering market share or decreasing lending standards. Loans are given at lower rates. Leverage is increased even more to maintain ROE. Fraud and mismanagement increase throughout the sector.

Decreasing leverage: Decreased standards from the prior phase will cause defaults to dramatically increase. Loan yields fall below profitable levels. The deteriorating loan performance of the industry causes capital markets to tighten. This deterioration will often happen at the same time as an overall economic recession which causes capital markets to be tight across the economy in general. Lenders are forced to exit the subprime auto market as they find their business unprofitable and/or access to capital markets absent. Some lenders go into bankruptcy. The tightening clears away all lenders with poor underwriting or too much leverage.

As you can see, we currently appear to be in the 'Decreasing Leverage' phase and can expect a return to higher profitability soon. Currently, the three companies we have invested in are still profitable but earning lower margins that they do normally. In 2016, even though its stock price did not move, Nicholas increased its book value per share by 9.4%.

For NICK, there is another possible upside in that it is trading at a discount to tangible book value (0.72), making it a tempting acquisition target by a larger financial company. Due to the funding advantages it might gain, Nicholas' business model perhaps would make more sense under the umbrella of a larger parent company.

A hedge fund, the Magnolia Capital Fund, has been buying up shares of Nicholas and currently owns 17% of the company[2]. Although they would like to possibly appoint a representative to the board, they say that they have no plans to push for management changes or a sale of the company and that they are buying up shares due to the valuation.

[2] https://www.sec.gov/Archives/edgar/data/1000045/000139834417003653/fp0024657_sc13d.htm

The Blue Tower Global Value strategy aims to outperform the market on rolling 5-year periods, but there will be significant draw downs and it will likely have more volatility than the market as a whole. This is an unavoidable side effect of being long-only and having exposure to small-cap stocks with less liquidity than most of the market. That a concentrated value investing strategy doesn't always work well in the short-term is one of the reasons why it works well in the long-term.

Sincerely,

Andrew Oskoui, CFA
Portfolio Manager

Disclaimer: This commentary does not represent a recommendation to trade any particular security, but is intended to illustrate Blue Tower's investment approach. These opinions are current as of the date of this commentary but are subject to change. The information contained herein has been obtained from sources believed to be reliable but the accuracy of the information cannot be guaranteed. Past performance is no guarantee of future results.