Blue Tower Asset Management, LLC
311 RANCH ROAD 620 SOUTH
SUITE 111
AUSTIN, TX 78734

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The Blue Tower Global Value strategy composite had its best quarter since inception with 21.14% net (21.49% gross) in Q2. This follows our worst quarter in Q1, which itself followed our then-best quarter of Q4 2019. These large moves are the result of the volatility in global markets, which affects lower-volume stocks to a greater degree. We should expect this extreme market volatility to continue until the various current crises affecting the world are resolved and investors have a clearer view of the future.

While statistically cheap value stocks greatly went up in Q2, they continued to underperform more expensive stocks and US stocks outperformed international stocks. Q1 2020 was the worst quarter for value in financial history and so far, year-to-date, the value factor is still deeply in the red. The valuation gulf between the most expensive and the cheapest stocks in the US has now reached a level unprecedented in history, eclipsing even the extremes seen in the dotcom bubble of the late 90s. Whether one uses price-to-book or price-to-earnings as metrics, both measures show the current distance between the most expensive and cheapest deciles of US stocks as being the greatest in history[1].

Large tech companies have benefited the most from this rally in high-growth stocks, with Microsoft, Apple, Amazon, Alphabet (Google), and Facebook now making up over 20% of the S&P 500, a greater concentration than was seen during the dotcom bubble. From the beginning of September 2019 to the end of June 2020, the tech-heavy Nasdaq 100 has outperformed the S&P 500 for 10 consecutive months.

Narratives about broad market moves in this fluid environment are confounded by just how many major macro drivers are occurring all at once, namely, the Covid-19 pandemic, the largest central bank and fiscal stimulus in history, trade issues, social unrest, and regulatory uncertainty from the US election. One hypothesis about the market price increases in high-growth technology stocks is related to real interest rates. As expectations of global economic growth for the next ten years have fallen, real interest rates in the US have plummeted to negative levels. 10-year yields on Treasury Inflation Protected Securities (TIPS) ended the quarter at -0.68% and dropped further during the beginning of July.

As real interest rates fall, this should increase the present value of cash flow streams as they are now being discounted at a lower rate. This should increase equity prices. However, since the decrease in real interest rates is related to the expectations of earnings growth, we must also take into account that earnings growth for equities will be lower and that should decrease their prices. As high-growth cash flow streams are weighted towards the future (they have higher duration), drops in discount rates

[1] Asness, Cliff. *Is (Systematic) Value Investing Dead?* AQR Capital Management, 8 May 2020, www.aqr.com/Insights/Perspectives/Is-Systematic-Value-Investing-Dead

increase their present value more than low-growth cash flow streams. This increase of the present value of high-quality high-growth cashflows can explain much of the increase in the value of the dominant tech platforms.

Additionally, these tech platforms may also benefit from a shift to remote work which could cause a greater reliance on their cloud platforms. However, investors often overreact to things that have a grounded rationale. We believe this current tech rally is an overreaction and investors are not taking into account potential risks facing these companies. Even if these companies grow earnings much faster than the rest of public companies, their stock price will not necessarily increase since high-growth expectations are already baked into their current prices. If we see general economic growth return, real interest rates increase, or stricter regulation of these dominant technology companies, these high-growth investors may have their hopes frustrated. It is difficult to predict how the next few years will unfold, but we believe the odds are in favor of the types of bargain companies in our current portfolio.

Our Negative Enterprise Value Holdings

In our Q4 2018 letter, I described an amazing thing that occurred with one of our portfolio holdings, Joban Kaihatsu (Tokyo:1782), which traded for a few days at a negative enterprise value that year[2]. After this year's first quarter market crash, Joban Kaihatsu again reached negative enterprise value[3] and another major Japanese position, Fujita Engineering (Tokyo:1770), joined it. Fujita, however, regained the lost ground in July and has slightly positive enterprise value again. It is an amazing feature of this current irrational market environment that companies can have high free cash flow generation, pay significant dividends, and still trade at less than their cash net of debt. Furthermore, Fujita has engaged in tender offers to buy back stock in the past and the CEO is a major shareholder demonstrating the company's alignment with investors. As a result of these two positions, at the end of our second quarter roughly a fifth of our portfolio traded at a negative enterprise value. We believe that these discounts are unjustified and that these companies provide excellent prospective returns at their current prices.

EZCORP

One of the companies in our portfolio that is not merely robust to the business cycle but actually benefits from recessionary environments is EZCORP. We previously discussed the company in our Q1 2016, Q2 2016, Q1 2017, and Q3 2019 letters, and therefore I will assume some familiarity with the company and focus on newer developments.

EZCORP is the second largest pawnshop chain in the western hemisphere (FCFS is the largest). With pawnbroking being a countercyclical industry, EZCORP has done well in previous recessions. In 2009, EZPW had a 40% increase in revenues followed by a 24% revenue increase in 2010. The current supply glut of oil is likely to cause unemployment amongst the energy sector in Texas. The coronavirus-led collapse in tourism and hospitality industries is going to affect Florida's economy. In the US, the largest number of EZCORP stores are located in Texas, followed by Florida.

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[2] Enterprise value = market cap – cash + debt

[3] However, if their holdings of marketable investment securities such as publicly traded stocks are taken into account, Joban Kaihatsu has had a negative enterprise value for over a year.

The profitability of a pawn business when well-operated is tremendous. In Q1 2020, the company earned a 14% monthly yield on their US pawn loans and a 16% monthly yield on their Latin American loans. This high yield is largely due to the short-term nature of the loans. If the loan goes into default, the loan is fully collateralized with merchandise which is then liquidated. In FY2019, the company earned a gross merchandise margin of 35%, well within their long-term target range of 35-38% for gross merchandise margins.

EZCORP replaced CEO Stuart Grimshaw this month with the current CFO Jason Kulas, who has been CFO since February. Kulas will hold both the CEO and CFO positions until a replacement can be found for CFO. Kulas will have a lower base compensation and incentive package as CEO than Grimshaw did, a step towards reducing EZCORP's excessive executive compensation.

In the first few months of the pandemic, the combination of stimulus checks and tax refunds led to a surge in retail demand for their inventory and a decrease of their pawn loan balances (down 7.5% year-over-year) as borrowers paid off their debts. As a result, EZCORP saw an over $100M increase in cash on hand in the first four months of the year. Unemployment payments were increased by $600/week by the federal government for Covid-19 relief, and some unemployed US workers are receiving more in government payments than what they earned when they were working. As these benefits will be ending soon, we may see renewed demand for loans in the second half of the year.

Lana, New Point-of-Sale Technology, and Other Technology Investments

EZCORP has realized that no industry, including theirs, is completely immune to technological disruption. They have made technology investments with the aim of increasing efficiency, optimizing lending decisions, giving centralized views of their inventory management, and improving the customer experiences.

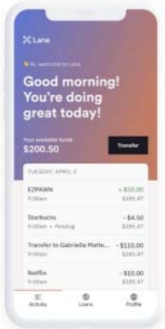
Their point-of-sale system was designed and built in-house and allows the company to optimize the transaction when originating a new loan. If a customer will be defaulting on an item, it is more profitable to give a small loan-to-value and thereby boost merchandise gross margins. On the other hand, a repaying customer benefits the company more if the customer has received a larger loan as that generates pawn service charges (PSC). Based on a machine learning algorithm taking into account the customer's past behavior, information about the item, store location, and time of day, the point-of-sale system will predict the customer's future behavior. The point-of-sale system will give the employee a range of loan amounts they can give on an item, allowing them to use their intuition of how likely the customer is to return for the item. Their long-term target range of gross merchandise margins is between 35-38% to achieve an optimal balance of PSC and sales gross profit.

The company has also developed a mobile app, Lana, using an outsourced development team at Boston Consulting Group Digital Ventures. Lana allows the customer to manage their loans with an online bank account through their phone, including renewing loans, or withdrawing cash amounts from their Lana debit card. Customers can also set up direct deposit from their employer into their Lana account which will be useful for unbanked customers. This will increase convenience for customers, make loans more likely to be renewed instead of abandoned increasing PSC, and reduce time demands on store staff. The company has stated that the app has the potential to be further expanded in the future with partnerships that add value for customers, such as the ability to send remittances for example.

(Digital) Financial Inclusion for EZ Customers

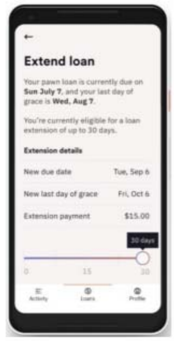
- *Access* to new account in minutes
- Safe place to *store* your money (secure logon, member FDIC)
- *No hidden* fees plus access to Lana Visa debit card

Real-time Control of your Money



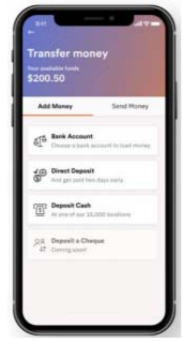
- Track and manage your money in real-time - All in one place
- Get access to your money more quickly

EZ Pawn Loans in your Pocket



- *Visibility* of your pawn loan through the Lana app.
- Load new pawn funds directly to your Lana account
- *Extend* your pawn loan from the palm of your hand

Easy Access to (all of) your Money



- Withdraw your money from over 19,000 ATM's in the US
- Deposit cash to your Lana account at over 90,000 locations (i.e. CVS, Walgreens)

source: 2020 Annual Meeting of Stockholders

The creation of the Lana app has proven prescient for 2020, as the app reduces the need for visits to physical stores.

These are exceptional and historic times that we are currently living in, and I appreciate the continued confidence in the strategy demonstrated by Blue Tower's investors. Please do not hesitate to contact me with any questions.

Best regards,

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.