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The following represents a portion of the Kippington Capital Q3 2020 Letter to Partners.

Portfolio Insight

The businesses in which our capital is invested continue to execute and perform. Boot Barn (NYSE:BOOT) is seeing a sequential recovery in same-store-sales. The company kept a tight grip on expenses and inventory through the COVID shutdown and has made up for a large portion of their decrease in brick-and-mortar sales with the performance of their ecommerce platforms. Both First of Long Island (NASDAQ:FLIC) and Lakeland Financial (NASDAQ:LKFN) are setting aside more-than-adequate reserves and experiencing acceptable loan losses due to conservative underwriting, which has led to strong returns on equity during an economic downturn: no easy feat. Aspen Group (NASDAQ:ASPU) continues to grow total student body at a higher rate than originally projected. The company recently received regulatory approval for two more BSN pre-licensure campuses (its highest-margin business): one in Tampa, FL and the other in Austin, TX.

As mentioned in previous letters, we took advantage of the market downturn earlier this year to both add to our positions and size up a full position in Boot Barn. At the end of July, in a similarly opportunistic fashion, I began building our 9th long position, PaySign, Inc. (NASDAQ:PAYS).

PaySign came to my attention in summer 2019, while qualitatively analyzing a list of US small-caps one-by-one. At the time, a "quick" initial valuation check revealed that shares were trading ahead of themselves. The shares' valuation stretched even further over the following nine (9) months until the economic downturn earlier this year. And while I was unable to capture the beginning of the opportunity in PAYS shares, as often happens, I was presented another opportunity to build a full position at a valuation I found reasonable over the past two months.

PaySign offers full-service white-label prepaid card programs to plasma donation centers (~80% of revenue), pharmaceutical companies, and other companies for corporate programs. For instance, when someone decides to donate plasma, instead of being paid in cash (typical payment is ~$45), it is now standard practice to compensate the donor with a prepaid debit card that can be used for purchasing just about anywhere they'd like. As the card provider, PaySign receives interchange, interest on the float and other fees through the usage of the cards with revenue aligned to the dollar amount loaded onto the cards.

The plasma center card business is an oligopoly. PaySign has been consistently taking market share from its largest (and really only) competitor, Wirecard, which was formerly owned by Citigroup and

never treated as a priority by the parent company. As a result, investment in technology and service suffered. This allowed PaySign to enter the market with a technologically superior service which virtually eliminated the downtime issues that plagued Wirecard customers, enabling centers to get operational in 45 days as opposed to 3-4 months. Further competitive advantages resulting from a superior technology platform allowed donors to manage their accounts at the kiosk and allowed centers to provide prepaid cards on an "in-person" basis the day of a donation instead of by mail. These factors led to a much better customer experience for both donation centers and donors themselves, which translated into 37% gain in market share.

PaySign's business model has several advantages, the most important of which makes it a part of an extremely small group of companies that enjoy substantial *implicit* switching costs. Plasma centers pay only a small amount to initiate a prepaid card program and pay <u>no ongoing fees for service</u> as PaySign's revenue comes from the usage of the cards themselves. By providing donors/cardholders excellent customer service, there is effectively no reason for plasma centers to switch to a different provider. This has led to PaySign's 100% customer retention in plasma centers for 8 years running. Pointedly, despite the fact that the *explicit* costs to switch to a different card company may be quite low, they far outweigh the existing costs and the business/execution risk of switching.

The number of plasma donations in the US has grown almost 10% per year for the past decade and the price paid per donation has over doubled over that timeframe. To that end, while PaySign has created a business that has high implicit switching costs, it benefits from another important advantage: leverage of existing infrastructure and work that other parties have already done or are doing. It could take as many as 1200 plasma donations to treat one person for a year depending on their condition, and plasma is a very profitable business. As such, plasma centers in concert with equipment manufacturers have endeavored to get the most plasma per donation in the quickest time in an effort to become efficient at moving as much plasma through a donation center as possible. PaySign essentially functions as a tollbooth that leverages all this effort. All in all, PaySign stands to not only continually take market share from Wirecard, but will likely see strong growth just from the industry's performance and from continued improvement in efficiencies.

The company is run by its founders, CEO Mark Newcomer and CTO Dan Spence. Combined, the two still own over 36% of the outstanding shares. CFO Mark Attinger joined the firm at the end of 2018 and has a strong background having worked for several other payment industry and financial firms in the past. Management has seemed to treat the company as their primary asset with a focus on long-term growth, and as such has reinvested all capital back into the company instead of paying dividends or repurchasing shares. They have overseen the plasma center customer count rise from low double digits to 290 at the end of June.

Based on the company's fairly consistent free cash flow margins and conservative growth projections, I believe the plasma business is worth between $5 and $6.60 per share alone, roughly what the shares trade for right now. PaySign's pharma business, though a good one, is much more competitive and it's future is more uncertain than the plasma business. Based again on quite conservative projections, I believe their pharma business is worth between $1.48 and $2.25 per share today (likely closer to the

lower end of that range.) This gives shares a fair value range between \$6.46 and \$8.85 with shares currently trading for roughly \$5.75.

My projections of PaySign's plasma business going forward may be too conservative. The name Wirecard likely jumped off the page since it was only a few months ago that Ernst & Young reported its German parent company, Wirecard AG, executed a sophisticated fraud that resulted in at least \$2 billion of missing money. Though Wirecard North America is technically a separate legal and business entity, it's quite feasible that reputational problems spilled over from the parent company. Quickly after the news broke about the German parent company, Wirecard North America put itself up for sale. It didn't take long for plasma center customers to make meaningful adjustments to ensure their businesses aren't affected. PaySign reported that a large client paid to have 104 centers brought online as part of a "business continuity plan", a hypothetical 36% increase to their number of plasma customers. Investor relations confirmed to me that these centers have kiosks and cards ready to go and could execute as soon as a "go-ahead" is given. Though PaySign management can't confirm, this can only be interpreted as a reaction to Wirecard's issues. More likely than not, there are other center operators that are considering changes because of these events as well, and this can only be beneficial for PaySign's business.

PaySign is exactly the kind of business I look to own: It has several competitive and structural advantages with competent owner-operators who have invested their capital and their lives in the business.

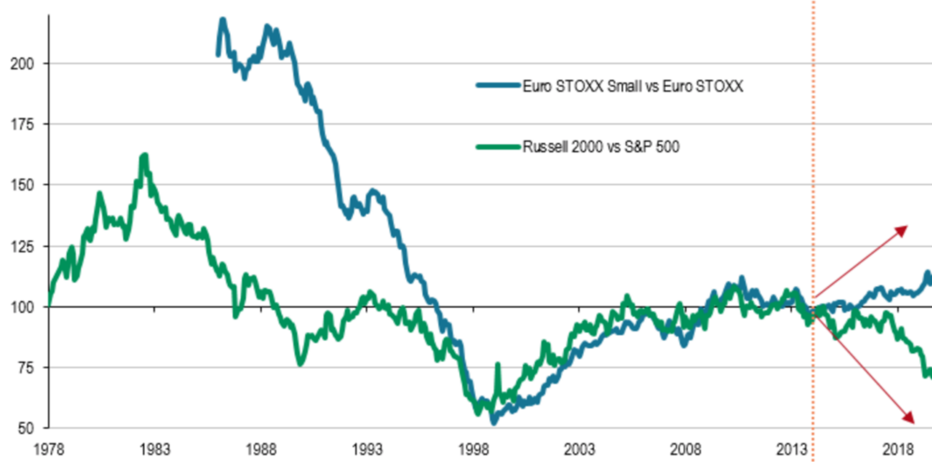
Market Insight

US equity markets continued their recovery in the third quarter. The Russell 2000 delivered a total return of 4.93%, and the Russell 1000 (a better gauge for large-caps nowadays than the S&P 500) returned 9.47%, both buoyed by optimistic economic indicators and the prospect for additional stimulus from the treasury department.

Though the September report didn't show quite what investors were hoping for, total nonfarm payroll has crossed the 50% recovery mark on its way back to pre-COVID levels. Unemployment is now at 7.9%, a substantial improvement from its 14.7% high. And lastly, the ISM manufacturing purchasing managers index pointed to significant expansion, if not quite at the same rate of August, an almost 2-year high.

The recovery has not been without volatility. Large and small caps both saw a high-single-digit drawdown in September largely attributed to the lack of a second stimulus bill. The Russell 1000 now sits net positive 6.4% for the year whereas its small-cap Russell counterpart is showing a net loss of 8.69%, an over 15% difference. The underperformance of small-caps for the past 5 years in the US has been well publicized, but this has not been the case in other developed nations. For example, European small-caps have outperformed in recent years, as is the historical norm (Chart 1).

Chart 1: Relative Performance of small cap vs. large cap, Europe & US



September 2020. Source: FactSet, BNP Paribas Asset Management

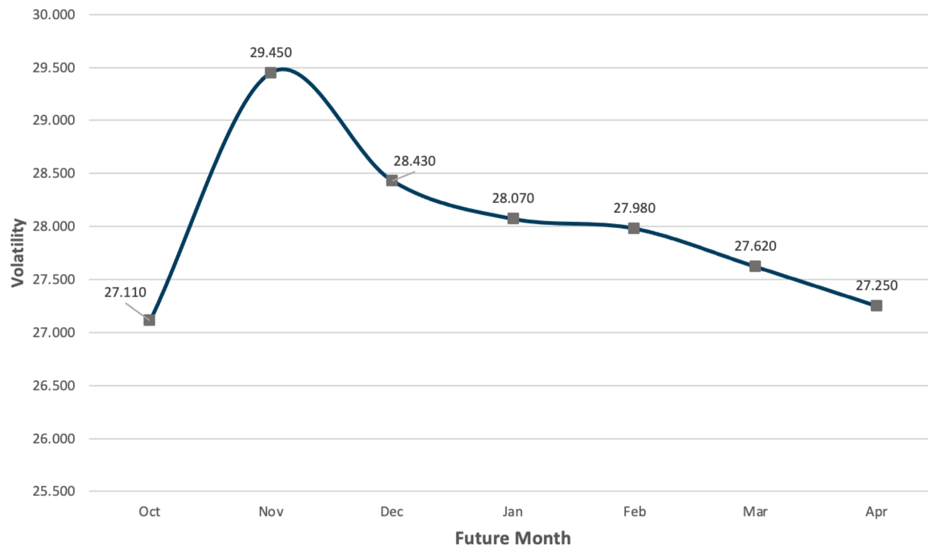
US small-caps also generally trade at a valuation premium to large-caps given that their smaller capital bases allow for better rates of growth. That premium has historically averaged around 25%, but it's recently been as low as 8%. As the domestic economy continues to recover, this valuation gap as well as the relative performance should experience mean-reversion.

Forward Insight

I've had many conversations with investors in the past two months regarding their outlooks, and a common theme among all of them has been extreme uncertainty. It's not surprising. There's plenty of reasons for uncertainty: a very divided election, a global pandemic and the economic impacts of such, and record fiscal and monetary stimulus. This uncertainty has manifested itself in a historic increase in investors' cash allocations to $4.65 trillion in June compared to $3.54 trillion at the end of last year.

And while volatility is probably one of the better single words to sum up the markets in 2020, it's unlikely to subside in the last few months of the year. VIX futures, a measure of expected volatility, are pointing to expectations of a peak in volatility in November around the election with elevated levels in December steadily decreasing through the start of next year (Chart 2).

Chart 2: VIX Futures Term Structure – Next 6 Months



Source: CBOE, Kippington Capital Management

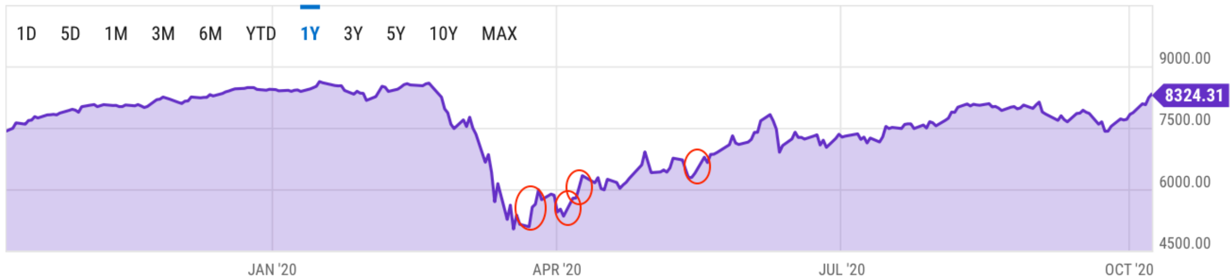
Markets are always more volatile around a presidential election. However, it's very important to note that the November VIX contract expires on the 17th of the month, two weeks *after* the election indicating that investors are pricing in high volatility and an extended election.

On the other side of the coin and equally important to understand is that markets are telling us the old adage that "this too shall pass". Volatility is expected to steadily decrease through the beginning of next year, and this is likely to be the case regardless of the election outcome.

With all the uncertainty and investor cash on the sidelines, if we have a second market downturn perhaps due to unforeseen economic impacts of the COVID pandemic or an election-related event, it's more likely than not to be short-lived (similar to the dive earlier this year). Market downturns are notoriously difficult to enter at the "right" time though this is frequently the plan investors have in mind. The game of "timing the markets" is a game most often lost. Due to a combination of factors including the proliferation of online (and in some cases free) trading of securities and large stimulus to the money supply, I believe we will have short-lived market corrections for the foreseeable future, which may in turn extend a "buy the dip" mentality by investors.

In the downturn earlier this year, the Russell 2000 found its low point on March 18th and has recovered 53.3% from that day through the end of September. In that period, fully 39.3% of that recovery occurred in just 6 trading days making it incredibly difficult to assess when to enter the market with sidelined cash (Chart 3).

Chart 3: Russell 2000 Total Return



Source: YCharts, Kippington Capital Management

Our biggest advantage is a long-term perspective. If that perspective is kept front of mind, volatility becomes not a frightening risk of short-term loss, but a compelling opportunity for long-term gain. For many investors that moved into cash, the 6 days of this year's market recovery that amounted to an almost-40 percent recovery were moving goal posts that were incredibly hard to hit.

At Kippington, our qualitative and quantitative process sets a specific fair-value range based on data and not a crystal ball. This perspective positions us to capture opportunities in the next downturn, so as investors move to cash and debate when to get back in, we will simply execute as we do day in and day out: with rigorous discipline.

As always, I welcome the opportunity to address any topics discussed herein as well as specific issues or portfolio objectives you may have. You can reach me directly at (847) 648 - 2667 or by email at conor@kippingtoncapital.com.

Best regards,

Conor Mahlmann
Kippington Capital Management