



April 28, 2021

Dear Partners and Friends,

In the first quarter Steel City Capital, LP gained 7.6% net of fees and expenses. The table below compares our returns to a collection of widely followed benchmarks. In May, the Partnership will celebrate its three-year anniversary. I am extremely grateful to those of you who have joined me on this journey so far, and I look forward to building relationships with new partners in the years to come.

	Steel City Capital, Net	Russell 2000	S&P 500	MSCI All World Index
2018 ¹	(8.0%)	(16.5%)	(7.6%)	(10.5%)
2019	23.4%	25.4%	28.9%	26.6%
2020	10.0%	20.0%	16.3%	16.3%
1Q 2021	7.6%	12.9%	5.8%	4.8%
Cumulative Return¹	34.5%	41.9%	46.4%	38.3%
Compound Annual Return¹	10.9%	13.0%	14.3%	12.0%

Necessary Arrogance

Regular readers should by now be accustomed to how I construct these quarterly updates. I try my best to avoid long treatises on “mental models” and angry diatribes about how the Fed’s easy money policy is distorting financial markets (often used as a guise for explaining away underperformance). Instead, I focus primarily on the rationale underpinning the investments held by the Partnership and discuss the reasons behind material portfolio management decisions. And I almost always frame decisions in the context of valuation because I’m a firm believer in the notion “there are no bad assets, just bad prices.”

In describing what he teaches his MBA students at Columbia University, Joel Greenblatt likes to say, “I always tell my students that if they do good valuation work, the market will eventually agree with them. I just don’t tell them *when* the market will agree with them.” This quote resonates with me because I believe the Partnership holds a collection of extremely undervalued securities that are in many cases worth multiples of their current values, but that the market simply doesn’t agree with me yet.

¹ Reflects returns since Steel City Capital’s launch on May 21, 2018.



Staking such a claim – **I’m right and the collective opinion of the market is wrong** – is what Seth Klarman referred to as the “necessary arrogance” required to make investment decisions. Writing in Barron’s in early 1999, Klarman said:

“At the root of value investing is the belief, first espoused by Benjamin Graham, that the market is a voting machine and not a weighing machine. Thus, an investor must have more confidence in his or her own opinion than in the combined weight of all other opinions. This borders on arrogance, the **necessary arrogance** that is required to make investment decisions.²”

Front and center in his Barron’s piece, Klarman highlights a prime example of the sort of “necessary arrogance” required to outperform the market over the long term: Warren Buffett’s investment in the Washington Post.

“The most dramatic and valuable lesson from the fabulous (and still counting) 50-plus-year investment career of Warren Buffett is the legendary account of his steadfast conviction amidst the 1973-75 bear market. He correctly identified by 1973 that the shares of companies such as the Washington Post were selling but for a fraction of the underlying business value represented by those shares. He observed that numerous buyers would readily pay several times the prevailing market price of Washington Post stock to acquire the entire company, but it was controlled by the founding family and not for sale. Buffett could acquire a minority interest in the business at a bargain price, but he could not force the valuation gap to close. For that, he was dependent on the passage of time to result in improved market conditions and/or the behavior of management to successfully run the business and to act in the best interest of shareholders.”

History never quite repeats itself exactly. But fortunately for us, it rhymes. Earlier this year, the Partnership took a position in **News Corp. (NWSA)**. There are a lot of similarities between Buffett’s investment in the Washington Post and ours in News Corp: the companies’ portfolios comprise(d) a collection of leading media assets; the assets are (were) on sale for a fraction of their private market values; and minority shareholders are (were) subject to the mercy of a founding family to close the valuation gap.

NWSA’s assets include a ~62% interest in Australia’s REA Group (Australia’s version of Zillow) which is publicly traded on the Australian Stock Exchange; an 80% interest in Realtor.com, the second largest online real estate portal in the U.S.; the Dow Jones Group which holds several financial media properties including The Wall Street Journal, Barron’s, and MarketWatch; HarperCollins, the second largest consumer book publisher in the world; a 65% interest in Foxtel, the largest pay-TV provider in Australia; and a collection of other print and online media properties in the U.S., U.K. and Australia.

The company – part of Rupert Murdoch’s global media empire – was separated from Murdoch’s TV and film assets (21st Century Fox, Fox News, etc.) in 2013. At the time, NWSA was widely regarded as “CrapCo” because of its focus on legacy media like newspapers and book publishing, not to mention the overhang from lawsuits related to the

² Seth Klarman, “Why Value Investors are Different,” Barron’s, February 15, 1999.



company's phone hacking scandal in the UK. Living up to its nickname, CrapCo shares underperformed the S&P 500 by more than 100% from the time of the separation through year-end 2020.



When the Partnership established a position, NWSA was trading with a market capitalization of ~\$11.0 billion. The company's interest in REA Group was worth \$10.1 billion, it had \$1.4 billion of unencumbered cash, and no corporate debt. This implied a value for the remaining operating businesses of **negative \$550 million**. This, of course, was utter nonsense.

HarperCollins generates average EBITDA of ~\$250 million per year with virtually no capital expenditures. Publisher Penguin Random House recently agreed to purchase competitor Simon & Schuster at an implied multiple of 14.5x EBITDA, highlighting the private market value of similar assets³. For its part, the Dow Jones Group continues to show success in navigating the transition away from print that has seen so many traditional publications disappear. The WSJ remains in a lane of its own as the financial and business “paper of record” in the U.S. while the New York Times and Washington Post battle it out on the political front. Dow Jones Group has grown circulation revenue at a 6% CAGR over the past five years on the back of growing subscriber numbers, generally offset print advertising declines with online ad growth (at least until COVID hit), and continually scaled EBITDA margins (18% on a TTM basis). During the last twelve months, Dow Jones Group printed \$290 million of EBITDA vs. \$220 million for the comparable period in 2019. For context, the New York Times generated ~\$250 million of EBITDA in FY'20 and boasts a pension-adjusted enterprise value of \$7.5 billion, representing a 30.2x multiple. The comparison is somewhat apples-to-oranges in part because of Dow Jones's Professional Information Business, but the broader point shouldn't be lost: the private market value of the Dow Jones Group is substantially higher than what the market is giving credit for.

³ A fair valuation for HarperCollins is probably somewhere below 14.5x as the price paid for Simon & Schuster included a control premium and assumed synergies.



\$MM	Jan-21	Apr-21
NWSA Shares (millions)	590.6	590.7
x Share Price	<u>\$18.50</u>	<u>\$26.75</u>
NWSA Market Cap	10,925.8	15,801.8
<i>Less:</i>		
REA Group Shares (millions)	81.1	81.1
x Share Price	<u>\$159.00</u>	<u>\$157.50</u>
x USD / AUD	<u>\$0.78</u>	<u>\$0.78</u>
REA Market Cap	10,063.2	9,965.6
+ Excess Cash ¹	1,407.0	1,801.0
- HoldCo Debt		(1,000.0)
Operating Stub Value	(544.3)	5,035.3

1. Pro-forma for \$1.0 billion debt issuance, less purchase of HMH Books & Media (\$349 million) and Investor's Business Daily (\$275 million)

Since establishing a position, a couple of events have occurred and the stock price has perked up a bit. The company has: agreed to acquire Investor's Business Daily and the consumer publishing segment of Houghton Mifflin Harcourt; entered into landmark agreements with Facebook and Google in Australia whereby the tech giants will pay NWSA for access to its news content; and raised \$1.0 billion of debt. While the implied enterprise value of NWSA's operating assets today sits closer to \$5 billion, this continues to make little sense when viewed in the context of future profitability and the private market value of the assets.

Dow Jones will do at least \$300 million of EBITDA this year and is growing; HarperCollins should continue to do \$250 million per year; I estimate Realtor.com is generating \$50 million which should also grow over time; the news agreements with Facebook and Google will probably add \$50 million per annum in the early years, with the potential for significant expansion if similar agreements are struck covering geographies beyond Australia; the recent acquisitions will add \$40-\$50 million; and the company is in the early stages of a shared services project that management estimates will eliminate \$100 million of back-office expenses. Netting out existing corporate costs and an estimated small operating loss at the legacy/traditional News Media segment yields EBITDA in the realm of \$550-\$600 million. At a sub-10x EBITDA multiple, the Partnership remains a buyer of NWSA shares.

So *why* are NWSA shares cheap? Is it the somewhat "messy" accounting that requires the consolidation of REA Group and Foxtel (which is itself a dog of an asset)? Maybe. Is it the stain associated with owning "old media" assets? Maybe. Personally, I think it's mostly driven by general investor distaste for sum-of-the-parts stories such as this. In my conversations with other investors, many have an aversion to SOTP in the absence of a well-defined catalyst to close the gap between price and value. This exact same dynamic existed with IAC which not only traded substantially below the value of its assets, *but continued to do so even after management clearly articulated plans to unlock value*



via a series of spin-offs (**PSA: Markets aren't fully efficient.**). While I sympathize to some extent, I can't help but feel more like Buffett when he built a position in the Washington Post. Unlocking value at NWSA might not come as quickly as your run-of-the-mill New York hedge fund would prefer, but for those with a long-term orientation, I'm confident that it will eventually occur.

Next up is **SIGA Technologies, Inc.** While there are stark differences between SIGA and NWSA (line of business, size), there are some striking similarities as well (messy accounting and the presence of a controlling shareholder). SIGA is a commercial stage pharmaceutical company whose sole product, TPOXX, is an antiviral drug approved by the FDA for the treatment of smallpox.

Smallpox is an incredibly deadly disease. The virus has a 1-to-2 week incubation period, meaning that "hosts" can carry and spread the virus asymptomatically for up to 14 days; it is highly transmissible (an average of 5 people infected by each sick person); and its historical mortality rate is ~30%. *A smallpox outbreak would make the COVID-19 pandemic look like a walk in the park.*

Hold up a second. You're probably asking yourself, "wasn't smallpox eradicated?" The answer is yes. The last natural outbreak of smallpox in the United States occurred in 1949. In 1980, the World Health Assembly declared smallpox eradicated. No cases of naturally occurring smallpox have occurred since. (**PSA: Vaccines are safe and effective.**)

What, then, is the purpose of a company that produces an antiviral for a virus that hasn't been naturally contracted in 70 years? While the prospect of contracting the virus naturally is effectively nil, smallpox is a widely recognized bioterrorism threat. From SIGA's investor presentation:

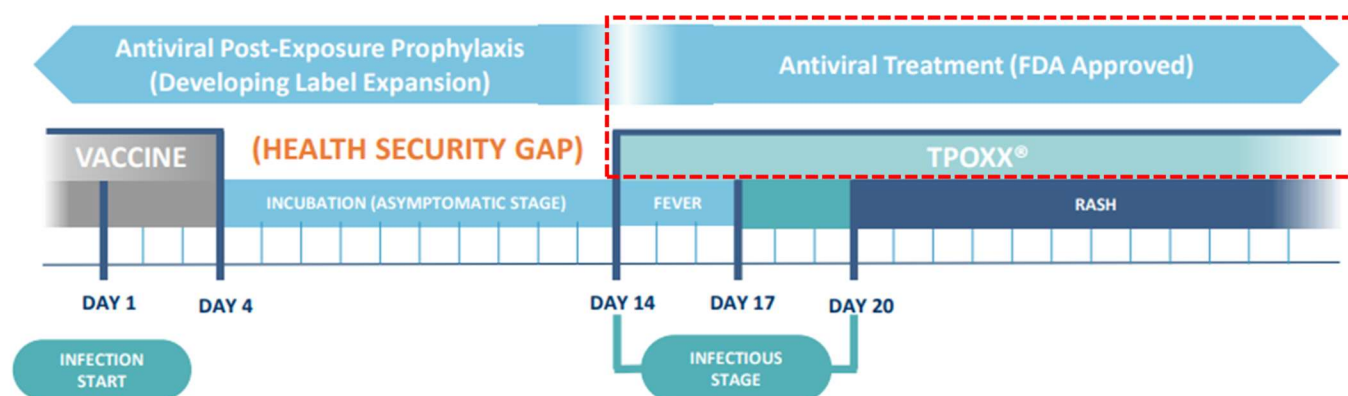
- "Somebody would reconstruct, say, a smallpox virus and have that spread, and that would not only kill millions, it could potentially kill billions." – *Bill Gates on bioterrorism in 2017*
- "In 2014, the NIH discovered live stocks in a storage room on its campus in Bethesda, Maryland. If the venerable and highly regulated NIH could lose track of smallpox, other institutions could have forgotten some vials as well." – *Nature, August 2018*⁴
- "North Korea is far more likely to use biological weapons than nuclear ones. The program is advanced, underestimated and highly lethal." – *Andrew Weber, Pentagon official in charge of nuclear, chemical and biological defense programs under President Obama in 2019*

The idea that an extremely deadly pathogen could be weaponized by an adversarial regime or other non-state actor was a primary focus in the years following September 11th and the 2001 anthrax attacks. The U.S. government has taken a multi-pronged approach to protect against the threat, including stockpiling enough vaccine for the entire population. However, a vaccine-only approach isn't sufficient for a variety of reasons: a portion of the population is contraindicated for the vaccine (it won't work or can't be taken); vaccine hesitancy persists; and the vaccine ceases to be effective at a certain point after infection. It's the latter situation where TPOXX is currently indicated. In the

⁴ I have no opinion on the theory that COVID-19 escaped from a lab in China, although this story about the NIH losing vials of smallpox certainly makes it seem less outlandish.



event of a smallpox outbreak, TPOXX can be prescribed to individuals who are exhibiting symptoms, which generally occurs 2-weeks after infection.



In 2011, SIGA signed an initial procurement contract with Biomedical Advanced Research and Development Authority (BARDA) and ultimately delivered 1.7 million courses of TPOXX to the Strategic National Stockpile (SNS) between 2013 and 2017. The drug has an FDA-approved shelf life of 7 years and in 2018 SIGA signed a new contract with BARDA with the explicit purpose of maintaining the government’s current 1.7 million course stockpile. The first deliveries under the maintenance contract, which is valued in excess of \$600 million, began in 2020, coinciding with the 7-year expiration of the 2013 product deliveries. Annual deliveries should continue through 2024⁵. Additionally, TPOXX has sufficient patent protection to support one more replenishment contract cycle that would begin in 2027.

The beautiful thing about SIGA is the replenishment nature of the contract provides investors with a fairly clear view into the company’s P&L over the next several years. Assuming the government exercises each of its remaining annual procurement options, which I believe is a high probability, SIGA’s financials should look roughly like the following:

	2021E	2022E	2023E	2024E
Courses Delivered	363,070	363,070	363,070	247,720
Revenue	112.6	112.6	112.6	85.3
- COGS	(14.6)	(14.6)	(14.6)	(17.1)
- SG&A	(15.0)	(15.0)	(15.0)	(15.0)
-R&D	(1.0)	(1.0)	(1.0)	(1.0)
-Patent Expenses	(1.0)	(1.0)	(1.0)	(1.0)
Operating Income	80.9	80.9	80.9	51.3
- Taxes	(20.2)	(20.2)	(20.2)	(12.8)
Net Income	60.7	60.7	60.7	38.5

⁵ Technically, SIGA’s contract with the government is structured as a series of options which must be proactively exercised each year, subject to the availability of funding.



Now moving on to valuation. SIGA's current market cap is ~\$540 million. The balance sheet has nearly \$120 million of cash and no debt. Seeing as the company should be free cash flow positive through 2024, the entirety of the company's cash balance is "excess." Market cap, ex. cash, is therefore \$420 million.

	12/31/2020	12/31/2021	12/31/2022	12/31/2023	12/31/2024
Shares	77.2	77.2	77.2	77.2	77.2
x Share Price	\$7.00	\$7.00	\$7.00	\$7.00	\$7.00
Market Cap	540.4	540.4	540.4	540.4	540.4
- Cash	(117.9)	(178.6)	(239.3)	(300.0)	(338.4)
Market Cap (ex. cash)	422.5	361.8	301.1	240.4	202.0
<i>Forward Earnings</i>	60.7	60.7	60.7	38.5	
<i>Forward P/E</i>	7.0x	6.0x	5.0x	6.3x	

Purchasing a commercially approved drug with a visible multi-year revenue stream backed by the US Government at a mid-single-digit earnings multiple is attractive to me on a standalone basis. But what makes the investment even more attractive is a list of "free options" embedded in the stock. These include:

1. *Stockpile expansion*: 1.7 million courses of TPOXX is an extremely small stockpile when considering the high transmissibility and mortality rates of the virus. As of late April 2021, there have been more than 32 million confirmed cases of COVID-19 and nearly 600,000 deaths in the U.S since the start of the pandemic. Seeing as smallpox is *more* infectious and deadly than COVID-19, it would make sense that the government would want to have more than just 1.7 million courses available. I expect preparing for and protecting against future pandemics will be a bipartisan focus in the years to come, creating an opening for SIGA to increase the value of its contract. This is a medium-term opportunity for the company (several years out) as near-term government efforts remain focused on COVID and there is an ongoing transition of key decisionmakers within the government.
2. *Post-Exposure Prophylaxis (PEP)*: SIGA is pursuing a label expansion for the purpose of Post-Exposure Prophylaxis. As it stands today, the course of treatment for smallpox exposure contains a wide "health security gap" as indicated in the image on Page 6 above. Vaccines are only effective if administered either 1) before exposure or 2) within ~4 days of infection. TPOXX is only indicated for symptomatic cases, with symptoms typically presenting ~14 days after infection. This means there is a roughly 10-day window where an exposed individual wouldn't benefit from a vaccine but technically isn't eligible for TPOXX. From a practical perspective, PEP is very important because in the face of a potential outbreak, health professionals won't want to be waiting around to prescribe TPOXX to individuals when they present with symptoms. Instead, they'll want to be proactive and dose everyone who has been within spitting distance (literally) of an individual with a diagnosed case – symptoms or not.

PEP would fill this health security gap, and for the company, also provide a meaningful increase in sales. PEP is a 28-day course vs. the 14-day course currently approved for symptomatic disease. This means that



if approved for PEP, the government's 1.7 million course stockpile would effectively be cut in half, requiring a doubling of the contract *just to maintain the current inventory*.

3. *International Sales*: Biodefense isn't solely an American concern and the company is actively pursuing international sales. Earlier this year SIGA announced a deal with the Public Health Agency of Canada (valued at \$33 million) and has foreshadowed one more contract announcement in the coming year. Again, this is probably a medium-term opportunity given the time required to achieve regulatory approvals and sign contracts, not to mention the limited bandwidth of key decisionmakers amidst the ongoing response to COVID.

So *why* are SIGA shares cheap? Like NWSA, the accounting, at least historically, has been messy. SIGA began fulfilling its obligations under the 2011 contract *before* TPOXX received FDA approval, and there was a clause in that contract that would have required the company to replace previously delivered doses to the extent the approved drug formulation was different than the one it had delivered. Because of this key regulatory contingency, accounting rules required the company to initially record cash receipts as deferred revenue, bypassing the P&L, resulting in a long string of net losses until 2018 when the company finally recorded \$477 million of revenue in one fell swoop in connection with final FDA approval of the drug. As a result, the company has rarely screened well on historical metrics (although this is now changing as it makes deliveries under the maintenance contract), and continues to screen poorly on the basis of forward-looking estimates as a result of the absence of sell-side coverage. The other potential reason for SIGA's cheapness is the overhang caused by the concentrated ownership by Ron Perelman's MacAndrews & Forbes, which holds ~30% of shares outstanding. MacAndrews and Forbes has reportedly suffered under the weight of its debt load, whose collateral included the firm's publicly traded stakes in several firms.

PORTFOLIO OVERVIEW

On 2/16, **Anterix (ATEX)** announced it had entered into an agreement with San Diego Gas & Electric (SDG&E), a subsidiary of Sempra Energy, for the sale of 900 MHz broadband licenses in its service territory. The agreement will support SDG&E's deployment of a private LTE network across San Diego, Imperial, and portions of Orange counties, where the utility covers 3.6 million people. Total payment for the broadband license will be \$50 million, comprising an initial payment of \$20 million in February 2021, with the remaining \$30 million to be paid through 2023 as broadband spectrum is delivered to SDG&E. The announcement is very positive for ATEX for several reasons:

- The \$50 million payment equates to ~\$2.30/MHz Pop, which is a near 40% premium to the \$1.68/MHz Pop (weighted average by population) paid for 600 MHz spectrum in the same counties. Recall that the nationwide clearing price in the 600 MHz auction was \$0.93/MHz Pop and that ATEX's current share price implies a spectrum valuation of ~\$0.40/MHz Pop.
- The deal illustrates that CBRS is viewed by utilities as a complimentary, not a competitive, solution to 900 MHz spectrum. SDG&E recently paid \$21 million for CBRS spectrum licenses covering its service territory. The announcement of SDG&E's intent to purchase 900 MHz spectrum as well should put to rest concerns from investors about an "either/or" decision from utilities.



- SDG&E was not a utility that had previously tested the spectrum utilizing an experimental license. Its decision to move forward without having tested the spectrum in advance of its purchase should enable investors to take an expanded view of the potential sales funnel.

One week prior to the contract announcement, management had indicated that it was possible for the company to sign up to two contracts before the end of its fiscal year on March 31. When the SDG&E contract was announced, management then noted the SDG&E contract was likely the last for the recently closed fiscal year. The implication is that one contract “slipped,” and I believe there is a high probability of a third contract announcement in the first half of the current fiscal year which will be a catalyst to push the shares higher. I suspect there’s a full court press to have an announcement coincide with the company’s planned analyst day (likely this summer), at which point management will be better positioned to discuss a framework for shareholder capital returns given ATEX’s budding cash position in excess of what will be required for retuning. In the meantime, the stock remains incomprehensibly cheap and none of the prior justifications (lack of FCC approval, absence of utility contracts) hold water. **There is still room for shares to double or triple from their current level.**

Liberated Syndication (LSYN) shares have stalled out, and probably deservedly so. The inability to timely report financials and pending restatements are really just the tip of the iceberg, and it’s what’s lurking beneath the surface that’s of more concern. The delay relates to unpaid European VAT in the 2015-2018 time period, which the company is only now going back and accounting for. Not only will the review result in restatements, but it’s going to cost LSYN a pretty penny as well. Management isn’t giving guidance on this front (they honestly don’t know), but when all is said and done, I suspect the hickey will end up being several million dollars after including penalties and interest. This won’t place an undue strain on the company financially given its cash balance and recent capital raise, but there’s certainly an opportunity cost both in terms of operational investment as well as management focus. My best guess is that it will take the better part of 2021 for the company to come current on the financials.

LSYN announced three acquisitions in quick succession this year. Auxbus, a podcast creation platform will improve the company’s customer acquisition funnel; AdvertiseCast will enhance podcasters’ ability to sell advertisements; and Glow enables podcasters to build subscription programs. The latter two are perhaps the most important, as the ability of podcasters to monetize their content is becoming increasingly important.

Shortly after the announcement of the Glow deal, Apple announced (to much fanfare) that it too is launching a subscription podcasting platform, à la Glow. In short order, Spotify announced that it is launching a similar platform. On one hand, you could argue this validates the company’s pursuit of Glow. The industry is moving in the direction of subscription podcasts (with ad-free listening and exclusive content) and LSYN is staying at the leading edge of this movement. On the other hand, you could argue that Apple and Spotify are cutting into the potential revenue stream that’s available to LSYN. Not only is Glow at risk of being relegated to the corner by the two behemoths, but Spotify’s aggressive pricing structure will probably drive a race to the bottom on price and commission, stymieing LSYN’s ability to meaningfully accelerate non-hosting revenue growth. This outcome is dangerous for the equity story considering the most likely path to value creation is through rapid top-line growth.



Think about it this way: Most listeners consume podcast content via Apple and Spotify. It stands to reason that's where most listeners will sign up for paid subscriptions as well. As a result, podcasters will make a disproportionate amount of their revenue on those platforms. If that's where most of the money is coming from, why bother with Glow? (The counter argument is that, aside from a small annual fee, profits from subscriptions on Glow should all drop to the podcaster's bottom line so there's no reason not to utilize that as well.)

The best way to mitigate this risk is by finding a way to directly connect with podcast listeners, which would mean acquiring or merging with the likes of an Overcast or GoodPods. Management and the Board have obviously been focusing on expanding LSYN's capabilities and value proposition via M&A, so maybe they have something up their sleeves.

The next 6-12 months are going to be critical for LSYN. First and foremost, it's imperative they get a CEO seated ASAP to establish a vision, integrate the acquisitions into a single platform (as opposed to existing as a hodgepodge of functions), and maintain the company's relevancy in the rapidly-evolving industry (**PSA: Come to Pittsburgh. It's great.**). Second, the company needs to wrap up its restatements at a reasonable cost and avoid going down a costly rabbit hole that won't create shareholder value (see Tandy Leather Factory). If they find themselves falling too far behind, the best path to shareholder value maximization may be putting the company up for sale. From the vantage of the Partnership, I'm sitting tight for the time being, as I have a tremendous amount of respect for Eric Shahinian at Camac and CFO Richard Heyse. They continue to do their best with the hand they've been dealt.

As I've long argued, **Trupanion's (TRUP)** Pet Acquisition Costs (PAC) have been growing at an unsustainable rate which will ultimately cause the company's preferred profitability metric – IRR – to fall beneath their target of 30-40%. By my calculations, the company is going to be hanging on by the skin of its teeth in 2021, although the "real" figure – excluding various self-help initiatives – will undoubtedly fall below the low end of its target.

Subscription pet revenue was guided to \$484 million at the midpoint. Assuming Monthly Average Revenue per Pet of \$63.99 (which is in-line with the company's commentary of ARPP growing 6.0% in 2021) means average pets will total 631,000 for the full year. To average this figure, year-end pets will need to reach 684,350 at 12/31/2021. Quarterly churn is running just shy of 4.0%, meaning that in a run-off scenario, year-end pets would decline to 493,550. In order to offset churn and grow subscription pets to 684,350, TRUP will need to add 191,000 gross pets during the year. Management indicated they expect to spend ~\$60 million on pet acquisition in 2021, which equates to ~\$315/pet. This is 28% higher than FY'20 PAC spend of \$247/pet.

The punchline is that, by year end 2021, IRR will fall to ~30%. And as I've consistently pointed out, this is a trailing twelve-month figure, meaning that as the year progresses, leading edge pet acquisition will more likely than not be below the 30% target.

I've also long been critical of the accounting sleight of hand used by the company to inflate IRR, specifically including several million dollars of non-operating items (rental income at company HQ and a VIE expense offset) making expenses appear lower than they actually are. In 2020, I estimate these items reduced OpEx by ~\$3.5 million.



And in 2021, the company will *exclude* anywhere from \$2-\$5 million (\$3.5 million at the midpoint) of pre-revenue "development expenses" when calculating IRR. It's really unclear what the expenses actually are, but my best guess is that it's some combination of fixed costs associated with its recent acquisition, potential costs associated with setting up its own underwriter in Canada, and expenses associated with its Aflac partnership. The company said, via footnote:

“As we enter the next phase of our growth, we expect to invest in initiatives that are pre-revenue, including adding new products and international expansion. These development expenses are costs related to product exploration and development that are pre-revenue and historically have been insignificant. We view these activities as uses of our adjusted operating income separate from pet acquisition spend.”

The intellectual dishonesty (hypocrisy) is stunning when you think about it. Management has the balls to **include non-operating items to boost IRR, but is selectively excluding operating items when they hurt it**. They must have a really low opinion of the intelligence of their shareholders. If we were to fully load the IRR calculation with development expenses and exclude the non-operating items, IRR would be ~25.2%.

The company's revenue guide crushed consensus going into the print (\$664 million guidance at the midpoint vs. consensus of \$627 million) and the stock has traditionally traded on revenue growth as opposed to profitability, so it was heartening to see the stock sell-off following the strong guide. At least based on the commentary of one analyst on the earnings call, subscription revenue guidance was in line with their expectations, while "Other" was substantially ahead. TRUP's management has long used the "Other" line of business to turbo-charge revenue growth, without corresponding profits, so perhaps investors are starting to "wake up" to the game. To be more specific, "Other" business revenue is forecast to grow by \$65 million this year, while adding only \$2.7 million of incremental profits.

Speaking of profits – they are still nowhere to be found, despite the forecast for topline growth of 32%. Isn't this company supposed to scale? Adjusted operating income is expected to be \$73 million, PAC will be \$60 million, "development" will be \$3.5 million, leaving only \$9.5 million of pre-tax profits. And with SBC likely to clock in between \$10-\$12 million (based on its historical relationships to revenue), then TRUP will, once again, report negative GAAP Net Income in 2021. The company has never reported GAAP Net Income in at least the past 10-years. **What's \$3.3 billion of market cap divided by negative net income?**

The prospective risk from a portfolio management perspective is management raising revenue guidance throughout the year. I found it curious that the "Other" segment is forecast to grow by 58% this year, a sharp deceleration from last year's 82% and the 4Q'20 exit rate of 92%. My guess is that management is sandbagging the numbers for a rainy day (unless people are returning their pandemic puppies).

WD-40's (WDFC) most recent quarter largely confirmed what I expected to see: a deceleration of sales growth rates (following a period marked by an explosion of pent-up demand) and an inevitable compression of margins (which had been boosted by extremely favorable oil-linked input costs).

On the sales front, 2Q'21 growth decelerated to 9% y/y (FX-neutral) from 23.6% y/y (FX-neutral) in 1Q'21. Perhaps more importantly, the company's full year sales guidance implies a further deceleration in the second half compared to the first, with 2H'21 sales growth expected to come in at 6.5%. This is particularly unappealing on two accounts.



First, the 6.5% growth is based off of a very easy comp as the comparable period in 2020 saw negative sales growth as a result of COVID. Second, the 2H'21 growth forecast now includes a sizable FX-related tailwind. Going into the print, the midpoint of sales guidance was \$453 million; management increased their full-year bogey to \$460 million (at the midpoint) based on favorable changes in FX rates. Excluding the new FX tailwind, the company is looking at constant currency growth of just 3.5% in the second half (again off of a very easy comp).

With respect to margins, management discussed a 200-300 bp deterioration of gross margin in the back half of the year, attributable to a mix of supply chain issues and higher input prices. While they are working to overcome a portion of the higher costs through changes to / expansion of their supply chain, management also noted that, to the extent oil prices remain at or near their current levels, margin pressure will persist.

Interestingly, the company has declined to provide formal guidance on anything other than sales, but management has also commented on every component of the income statement in response to analyst questions. In the second half we know that gross margin is going to deteriorate by 200-300 bps; Other OpEx will be 34% of sales; and the effective tax rate will rise towards 20%. Putting all of the pieces together, we can pencil out 2H'21 EPS of \$2.47, which is flat-to-down y/y despite 6.5% sales growth. Since that's nothing to write home about, I suspect management just decided not to talk about it.

While shares sold off on the day following earnings, valuation remains exceptionally stretched. Full year EPS will be in the realm of \$5.45, putting WDFC's P/E at 47x. Valuation doesn't look much different on the basis of FCF, with shares trading at ~50x normalized FCF. Looking forward to FY'22, as the world continues to normalize, I expect WDFC's top-line growth will revert back towards historical levels in the low-single digits (GDP-like), while EPS growth will be harder to come by to the extent margin headwinds continue to prevail (and without the help of a repurchase program which the company has discontinued for the time being). There continues to be a meaningful disconnect between valuation and fundamentals. With earnings growth grinding to a halt – and potentially even inflecting into negative territory next year – I continue to expect shares will be pressured over the medium term.

Carvana's (CVNA) 4Q'20 results weren't particularly great. EBITDA was negative (\$70) million, a stark turnaround on a sequential basis from a first-ever EBITDA profit of \$21 million in 3Q'20. The culprit was a steep drop off in retail unit GPU (\$1,265 vs. \$1,857) and wholesale unit GPU (\$358 vs. \$1,113) as some of the COVID-driven aberrations in the used car market began to abate.

The company's presentation of EBITDA (calculated “bottom up”) is dubious, as it commingles non-operating items including mark-to-market changes in its retained securitization portfolio. With the exception of 1Q'20, when ABS markets were going haywire, this line item provided a tailwind throughout 2020, including a gain of \$5 million in 4Q'20. Also on the non-operating self-help front, management released a reserve for vehicle service contract cancellations in 4Q'20, adding another \$7 million to EBITDA, and boosting "Other" GPU by \$96.

Putting it all together, I put operating EBITDA closer to negative (\$82) million vs. the \$70 million printed by the company. This is a larger loss than 4Q'19 (calculated on a similar operating basis) despite the company selling 43% more retail units y/y!



Management didn't provide formal guidance for 2021, but did offer guardrails for how to think about the year. Retail unit growth is expected to accelerate from last year's 37%, with total revenue tracking in-line with retail unit growth. Total revenue per retail unit was \$22,885 last year, meaning the company thinks it can hold this metric relatively flat throughout the year. Management also noted it expects some softening in retail ASPs throughout the year ("*I think the gains that we saw in ASP in the back half of the year, we expect to moderate a little bit in 2021⁶*"), with the implication being "Other" revenue – including financing – will serve as an offset.

Why look at total revenue per retail unit? The company guides to total GPU, which itself is an apples-and-oranges mix of total gross profit divided by only retail units. As for total GPU, management called out expectations for "mid-\$3,000s" in FY21. Putting the pieces together, \$3,500 of total GPU divided by \$22,885 of total revenue per retail unit implies gross margin of 15.3% for the year, roughly 100 bps of pickup vs. last year's 14.2%.

On the EBITDA front, management guided to continuing cost leverage but still a "small EBITDA margin loss" in FY'21. Splitting the difference between last year's negative 4.6% EBITDA margin and breakeven gives us something in the realm of a 2.5% EBITDA margin loss for FY'21. So, 200 bps of total improvement, 100 bps of which we know is coming from GPU margin. The other 100 bps, therefore, must come from SG&A.

Applying a negative 2.5% margin to \$22,885 of total revenue per retail unit implies about \$575 of negative EBITDA per unit sold. This also allows us to back into implied cash SG&A per unit of \$4,075, which is 17.8%, and 100 bps better than last year's 18.8%,

The unknown variable is what retail unit growth actually looks like in 2021. All we know is it's going to "accelerate" vs. last year's 37%. Doing some back of the envelope sensitivity implies negative EBITDA ranging from a (\$210) million loss at 50% unit growth to a (\$250) million loss at 80% growth (**A classic case of "We lose money on every sale but make up for it in volume!"**). For context, the street is currently forecasting a negative EBITDA margin of 1.0% and negative EBITDA of (\$87.5) million.

I think one of the big risks to the company's outlook isn't necessarily on the volume front – I believe management when they say they can't keep pace with demand – but instead on the GPU front. Before 2H'20, only once in the prior 14 quarters did total GPU exceed \$3,000. 3Q'20 reached an all-time high due to strong vehicle pricing and strong finance gross profit, while 4Q'20 got its boost from finance gross profit and the abovementioned reserve release. Finance GPU is a function of both absolute interest rates and ABS spreads, and the trajectory of absolute rates since the beginning of 2021 calls into question the company's ability to maintain finance GPU at \$1,400, let alone grow it.

⁶ This may not end up being the case in 2021 given the still red-hot prices in the used car market.



	2017	2018	2019	2020	2021E
Total Revenue	858,870	1,955,467	3,939,896	5,586,565	8,379,848
Gross Profit	68,091	196,709	506,414	793,765	1,281,583
Cash SG&A	(203,277)	(401,719)	(745,452)	(1,052,370)	(1,491,079)
Other non-operating	9,903	1,178	3,730	(1,447)	
Total EBITDA	(145,089)	(206,188)	(242,768)	(257,158)	(209,496)
Gross Profit Margin	7.9%	10.1%	12.9%	14.2%	15.3%
Cash SG&A / Revenue	(23.7%)	(20.5%)	(18.9%)	(18.8%)	(17.8%)
Other non-operating / Revenue	(1.2%)	(0.1%)	(0.1%)	0.0%	
EBITDA Margin	(16.9%)	(10.5%)	(6.2%)	(4.6%)	(2.5%)
Total Retail Units	44,252	94,108	177,549	244,111	366,167
Total Revenue / Retail Unit	\$19,409	\$20,779	\$22,190	\$22,885	\$22,885
Total Gross Profit / Retail Unit	\$1,539	\$2,090	\$2,852	\$3,252	\$3,500
Cash SG&A / Retail Unit	(\$4,594)	(\$4,269)	(\$4,199)	(\$4,311)	(\$4,072)
Other non-operating / Retail Unit	\$224	\$13	\$21	(\$6)	
Total EBITDA / Retail Unit	(\$3,279)	(\$2,191)	(\$1,367)	(\$1,053)	(\$572)
Margin Check	(16.9%)	(10.5%)	(6.2%)	(4.6%)	(2.5%)

On the cash flow front, 2021 will be much of the same. Layering debt maturities, financing lease payments, interest, and capex on top of already negative EBITDA will result in another year of negative free cash flow in the realm of three-quarters of a billion dollars.

	Retail Unit Growth			
	50%	60%	70%	80%
EBITDA	(209,500)	(223,500)	(237,500)	(251,000)
- Notes Payable	(17,356)	(17,356)	(17,356)	(17,356)
- Financing leases	(26,405)	(26,405)	(26,405)	(26,405)
- Interest payments	(69,793)	(69,793)	(69,793)	(69,793)
- Real estate financing	(31,562)	(31,562)	(31,562)	(31,562)
- Retail estate commitments	(99,785)	(99,785)	(99,785)	(99,785)
- Capex (2 IRCs, Maintenance)	(300,000)	(300,000)	(300,000)	(300,000)
Levered Free Cash Flow	(754,401)	(768,400)	(782,400)	(795,900)

* * * * *

I know these updates are long, but I believe it is vitally important for partners and prospective partners to understand my thought process and rationale for making investments. I am available for any questions, comments, or concerns that you may have.

If you are an accredited investor who would like to learn more about becoming a partner, please reach out to me and we can arrange a time to have a more in-depth conversation. Please also know that even if an investment in the Partnership isn't for you, the highest compliment that you can pay me is an introduction to someone who might be a good fit.



I want to thank those of you who have already joined as partners of the Fund. I am grateful for the opportunity to grow your assets alongside mine and appreciative of your trust.

*“To be yourself in a world that is constantly trying to
make you something else is the greatest accomplishment.”*

- Ralph Waldo Emerson

Sincerely,

Michael G. Hacke, CFA
Steel City Capital Investments, LLC



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