RF Capital Management LLC

615 Las Tunas Drive, Suite 203 • Arcadia, California 91007 • Phone: 626-623-6012 • Fax: 626-623-6012

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Dear Investors,

RF Capital returned 18.82% net for the second quarter. Please check your individual statements for your exact returns.

We had a great quarter. On a risk-adjusted basis, we generated a strong absolute return considering our large cash position. During the quarter, our cash position decreased to ~35% as we took advantage of the market volatility. We ended the quarter with a 69.51% cash position. As the market recovered from its lows, we trimmed and exited our investments accordingly – hence the large cash balance to close the quarter.

In this letter, we will briefly touch upon our value trading framework. Next, we will discuss our top five holdings. Finally, we will comment on a couple of our closed positions and provide our H2 2020 outlook.

IMPROVING OUR VALUE TRADING FRAMEWORK

In hindsight, we should have been more aggressive in the second quarter by putting more of our cash to work. We tried to average down on many of our positions and it ended up costing us in terms of gross exposure versus cash. Instead of establishing 10%+ position sizes in our best ideas, we were unable to establish new positions past 5%. However, we do not regret how we managed our trading activity. Maintaining our trading discipline will lead to better performance over the long term.

Going forward, we will incorporate a new rule into our value trading framework. During significant market declines like the drawdown in March, we will either build positions quickly (over the span of a few days) or buy all at once. Although there is always the risk that the market continues to decline, trying to call the absolute bottom is a fool's errand. We are not in the business of market timing. Markets also tend to rebound from the lows quickly. Thus, it is preferable to build a full position as soon as possible in order to take advantage of the distressed selling. We can always average down later if the markets drop further or exit a position if we made a mistake.

TOP 5 HOLDINGS

Foot Locker (FL) – In response to COVID-19, the company took the necessary steps required to manage its business through the crisis. Actions taken include:

- Borrowing $330 million under the company's credit facility
- Reducing full-year capital expenditures by 50%

- Cutting non-essential spending
- Limiting rent payments
- Extending payment terms
- Reducing merchandise purchases
- Reducing salaries and deferred incentive compensation for the CEO and senior executives
- Suspending the Q2 dividend
- Temporarily suspending its share repurchase program

Not surprisingly, the first quarter wasn't great given seasonality and stores being closed due to the pandemic. Q1 comparable-store sales decreased by 42.8%, and the company had a net loss of $98 million and negative free cash flow of $174 million. The gross margin rate also declined to 23% while inventory was 20.4% higher than the prior-year period.

Despite weak earnings, the balance sheet remains strong with $1.01 billion in cash versus $121 million in long-term debt, $330 million drawn from the credit facility, and a market cap of $3.06 billion.

Over the next few quarters, the company should benefit from an increase in e-commerce volume. For example, FL processed 200,000 e-commerce orders in a single day this past quarter. Prior to COVID-19, 25,000 orders was considered a peak amount of orders. Additionally, the gradual reopening of stores should drive earnings as well. At the end of May, only 1,400 stores (~45% of all locations) were open with limited hours and social-distancing protocols.

Czech billionaire Daniel Kretinsky also acquired a 6% stake in Foot Locker. He clearly sees value in U.S. retail despite the industry's continued headwinds. He also purchased a 5% stake in Macy's. From what we've gathered, Mr. Kretinsky is a sharp investor who made his fortune through smart acquisitions and investments.

Although we neither added nor trimmed our position in FL this quarter, we continue to own shares. The strong balance sheet provides us with comfort knowing that Foot Locker will be able to survive this crisis and participate in an eventual recovery.

Aimia (AIM.TO) – There have been many changes at Aimia since we published our Q1 investor letter. Most notably, Phil Mittleman, Michael Lehmann, and Chris Mittleman joined the company as the new CEO, President, and CIO, respectively. The Loyalty Solutions business also merged with Kognitiv. (Aimia now has a 49% stake in Kognitiv.) Additionally, Aimia acquired Mittleman Brothers, LLC, the investment vehicle of Aimia's current CEO and CIO.

For Q1 2020, the company reduced its operating loss by 71% compared to the prior-year period and reduced corporate expenses by almost 50%. According to management, Aimia has the potential to be EBITDA and cash flow positive in 2021.

The new management team also put some cash to work relatively quickly and took a 10% stake in Clear Media. Clear Media appears to be an undervalued company at ~5x EV/EBITDA. The company generates free cash flow, is debt free, and has growth potential. Aimia was able to participate in the change of control transaction because Mittleman Brothers, LLC had been long-time shareholders of the company. Clear Channel Outdoor sold its 50.9% stake in Clear Media to Ever Harmonic Global (40% owned by Clear Media CEO Han, 30% by Jack Ma's Ant Financial, 23% by JCDecaux SA, and 7% by JIC Capital).

Aimia also signed a 20-year extension of the commercial agreement between Aeromexico and PLM. The agreement extended the current term to September 2050, provided $100 million to Aeromexico, and gave them a 7-year option to buy Aimia's PLM stake for $400 million minimum or for 7.5x adjusted EBITDA, whichever is greater. The eventual goal was to do a recapitalization at some point and provide a dividend to Aimia and Aeromexico.

When the extension was signed initially, the deal was certainly in Aeromexico's favor. However, it was also a win for Aimia because it provided a floor valuation for their PLM stake. Now, the deal looks increasingly worse for Aimia. The recapitalization has been compromised.

Not long after the agreement was signed, Aeromexico filed for bankruptcy. In essence, Aeromexico took $100 million, delayed a much-needed recapitalization and dividend to Aimia, and filed for bankruptcy – with or without advance notice to Aimia's management team.

We trimmed our position this past quarter, and we are currently taking a "wait-and-see" approach with current management. The investment thesis for AIM has changed dramatically since the inception of our investment. The company has transformed from being a company that earned a majority of its free cash flow from Aeroplan to an investment holding company that depends on the capital allocation skills of its CEO/CIO.

By our estimates, AIM continues to be undervalued. If PLM, Clear Media, and cash are added together while backing out the preferreds, the company is still worth around CAD$600 million – a 100% upside from its current market cap. The question is whether management can unlock value from its stakes in PLM, Clear Media, Kognitiv, BIGLIFE, and future investments/acquisitions. Although our IRR continues to languish, we continue to hold shares knowing that the balance sheet (no debt and $190 million in cash) gives management some time to close the gap between the company's current market cap and intrinsic value.

Undisclosed Top Holding – This company continues to benefit from COVID-19. In fact, the business has performed better in this environment compared to 2019.

The company's share price has responded accordingly. We sold some shares at an average price of $25.70/share (our average entry price was $16.32/share) and trimmed our position size to 4.5%. We continue to look for an opportunity to increase our position size to 10%.

Gamestop (GME) – Gamestop continues to perform poorly as many of its stores have been closed due to COVID-19. However, ~85% of US locations were open with limited access and ~90% of international stores reopened with curbside pickup at the end of May. Management has also taken the necessary steps like Foot Locker has to manage the company through the current crisis. Inventory was reduced by 43% and accounts payable declined by 54%. $135 million was also drawn from the revolver with $35 million paid back in June. Currently, there is $570 million of cash on the balance sheet.

Going forward, management expects positive adjusted EBITDA in 2020, $575 to $625 million in cash and flat or positive cash flow from operations for the next quarter, and $43 million in CapEx (compared to $80 million last year). Also, peak availability on the revolver is likely to be around $430 million for November and December since the revolver is asset-backed by primary factors like inventory and accounts receivable. Before those last couple of months, the available amount is more realistically between $150 million to $250 million.

Other notable developments include an exchange offer and newly elected Board members. The exchange offer was for the $416.6 million of 6.75% Senior Notes due in 2020. 50.36% of those outstanding notes were validly tendered for newly issued 10% Senior Secured Notes due in 2023. Thus, management has bought the company some time by extending the maturity on some of the notes outstanding, albeit at a higher interest rate. Kurtis Wolf and Paul Evans (Hestia Capital and Permit Capital's nominees) joined the Board as well. Both Wolf and Evans should be valuable additions to the Board given that Permit and Hestia have been long-term shareholders of GME since 2011 and 2012, respectively.

Like several of our other holdings, we are content with holding Gamestop at the moment given its balance sheet strength. We are optimistic that the new console cycle and key software titles will help GME return to profitability. Additionally, e-commerce sales continues to be a bright spot for Gamestop. Between March and April, the company experienced 1500% growth in e-commerce sales. For the quarter, the growth rate was 519%.

Undisclosed Top Holding – This business continues to be directly impacted by COVID-19, so the short-term outlook is uncertain. However, the company's shares rallied along with the rest of the market. Thus, we sold some shares at an average price of $16.78/share (our average entry price was $8.46/share) and trimmed our position size to 2.5%. Going forward, it will be a combination of looking for a better entry price and deciding whether we want to increase our position size or not given the direct impact of COVID-19 on its business operations.

CLOSED POSITIONS

GrafTech International (EAF) – We exited EAF at an average price of $6.60/share. It was a painful decision to sell since we still saw potential upside despite the impact of COVID-19 on the global steel industry. In fact, we sold purely based on technicals, not fundamentals, per our trading framework. While it may seem like a silly rule to sell on negative momentum, we derived the rule from our extensive review of the firm's trading history since inception. Thus, we adhered to our framework, remained disciplined and exited completely.

Sabre Corporation (SABR) – This holding never became a large position in our portfolio. However, SABR was a profitable investment for us. We bought at an average price of $4.52/share and sold at $7.38/share. We sold our shares due to the quick gain and the company's increasing leverage on the balance sheet. The airline and travel industries continue to be challenged, so we wanted to reduce our overall exposure as well.

OPERATIONAL UPDATE

After eight weeks with our firm, Pallav Chaturvedi, our research intern, left in the beginning of May to pursue a different opportunity in the private markets. We wish him the best of luck with his career going forward.

In mid-May, we welcomed Luis Ramirez to RF Capital as an Investment Summer Analyst. He helped us generate new ideas, provided coverage on three of our current holdings, and worked on several research projects.

Luis is currently the Chief Executive Officer of the Kennesaw State University Student Managed Investment Fund. Previously, he interned at a $2 billion asset manager in Georgia. He is currently a rising senior at Kennesaw State University pursuing a BBA in Accounting.

As we write this letter, Luis has completed his 10-week internship with our firm. He did an excellent job of generating potential micro-cap and small-cap investment ideas. We initiated a starter position in a nano-cap company that he recommended. Additionally, he conducted primary research on two of our portfolio companies, which helped us considerably with our maintenance due diligence process.

We wish him all the best with his career going forward.

OUTLOOK

The situation with COVID-19 continues to be an ongoing development and a huge concern for investors. However, we are not in the business of figuring out if stay-at home orders will be implemented again, when the curve will flatten, when a vaccine will be developed, etc. We were hired to manage a portfolio of publicly-traded companies. Therefore, we will continue to focus on evaluating businesses with a bottom-up approach. The only thing we can do amidst all of the uncertainty is to make our best guesses as to how the revenues, margins, cash flows, and the balance sheets of our portfolio companies will be impacted over the next 3 to 5 years.

Currently, we believe the U.S. stock market is overvalued after rallying from the March lows. We have found few actionable ideas in recent weeks and months. Thankfully, our firm's mandate allows us to invest globally.

So far, we have found more value in foreign markets. In recent weeks, we have shifted our search process and focus to outside of the U.S. As expected, we now have a full research pipeline and expect to put a significant portion of our cash balance to work over the next couple of quarters. We look forward to sharing our new investment ideas with you in future letters.

Thank you for your support, continued interest, and referrals. Please call me at +1626.623.6012 or email me at roger.fan@rfcapitalmanagement.com if you have any questions, concerns, or comments.

Best regards,

Roger Fan
Chief Investment Officer
RF Capital Management LLC
roger.fan@rfcapitalmanagement.com

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