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Artko Capital LP

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Dear Partner,

For the second calendar quarter of 2019, an average partnership interest in Artko Capital LP returned 15.1% net of fees. At the same time, an investment in the most comparable market indexes—Russell 2000, Russell Microcap, and the S&P 500—were up 2.1%, 0.9%, and 4.3%, respectively. For the first 6 months of calendar 2019, an average partnership interest in Artko Capital LP returned 26.9% net of fees, while investments in the aforementioned market indexes were up 17.0%, 14.2%, and 18.3%, respectively. Our monthly results and related footnotes are available in the table at the end of this letter. Our results this quarter came from broad portfolio contributions from Joint Chiropractic, Skyline Champion, NRC Group Warrants, USA Technologies, Repro Pharma, Spartan Motors, and Research Solutions while continued pullbacks in Gaia have detracted from the overall performance.

	3Q18	4Q18	1Q19	2Q19	YTD	1 year	3 year	Inception 7/1/2015	Inception Annualized
Artko LP Net	0.5%	-27.1%	10.3%	15.1%	26.9%	-7.1%	12.1%	59.1%	12.3%
Russell 2000 Index	3.6%	-20.2%	14.6%	2.1%	17.0%	-3.3%	12.3%	32.0%	7.2%
Russell MicroCap Index	0.8%	-22.1%	13.1%	0.9%	14.1%	-10.4%	11.2%	20.9%	4.9%
S&P 500 Index	7.6%	-13.7%	13.7%	4.3%	18.5%	10.4%	14.2%	54.9%	11.6%

Think Like an Investment Banker, Invest Like an Owner

One of the most frequent questions we get as a General Partner of Artko Capital is why we tend to invest in small and micro capitalization companies. There are many answers to this question, including a goal to provide an unindexable public securities product for our investors and that studies show the smallest, most illiquid stocks provide the highest absolute returns; however, the "odd" answer we would like to focus on in this letter is that, in general, we believe most of our investments should not be public companies. That is to say, most of our investments would be better off in the hands of private or strategic investors. A big part of our research process is figuring out whether additional "free" optionality exists via industry dynamics and company specific incentives such as management ownership and tax structures for value added transactions such as recapitalizations, spin offs or outright sales of the companies at a premium to bigger players. As a reflection on the process, in the four years since we have launched our fund approximately 20% of our 30+ investments have undergone some sort of value unlocking transaction, including last quarter's merger announcement between NRC Group and US Ecology, a number with which we are very happy.

We tend to focus on two sources of likely value add through take private transactions: the target company's cost structure and the ability of the potential acquirer to reduce costs, and the target's strategic value within the industry. For example, our investment in Ecology & Environment (EEI) is predicated on a potential value add to a strategic acquirer through the possibility of eliminating most of the SG&A costs which could improve operating margins by over 15%. Another example is the 2017 strategic buyout by Markel of one of our favorite investments, State National Companies (SNC), where SNC's unique leadership positions within its insurance segments fit well with Markel's strategy of focusing on niche, high Return On Invested Capital (ROIC) insurance products. One of the easiest costs to eliminate from public companies are public company costs such as board fees, investor relations, exchange fees and costly audits. Average public company recurring expenses can be close to $2.5mm which often are a significant expense relative to the company's overall cost structure and market capitalization. Our smallest investment by market capitalization in Acorn Energy (ACFN) - a $10mm market cap company - has close to $1mm in public company costs annually, or 10% of the market cap, which would be easily eliminated in any buyout scenario, in addition to ACFN's significant Net Operating Loss (NOL) tax shield. In other words, it does not make sense for ACFN to stay public and is why the CEO led and financed rights offering this past quarter was used to consolidate ACFNs ownership of its main segment, OmniMatrix, to make it a more attractive target for a number of strategic acquirers.

In the end, it is all about having the right management and ownership incentives otherwise, even the most lucrative transactions will not happen if management is incentivized to keep the status quo. In another example, our sale of the USA Technologies (USAT) position from the Core Portfolio, in September 2017 was based on an assessment that despite the obvious fact that the company would be much more valuable in the hands of a larger, more experienced strategic acquirer within the payments space, the CEO's $1mm+ annual salary, miniscule ownership of shares, and obtuse attitude toward shareholders would preclude any such transactions. Our re-investment late last year at sub $4.00 prices back in USAT via a smaller Enhanced Portfolio position was based on the assessment that while the company retained its strategic value, better board oversight, a severely weakened CEO and over $13mm in public company costs in the last nine months, significantly increased the probability of an eventual sale of the company relative to the time of our first exit. This past quarter a reputable activist investor, Hudson Executive Capital, with a history of forcing company sales reported a 12% stake in USAT which contributed to the doubling of our 4.0% position from late last year. We have taken some gains off the table as a result above $7.50 and are comfortable with the current 4.0% weighting as we expect the company's filing of its financials by September 2019 will result in more calls for outright sale or firing of the mediocre and entrenched CEO, Stephen Herbert, an event which would lead us to consider making USAT a higher weighting in the overall portfolio. While we certainly do not expect every transaction that we consider as part of our thesis to happen, we believe assessing the likelihood of them happening as a core part of our research process has served our partnership well and we are excited to report that a significant part of this past quarter's outperformance was as a result of these assessments.

Core Portfolio Additions

- <u>Command Center (CCNI)</u> - We added a 10% Core Portfolio position in the $25mm market cap staffing company that underwent a reverse merger/tender offer transaction in July 2019 with a bigger, more profitable competitor, Hire Quest - which after the recent close of the transaction took the market capitalization of the new company close to $80mm. We believe, given the nano cap size of Command Center, this very lucrative transaction is currently not noticed by the overall market and we expect significant appreciation to our assessment of fair value in the next few years. We will not try to sugar coat the economics of the staffing industry as it is a somewhat cyclical and low margin business as well as certain small red flags with management. However, with our average purchase price of $5.40 implying a $65mm market cap on management guidance for $15mm in EBITDA for 2019 (though we think will be slightly lower) we believe we are well compensated for the risks at a sub 5.0x EV/EBITDA purchase price which does not take into consideration the company's stated goal to convert CCNI's branches into franchises.

  The combination involves merging Command Center's 67 owned branches with Hire Quest's 97 franchised and 1 owned branch. However, the real goal of the transaction is to convert CCNI's branches into franchises resulting in de-risking of the business model as well as in a significant cash inflow from the sale of franchise agreements. Based on our research into Hire Quest's past franchise agreements, this can result in additional cash inflows of $20mm to $40mm over the next couple of years. While there is currently limited information, we expect the new CCNI led by its founder, Richard Hermanns with 40% ownership of the new company, to be able to generate over $20mm in EBITDA within a couple of years, especially with staffing industry performing better during economic slowdowns at a mid-single digit unemployment numbers. While we do not think that this business should trade at high double-digit franchise EBITDA multiples we believe a 10-12x EBITDA multiple will be appropriate, with the aforementioned franchise agreement cash inflows, taking the enterprise value to over $250mm or over 200% upside from today's levels. Finally, we will note with curiosity, the company's relationship with the strategic partner Dock Square Capital, for up to 12% dilution for "introduction to customers", which happens to be Jeb Bush's family office.

Core Portfolio Sales

- Joint Chiropractic (JYNT) – We have sold the remaining 6% Core Portfolio position in Joint Chiropractic at $17.50-$18.50 price levels, resulting in a 200%+ return on this investment. We are still big fans of the business model and the CEO; however, we felt that the price has gotten ahead of its fundamentals while an increased risk of potential copycat competition modeling on the success of the Joint's chiropractic subscription service model was not reflected in the stock price. We will continue to follow the company closely and hopefully be able to invest again at much better prices relative to fundamentals.

Enhanced Portfolio Sales

- Where Food Comes From (WFCW) – We have exited our 2% Enhanced Portfolio investment in Where Food Comes From at $1.70-$1.80 price levels, resulting in a 5% loss on the position. WFCF was a slight disappointment for us in that in the year that we have held it, we just did not see a modicum of leadership from the management of the company to realize the potential to grow significantly into the company's large addressable markets. While we commend the co-founders for their vision to launch this company and to grow it into a stable food industry mainstay, despite our encouragement we frustratingly did not see any attempts to capitalize on the growth potential of the company. Without the growth and the operating leverage upside, the company's current market capitalization is probably too richly valued even for an unlikely strategic acquirer and we were happy to exit with a modest loss. We would be open to having another go at this investment with new leadership or strategic plan for high growth but for now we felt our capital was better allocated to the aforementioned new investment.
- Full House Resorts (FLL) – We have exited our 2% Enhanced Portfolio investment in Full House Resorts at $2.10 price levels, resulting in a 20% gain over the almost four years that we have held it since our fund's launch. Full House has been a fun investment in a handful of casinos scattered all over the United States led by a respected industry veteran, Dan Lee, who has done a fantastic job of turning around operations, re-financing the balance sheet, and taking on both large and small growth opportunities. However, we invest in our Enhanced Portfolio positions with the expectation of significant upside for the risks we take on and unfortunately FLL has not lived up to our expectations to the point where we felt capital would be better deployed in new opportunities.

Other Portfolio Updates

- NRC Group 10/18/23 $11.50 Warrants (NRCGW) – In a pleasant surprise, during the last week of the quarter NRC Group announced a merger with US Ecology, a fantastic high-end waste management business, resulting in a 100%+ gain from our mid $0.80s cost basis for our 3.5% position which we increased throughout the quarter. We think the merger makes excellent sense given the specialized, high margin nature of the waste disposal business models and footprint of the two companies. However, we are more excited about the opportunity for the NRCG warrants to be converted into warrants of the new company, removing most of the SPAC overhang and allowing us to participate in the significant potential upside of the new company.

Markets do not always give credit to merger situations and often capital structure securities tend to remain mispriced until the close of the deal. In this particular case, despite the increase in value on the announcement of the deal, the warrants remain significantly underpriced and we believe are even more lucrative now than prior to the announcement. As a brief reminder, option values tend to be split into two buckets: Intrinsic Value, or the value of the option if it were exercised today, i.e. the difference between current stock price and exercise price; and Time Value, or the price of the option one pays for instead of purchasing the security outright. The most important component of pricing the Time Value of the option is the volatility of the underlying security. We believe the new US Ecology warrants are significantly mispriced on their implied Time Value as well as offer significant near-term upside on their potential Intrinsic Value.

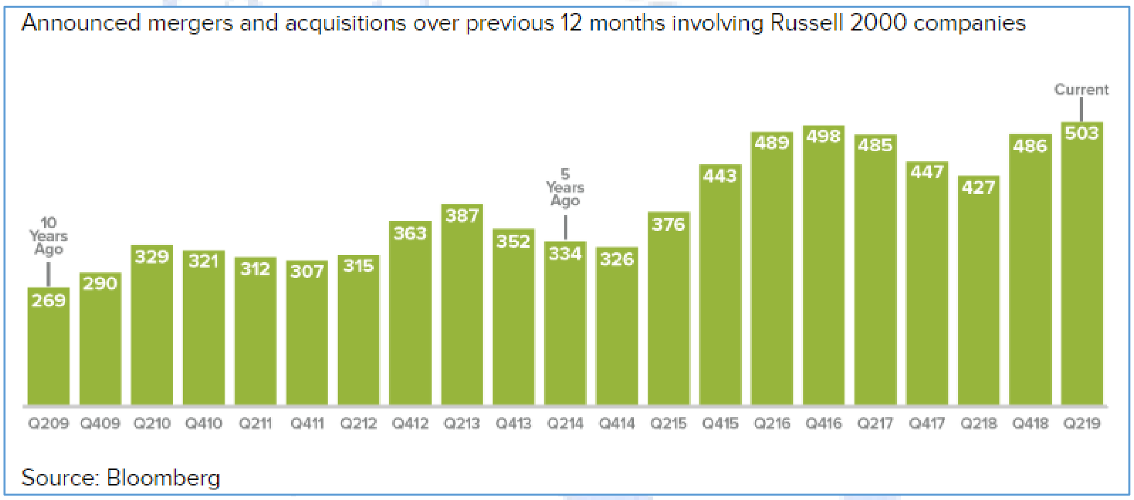
The warrants are currently fairly priced with NRCG as the underlying security, however, we believe the Time Value portion of the warrant value is currently mispriced by 30% with ECOL as an underlying security using the implied volatility of currently outstanding ECOL options. In addition, we believe the combined company can generate over $300mm in EBITDA in 2020 and, using the company's and the industry's historical median forward EBITDA multiples (as well as a Discounted Cash Flow valuation), we believe an $80-$90 price for US Ecology is not a very high hurdle, giving an additional implied 200% to 280% upside from current warrant prices. Additionally, we believe that it would make sense for US Ecology to buy back the warrants at a premium once the deal closes in the 4th quarter of 2019, to prevent an expensive dilution that the warrants would represent – not unlike our previous investment in the SPAC warrants in Del Taco. In short, despite the significant run up in the original investment and an almost 7% position in the portfolio we believe the current investment presents us with a lucrative 10-to-1 risk reward ratio which we will be more than happy to keep at the current proportion in the partnership's portfolio. Finally, purely as a parting thought in the spirit of our strategic consideration discussion we believe our investment in a specialty waste manager Sharps Compliance (SMED) would represent an excellent strategic addition to the new US Ecology and we would encourage the managements of the combined companies to consider this addition, as well as the warrant buyback upon the close of the deal.

- We have continued to successfully deploy small, sub-1% of portfolio capital, amounts into Tesla puts which have, on a trailing twelve-month basis, contributed approximately 3.5% to overall portfolio performance including 2% this past quarter as worries about the company's demand and liquidity weighed on the stock price during the quarter. We continue to believe that over the long term the highly overvalued and over leveraged auto manufacturer led by an erratic CEO with a public history of fraud will face significant demand and profitability headwinds and with properly sized investments will continue to be a source of profit for our partnership.

Market Outlook and Portfolio Commentary

In July 2019 the United States set a new record. No, it was not for the longest economic expansion on record, although that is a pretty good one as well. The record was for having the longest ongoing debate on whether the economy is imminently entering a recession, which is now entering its 10th year. We continue to be concerned about certain pockets of weakness, especially if the bigger global slowdown spills over into the domestic economy as well as increasing uncertainty with the trade policy by the executive branch. However, contrary to increasingly louder voices calling for a recession, we do not see one on the horizon and are expecting a period of slow economic growth while the economy, supported by lower interest rates, digests global economic uncertainty. We are still seeing strong wage growth, low inflation, and low unemployment leading to a confident US consumer, long the mainstay of the domestic economic engine, outperforming the slowdown in domestic manufacturing.

The Russell 2000 and the Russell Microcap remain stubbornly 11% and 17% below their September 2018 highs; however, in keeping up with the investment banking theme of our letter we will note that the number of U.S. small-cap M&A deals recently hit a 10-year high, with 503 announced for the trailing four quarters through June 30th, according to Bloomberg data. That is the highest number of deals in the asset class since before the Financial Crisis. For comparison, there were 334 deals five years ago in the trailing 12-month period ended 6/30/14, and only 269 deals 10 years ago in the trailing one-year period ended 6/30/09 (via Royce Associates).



We are pleased with our portfolio performance so far this year, especially within the Enhanced Portfolio, and are still seeing strong potential upsides from these levels based on our estimates of fundamental growth. Small caps (and any international equity class for that matter) continue to be out of favor vs. US large caps, just as value continues to be out of favor versus growth. As a matter of fact, the ratio of the SPY price (the S&P 500 Index ETF) to the IWM (the Russell 2000 Index ETF) is near its 10-year maximum. We have been through this cycle before, and our focus has not changed: finding under-the-radar, high-probability situations outside of the indexing tide. We have a strong pipeline of potential investments and will continue to monitor the potential upsides and risk-rewards relative to the rest of our portfolio.

Partnership Updates

We welcomed one new partner to the partnership this quarter, bringing our total to 40 at the end of June. We are excited about the continued growth in partners and assets under management and - as always - are thankful for your business.

Next Fund Opening

Our next partnership openings will be August 1, 2019, and September 1, 2019. Please reach out for updated offering documents and presentations at info@artkocapital.com or 415.531.2699.

Appendix: Performance Statistics Table

	Artko LP Gross	Artko LP Net	Russell 2000 Index	Russell MicroCap Index	S&P 500 Index
YTD	28.9%	26.9%	17.0%	14.2%	18.5%
1 Year	-6.8%	-7.1%	-3.3%	-10.4%	10.4%
3 Year	16.1%	12.1%	12.3%	11.2%	14.2%
Inception 7/1/2015	85.4%	59.1%	32.0%	20.9%	54.9%
Inception Annualized	16.7%	12.3%	7.2%	4.9%	11.6%
Monthly Average	1.4%	1.1%	0.7%	0.5%	1.0%
Monthly St Deviation	5.2%	4.7%	4.9%	5.1%	3.6%
Correlation w Net	-	1.00	0.81	0.78	0.73

Legal Disclosure

The Partnership's performance is based on operations during a period of general market growth and extraordinary market volatility during part of the period, and is not necessarily indicative of results the Partnership may achieve in the future. In addition, the results are based on the periods as a whole, but results for individual months or quarters within each period have been more favorable or less favorable than the average, as the case may be. The foregoing data have been prepared by the General Partner and have not been compiled, reviewed or audited by an independent accountant and non-year end results are subject to adjustment.

The results portrayed are for an investor since inception in the Partnership and the results reflect the reinvestment of dividends and other earnings and the deduction of costs, the management fees charged to the Partnership and a pro forma reduction of the General Partner's special profit allocation, if applicable. The General Partner believes that the comparison of Partnership performance to any single market index is inappropriate. The Partnership's portfolio may contain options and other derivative securities, fixed income investments, may include short sales of securities and margin trading and is not as diversified as the indices, shown. The Standard & Poor's 500 Index contains 500 industrial, transportation, utility and financial companies and is generally representative of the large capitalization US stock market. The Russell 2000 Index is comprised of the smallest 2000 companies in the Russell 3000 Index and is generally representative of the small capitalization U.S. stock market. The Russell Microcap Index is comprised of the smallest 1,000 securities in the Russell 2000 Index plus the next 1,000 securities (traded on national exchanges). The Russell Microcap is generally representative of the microcap segment of the U.S. stock market. All of the indices are unmanaged, market weighted and reflect the reinvestment of dividends. Due to the differences among the Partnership's portfolio and the performance of the equity market indices shown above, however, the General Partner cautions potential investors that no such index is directly comparable to the investment strategy of the Partnership.

While the General Partner believes that to date the Partnership has been managed with an investment philosophy and methodology similar to that described in the Partnership's Offering Circular and to that which will be used to manage the Partnership in the future, future investments will be made under different economic conditions and in different securities. Further, the performance discussed herein does not reflect the General Partner's performance in all different economic cycles. It should not be assumed that investors will experience returns in the future, if any, comparable to those discussed above. The information given above is historic and should not be taken as any indication of future performance. It should not be assumed that recommendations made in the future will be profitable, or will equal, the performance of the securities discussed in this material. Upon request, the General Partner will provide to you a list of all the recommendations made by it within the past year.

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