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Third Quarter 2012 Letter

Dear Friends,

During the third quarter of 2012, US equity markets were very strong with index levels higher than the previous highs seen in Q1. None of the issues that market participants worried over the previous months have been resolved yet Mr. Market was in the mood to buy stocks. The Fed announced a third round of purchasing assets such as treasuries and mortgage backed securities. The Fed has promised to keep short term interest rates low till mid- 2015.

Portfolio activity

We had a very busy quarter. In the Generals portion of the portfolio, we bought three new positions while adding to another. We sold out of two positions while reducing another position. We participated in 15 special situations in the quarter and by the time of this letter, we had closed or received cash for all but one position.

Special Situations:

We are always on the lookout for special situations – mainly tenders and mergers. This portion of the portfolio has achieved excellent results boosting portfolio performance while reducing volatility. These positions have low correlation to the rest of the market and investment period is in weeks.

Share and Closed End Fund (CEF) tenders

We participated in eight CEF tenders and five share tenders, including HTA, AOL, SRDX, DCAQP and CCRT. We had another successful run with 12 of the 13 tenders being profitable. Our only loss was in CCRT (-11%). Our mistake in CCRT was that we looked at the large % upside in the tendered portion of the shares, while underestimating the downside of the pro-rated shares that would be returned to us post tender. Shares came under pressure right from our purchase and we exited the position prior to the expiry of the tender.

Merger Arbitrage

We bought shares of CIC Energy in Canada as the spread on the pending acquisition by Jindal Steel (a large Indian company) was ~10%. As the spread reduced to 5%, we exited the position.

The Shaw Group (SHAW) is being acquired by Chicago Bridge & Iron Company (CBI) in a cash and stock deal worth $3 billion. The spread was about 8-10% on the day of the announcement. We initiated our position when the spread ballooned to ~20%. As the weeks went by, the spread reduced significantly to ~5% and we reduced our position.

Generals:

<u>Portfolio exits</u>:

We closed our position in UFP Technologies (UFPT) for a 20% return under a year. We had expected 5-10% free cash flow (FCF) growth from UFPT and results since purchase did not live up to our modest expectations. UFPT does not buy back shares or issue dividends despite the ample cash balance and FCF. Finally, there has been share dilution over the years via options. We bought UFPT at a 10% FCF yield and despite lack of growth, we benefited from multiple expansion. We took the opportunity to book profits and raise cash.

CSG Systems (CSGS) experienced an excellent run since April 2012. We bought CSGS for a FCF yield of 20% in Q4 2011. CSGS had two poor quarters in 2011 and investors were unhappy with the Intec acquisition. Prior to the Intec acquisition, CSGS had been generating $90 million in annual FCF. At a market cap of $450-$500 million, we felt the shares were significantly mispriced. While CSGS carried net debt of $175 million, it was very well covered by predictable FCF. The other risk was the heavy customer concentration with top three customers making up 45% of revenue. CSGS reported a couple of good quarters and investors took notice and bid the shares up. While CSGS remains relatively cheap, the risk reward is not as favorable, especially with the upcoming contract renewals with two large customers. We feel these contracts would be renewed with possibly some discounts offered. We sold for an average price of $21.5 for a 40% gain under a year.

<u>New Positions:</u>

Sauer-Danfoss (SHS) is a global leader in the manufacture of hydraulic systems used in mobile equipment. The company’s products are sold primarily to the agriculture, construction, road building, turf care, material handling, and specialty vehicle markets. SHS is majority owned by Danfoss Group. SHS was hit in the financial crisis of 2008-2009. SHS under CEO Sven Ruder underwent a remarkable turnaround which can form an excellent case study for business schools. Several actions were taken to right size the business including (1) dividend suspension, (2) capital expenditure reduction, (3) closing or consolidating plants, (4) exiting unprofitable businesses, (5) lay-off of 40% employees (for a primarily European company!), (5) salary freeze for all employees and (6) reduced executive salaries by 15%. SHS had $500 million in net debt at the end of 2009 and by Q4 2011 SHS had net cash of $50 million! At the time of our purchase, SHS was trading at $34 with a market cap $1.65 billion. FCF in the last two years was $225 million and $310 million. Management also re-instated the dividend which is $1.4 annually. SHS ended the quarter around $40.

Gravity (GRVY) makes a second appearance in our portfolios. GRVY is a tiny Korean game developer that offers multiplayer online games, casual and social games. Their main game is Ragnarok Online that was a success several years back but its next generation game had been delayed for several years. The sequel was recently launched and the reception in Korea has been weak. We sold our shares too soon earlier in the year and price appreciated strongly as the catalyst of the sequel launch came to fruition. However, soon after the price came down and after a poor Q2, <u>shares once again trade significantly below cash and securities held on the</u>

balance sheet. That said, there is no clear path to value realization as there would not be any buybacks or dividends. This is not a typical investment for us and hence we have sized the position accordingly.

Mind CTI (MNDO) is an Israeli company that provides convergent end-to-end billing (80% sales) and customer care product based solutions for telecom service providers as well as telecom expense management solutions. Sales are about $18-$20 million annually with $4-$5m in FCF. The balance sheet is pretty with $17.7 million in cash while the market cap at the time of purchase was $32.2 million ($1.72 share price). So, essentially at an enterprise value of $15 million, the company has produced an average FCF of $4-$5 million for a 25% FCF yield. Management is very shareholder friendly with 100% of FCF being paid out in the form of dividends. The dividend yield based on last years' $0.24/share payout was 14%. Management has announced a buyback which makes a lot of sense at recent prices. The founder CEO owns 20% of the shares outstanding.

Reduced positions:

We reduced our position in UK based Tesco (TSCDY). We booked a small capital gain combined with the dividend we received earlier.

Increased positions:

Big Lots (BIG) suffered a large decline in the quarter after disappointing Q2 earnings, a management shuffle, weak Q3 guidance and reduced cash flow guidance. Management continues to reduce share count, though the recent purchases were odd – both in size, price and the fact that they borrowed money to do so. The Canadian acquisition is on track to break even earlier than expected and could provide a boost to the bottom line. We added to our existing position despite the bleak near term outlook, as we think the current valuation discounts the negatives.

Mistakes with Aeropostale (ARO)

ARO reported several weak quarters last year with negative SSS and rapidly declining margins and the share price declined by more than 50%. At that point, I felt all the negativity was priced in and selling at that point made no sense. We wanted to give ARO a chance to recover in late 2012/early 2013 as cotton prices would eventually subside. Early in 2012, ARO had a superb run, more than doubling from the lows and touching low $20s and vindicated our patience. However, the Q1 report did not reveal drastic improvement in the business and Q2 guidance was weak. In the previous two quarters, management had played the game of low balling guidance and then beating those tempered down expectations. This analysis combined with sharp increase in price and a 10% position were valid reasons to scale down the position. However, I put in a limit order at a higher price, and our order was never executed. This is a mistake that I will endeavor not to repeat in future transactions.

What happened next: Q2 pre-earnings were pathetic with flat SSS, negligible net profit, weak Q3 guidance and ARO shares took a 30% hit.

I took another fresh look and concluded that the current valuation seems quite cheap. With 81m shares outstanding and a share price of $14, market cap is $1134 million. Ex-cash of $170m, enterprise value is $930 million. Average FCF of last four years is $150 million. Even at FCF of $100 million, ARO is valued ~9x FCF.

Other lessons learnt

I usually average down on a position if it declines in price after the initial purchase, all other things unchanged. Hence, we now take smaller initial positions to leave room to average down. What I learnt is that I need to space out my 2nd purchase by time and/or significant price decline. If the price declines but fundamentals have also weakened, then I should be very confident before adding to the position.

Other news

I participated in the 1st Value Investing Challenge competition sponsored by SumZero and Value Investors Congress. My submission for our portfolio holding Western Digital made it to the semi-finals.

Most of our accounts are under $100,000. The smaller accounts have benefitted quite a bit from the special situations portion of the portfolio. Based on nine months results, the special situations strategy could contribute 3% to 7% annually for accounts under $100k. Potential clients with investable capital of under $100k could benefit by having us manage a 'special situations only' account. If you have an interest in us managing a part of your investment capital, please feel to call me to have a discussion. We can go over our investment process in more detail.

We would like to thank our clients for placing your trust in Motiwala Capital.

Sincerely

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