VOSS

CAPITAL

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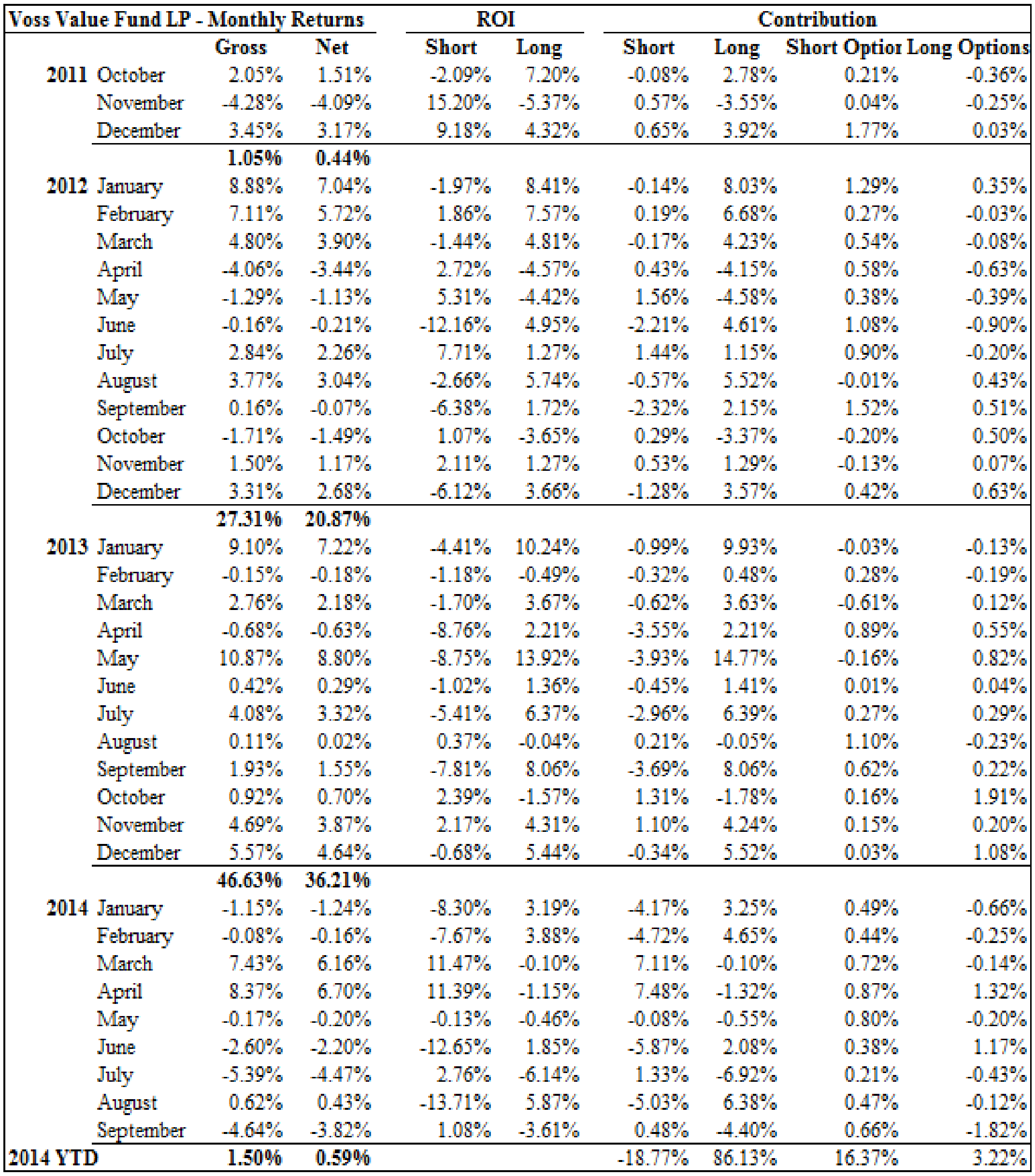
October 24th, 2014

Dear Partners,

During the third quarter of 2014 the Voss Value Fund returned -7.73% net to Partners, bringing our YTD net return down to 0.59%. The end of Q3 concludes our third year in business. Despite stumbling across the three-year mark, our compound annual returns to investors net of all fees and expenses since inception comes in at 18.6%. We review some more three year risk and performance statistics in the appendix.



Voss Value Fund LP - Monthly Returns				ROI		Contribution			
		Gross	Net	Short	Long	Short	Long	Short Optior	Long Options
2011	October	2.05%	1.51%	-2.09%	7.20%	-0.08%	2.78%	0.21%	-0.36%
	November	-4.28%	-4.09%	15.20%	-5.37%	0.57%	-3.55%	0.04%	-0.25%
	December	3.45%	3.17%	9.18%	4.32%	0.65%	3.92%	1.77%	0.03%
		1.05%	**0.44%**						
2012	January	8.88%	7.04%	-1.97%	8.41%	-0.14%	8.03%	1.29%	0.35%
	February	7.11%	5.72%	1.86%	7.57%	0.19%	6.68%	0.27%	-0.03%
	March	4.80%	3.90%	-1.44%	4.81%	-0.17%	4.23%	0.54%	-0.08%
	April	-4.06%	-3.44%	2.72%	-4.57%	0.43%	-4.15%	0.58%	-0.63%
	May	-1.29%	-1.13%	5.31%	-4.42%	1.56%	-4.58%	0.38%	-0.39%
	June	-0.16%	-0.21%	-12.16%	4.95%	-2.21%	4.61%	1.08%	-0.90%
	July	2.84%	2.26%	7.71%	1.27%	1.44%	1.15%	0.90%	-0.20%
	August	3.77%	3.04%	-2.66%	5.74%	-0.57%	5.52%	-0.01%	0.43%
	September	0.16%	-0.07%	-6.38%	1.72%	-2.32%	2.15%	1.52%	0.51%
	October	-1.71%	-1.49%	1.07%	-3.65%	0.29%	-3.37%	-0.20%	0.50%
	November	1.50%	1.17%	2.11%	1.27%	0.53%	1.29%	-0.13%	0.07%
	December	3.31%	2.68%	-6.12%	3.66%	-1.28%	3.57%	0.42%	0.63%
		27.31%	**20.87%**						
2013	January	9.10%	7.22%	-4.41%	10.24%	-0.99%	9.93%	-0.03%	-0.13%
	February	-0.15%	-0.18%	-1.18%	-0.49%	-0.32%	0.48%	0.28%	-0.19%
	March	2.76%	2.18%	-1.70%	3.67%	-0.62%	3.63%	-0.61%	0.12%
	April	-0.68%	-0.63%	-8.76%	2.21%	-3.55%	2.21%	0.89%	0.55%
	May	10.87%	8.80%	-8.75%	13.92%	-3.93%	14.77%	-0.16%	0.82%
	June	0.42%	0.29%	-1.02%	1.36%	-0.45%	1.41%	0.01%	0.04%
	July	4.08%	3.32%	-5.41%	6.37%	-2.96%	6.39%	0.27%	0.29%
	August	0.11%	0.02%	0.37%	-0.04%	0.21%	-0.05%	1.10%	-0.23%
	September	1.93%	1.55%	-7.81%	8.06%	-3.69%	8.06%	0.62%	0.22%
	October	0.92%	0.70%	2.39%	-1.57%	1.31%	-1.78%	0.16%	1.91%
	November	4.69%	3.87%	2.17%	4.31%	1.10%	4.24%	0.15%	0.20%
	December	5.57%	4.64%	-0.68%	5.44%	-0.34%	5.52%	0.03%	1.08%
		46.63%	**36.21%**						
2014	January	-1.15%	-1.24%	-8.30%	3.19%	-4.17%	3.25%	0.49%	-0.66%
	February	-0.08%	-0.16%	-7.67%	3.88%	-4.72%	4.65%	0.44%	-0.25%
	March	7.43%	6.16%	11.47%	-0.10%	7.11%	-0.10%	0.72%	-0.14%
	April	8.37%	6.70%	11.39%	-1.15%	7.48%	-1.32%	0.87%	1.32%
	May	-0.17%	-0.20%	-0.13%	-0.46%	-0.08%	-0.55%	0.80%	-0.20%
	June	-2.60%	-2.20%	-12.65%	1.85%	-5.87%	2.08%	0.38%	1.17%
	July	-5.39%	-4.47%	2.76%	-6.14%	1.33%	-6.92%	0.21%	-0.43%
	August	0.62%	0.43%	-13.71%	5.87%	-5.03%	6.38%	0.47%	-0.12%
	September	-4.64%	-3.82%	1.08%	-3.61%	0.48%	-4.40%	0.66%	-1.82%
2014 YTD		**1.50%**	**0.59%**			-18.77%	86.13%	16.37%	3.22%

Fed policy during this cycle has not only acted like anesthesia, helping ease the pain of wealthy asset owners, but also it's as if they mixed in an amnestic into the addictive kool-aid—a memory eraser to dim awful recollections of pain in insufficiently anesthetized patients. 0% interest rates for six years running has sufficiently warped people's mindsets, so much so that in most cases it has become quite clear that some people literally can no longer conceive of any downside risk. Many corporate managers are losing their minds along with everyone else and levering up to make overpriced acquisitions (including of their own stock) despite their constant boasting of their own exaggerated M&A discipline. When everyone is drunk who can resist dancing while the music is playing? Unfortunately for us, the M&A has been concentrated in the larger capitalization names and surprisingly small and micro caps are being relatively left out of the party. In addition to the style divergences, the timeline of investors has also bifurcated into two illogical extremes: for cheap micro cap stocks valued based on actual cash flow the timeline has become three months or less (quarterly earnings reports), and for larger companies with abstract plans for profitability, yet good heartwarming stories and large total addressable markets the timeline becomes five years or longer. Although the broad indices have flat-lined, it is once again optically misleading as there are plenty of reallocations happening under the surface, namely a continuing divergence between small cap value and larger cap hype.

With the IPO window wide open again, the Wall Street hype machine has kicked into overdrive. The longer some technically driven trends go on, the more people pile in pointing to the stock prices as justification or proof of a positive fundamental view. It is devastating to one's psyche to be absorbing paper losses while betting against people who do not know the difference between gross margins and net margins or that nominal share price is not the same as value. People often state that the market is so efficient that a smart investor applying themselves cannot systematically outperform. I am confident any objective observer would not so slowly come to the *exact opposite conclusion*—that is that the market is so incredibly and systematically inefficient for such long periods of time and *that* is why it is difficult to outperform.

> "Direct observation of man reveals at once the fact that a very considerable proportion of his beliefs are non-rational to a degree which is immediately obvious without any special examination and with no special resources…" Wilfred Trotter in *Instincts of the Herd in Peace and War*

In small and microcap land, there *actually has* been extreme weakness and the current breadth is abysmal. The Russell Micro Cap Index pulled back 17% from its peak on March 5th of this year and remains down 6.7% on the year, underperforming the Nasdaq composite by **15.35%** YTD through the end of September. It is an oddity that mega-cap is now performing so much better when the prevailing wisdom is that the US economy has positively diverged from the rest of the world economies despite mega-caps getting over half of their revenue and earnings from outside the US (not to mention a stronger dollar will generally hurt larger cap companies when they convert these foreign sales back into fewer dollars), whereas Russell micro-cap type stocks are more domestically-geared.

More money has flowed out of small cap this year than in any year since 2008. Within those flows more money is shifting away from active management and into passive management, creating even more divergences between the upward and downward price momentum based on liquidity and float. This means companies with decreasing float get money flowing out and those likely losing money, issuing equity and thus increasing their float get more passive money inflows. Within all of this, people also seem to be selling losers to chase recent performance, so all of these themes mentioned are compounding at an increasing rate. This is akin to the end of the TMT bubble as then the NASDAQ peaked the very same day that Berkshire Hathaway bottomed as the two assets moved inversely. Unfortunately in the present moment, even with median valuations above the 1999 craze and the US Service Sector ISM hitting a 10-year high, the Fed is just now stopping buying bonds, but of course not yet raising short terms rates away from zero. Compare this to 1999 when the Fed Funds Rate was already over 5%. As I like to say, in modern life most things are intuitively, rationally and logically backwards.

If our top holdings were recent profitless IPOs instead of growing cash cows we are confident they'd be valued at least 3-4x higher. I wish I were even half joking. As way of quick example, IACI owns dating app Tinder, to which management has deftly focused the Street's attention on despite it having no revenue at present. The sell-side is now valuing Tinder at up to $1.5 billion in a sum of the parts analysis, 2.4x the entire enterprise value of one of our top long ideas, Blucora, which has produced $75 million in Free Cash Flow in the past year (more than Tinder will likely ever do in revenue—at least within the next few years). A new bubble is being forced instinctively into flawless execution in this market niche as Wall Street plays tennis without the net making up new ratios, rules, metrics, etc. For example on a recent IPO Morgan Stanley uses "diluted share count excluding share based comp." In other words, diluted share count without counting the dilution. There are becoming sillier and more elaborate rationalizations and justifications for non-rational conclusions. Morgan Stanley upped the price target of said stock six days after previously upping it. Of course the stock had moved beyond their previous target and there was no news or development, but rather a forced short squeeze underway. We continue to monitor many of the recent IPOs, waiting with baited breath to short many of them as they approach their lock-up expiration dates, as the inevitable potential flood of supply--or at least the threat of it--trumps the suddenly waning demand.

Nothing in our process or philosophy has changed, rather in this present environment and this late in a bull market people are less likely to dig into hairy microcap situations when the incremental funds just flow into household mega cap names, IPOs that capture all the media attention, and larger index ETFs. Compounded on top of these stylistic headwinds, we have also had some really terrible stock picks.

Don Quixote was thought to have hit wits backwards, famously confusing things in his mind. We are each equally susceptible to dupe ourselves. Lately I can associate with Quixote who mistakenly attacked windmills (hence the saying "tilting at windmills") thinking they were evil giants, and who viewed an average looking village girl as a virtuous goddess in his mind's eye. Like Quixote, I have made some similar mistakes, turning some mediocre short ideas into scheming houses of cards and longs that are comparable to Quixote's Dulcinea into beautiful Aphrodites and Venuses. Often times our fundamental view or way of valuing a company is so incredibly far off from the ongoing false Wall Street narrative that we appear crazy, but of course the difference between appearing crazy and being ahead of the herd on deep value investments is entirely indistinguishable. Hopefully Mr. Market's schizophrenia will eventually swing back in our favor, proving--as did Quixote finally--that we are at least quasi-sane, after all. However, below is one investment where we've clearly idealized a repulsive situation whose positive catalysts so far have proved as illusory as Quixote's giants.

magicJack - CALL

Oh, Magical Jack, how you've tragically whacked my once fantastical track…record. With selling pressure anything but sporadic, I'd be ecstatic if you're comebacks dramatic and you brought us outstandingly back into dazzling black.

With CALL I let an un-realized 100% gain in first three months of holding time slip into the biggest dollar loser since the fund's inception as we averaged in too early on the way back down and the shares subsequently collapsed to 30% below our original bear valuation case. CALL is one of the cheapest stocks in our entire "Voss Vanilla" stock universe and also has one of the top 20 highest short interest at 26.6% of the float. It is safe to say by any conceivable measure that the stock is very much out of favor.

magicJack VocalTed Ltd. (ticker CALL) sells voice-over-internet-protocol (VoIP) services to consumers. Despite many seemingly passionate *negative* reviews online, our ongoing analysis and personal use of magicJack's service strengthens our convictions that magicJack does indeed have a great value product with real use cases and that competitors are either way more expensive or are missing key features that separate MagicJack. Top competitors include traditional phone services companies such as AT&T, Verizon, Sprint, and Comcast, as well as other VoIP providers such as Vonage, Ooma, netTALK, Skype, and Google Hangouts. CALL has a significant pricing advantage over all its main competitors except netTALK. This advantage is primarily due to the vertical integration of the company, since it is a registered CLEC in all 50 US states and therefore does not have to pay to originate calls on other companies' landline networks.

There is no doubt there are ongoing technological shifts within VoIP and telecom overall, with competing services emerging such as Google Hangouts and WhatsApp, but these lack many of the benefits and features that many consumers choose magicJack for. As a nod to the value proposition to consumers and their experience, CALL won Frost & Sullivan's North America Consumers' Choice Award for Overall Best VoIP Service Provider, to wit:

> "Based on Frost & Sullivan's independent research, Consumer Communications Preferences, surveying North American Voice over Internet Protocol (VoIP) consumers, magicJack emerges as the overall best VoIP service provider. Frost & Sullivan's Choice Awards measure the major competitors based upon consumers' evaluations of the brands they use. The survey, which evaluated magicJack along with its peers on various parameters, including overall quality, ease of use, billing practices, value and pricing for VoIP services, showed magicJack's lead in all of these categories."[2]

A compelling part of the situation is that CALL's management and board got a makeover, replacing and distancing itself from the controversial and whimsical founder, Dan Borislow. Geraldo Vento was named magicJack CEO at the very end of 2012 and hosted his first conference call in Q1 2013. He has three decades of telecom experience and his most notable achievement was founding TeleCorp PCS, Inc. in 1996. Per the company press release:

> "[he] grew TeleCorp's annual revenue to $1.1 billion and sold the company to AT&T Wireless for $5.7 billion in 2002"

Tim McDonald was named COO one year later, in December 2013. He has a long history of restructuring, turning around, building, and selling telecom companies, and has additional experience in the finance arena. For the sake of brevity we will focus on the stock's current valuation and some of the upcoming potential catalysts.

To put the stock's current valuation into perspective:

- **Balance Sheet**: magicJack has $72.4 million in cash and no debt, resulting in a market cap of $158.5 million and an enterprise value of $86.1 million. That's over $4.00 a share in net cash and a market price of $8.89.
- **Free Cash Flow**: FCF is ultimately the most important metric to us. CALL is still generating solid FCF. Through the first two quarters, they generated over $18 million in FCF. Current 2014 estimates are at $21 million. Even if they generate no more cash flow this year, they have a 20.9% trailing FCF Yield. At $21 million, shares are at a 24.4% unlevered FCF yield. Q4 is seasonally their best quarter for FCF generation, although they are spending more in Q3/Q4 on marketing (as they should), so the consensus is that FCF will be depressed, maybe even flat as they spend more to try and grow the subscriber base. They may also spend some cash on their international launch in Mexico.
- **Renewal Revenue**: Renewal revenue has risen for eight straight quarters. Their renewal revenue actually rose 14% in the last quarter, **with a substantial and noticeable drop in churn**. Their current renewal run rate is ~$64 million, meaning EV/Renewals Revenue is 1.35x. Generally software names get between 4 -8x renewal revenue as it's much more visible and much more profitable.
- **Summary**: Here we have a depressed FCF yield of ~20%, an EV/Renewal Revenue at under 1.5x, and a total EV/Sales at 0.62x versus the stock's 3-year average of 2x. It is down in a straight line from an EV/Sales of 2.67x. Note that 1.0x has been a historical low for the company, and the range has been between 1-3x (but over 5x in early 2012).

Like a modern day Walter Mitty, CALL is off in its own little world, but the opposite of the way Tesla is. With such relentless selling one can't help but wonder what "other people know." We won't try to understate the importance of the upcoming quarter, as it's the first quarter that the magicJack GO launch (with increased advertising dollars/campaign, new packaging, roll out to new locations, app integration, etc.) will be "fully live." If the quarter is a disaster, it could more or less invalidate the turnaround strategy that the new management has put in place, or at the very least put much more pressure on the holiday season in Q4. Perhaps people know something, or perhaps people are getting cold feet before the quarter and want to see execution before buying in. Judging from various internet commentary there is also a very large retail trading cohort focused on CALL shares with gibberish that is purely technically driven and doesn't know how nor attempt to value the company (e.g. comments akin to "I'm shorting more because the stock is trending down.").

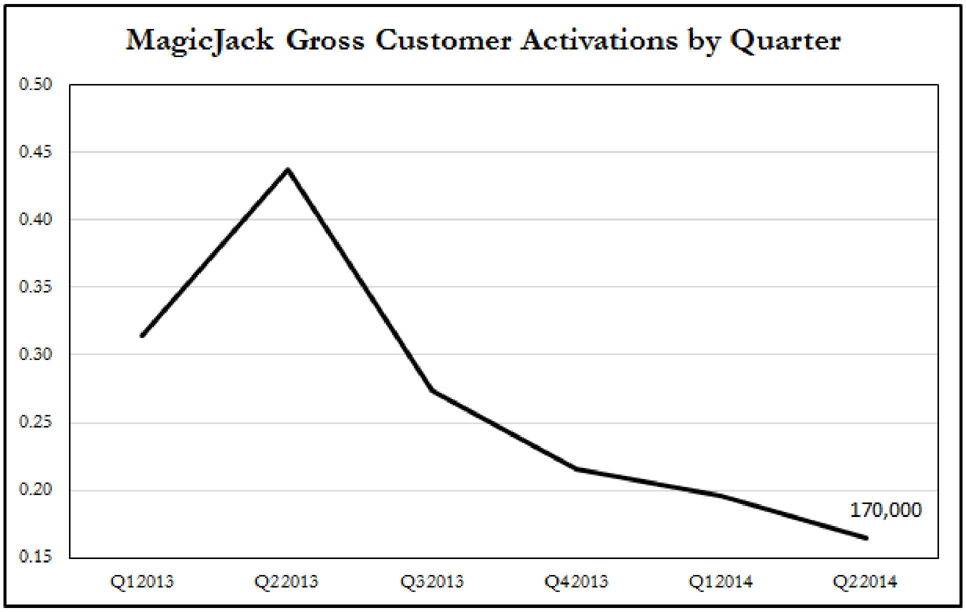
Why is there such extreme negative sentiment? Mostly from skepticism about the company's ability to turn around in an increasingly competitive environment, combined with a major guide down in Q2 (original guidance was about $45 million EBITDA, now $28-$30 million—still puts the stock at 3x EBITDA at the low-end of guidance). **However, there was a very odd caveat to the guidance**...straight from the horse's (CFO's) mouth:

> "This updated guidance reflects no revenues from three key initiatives; number one, any meaningful uptick in sales of the magicJack GO; number two, any app monetization initiatives; and number three, any international sales through our partnership with Telefonica."

This strikes us as a classic "throw out everything including the kitchen sink" expectations reset type of quarter. The three things listed above are, after all, the three biggest catalysts for the stock. The way management has framed the upcoming periods, it implies those would be the results if none of their initiatives had positive contributions.

Going through each of the potential catalysts:

1) "Any meaningful uptick in sales of the magicJack GO"- It will be determined whether this is working within the next two quarters. One can see the trend of gross ads hasn't been awe-inspiring; however, Q3 and Q4 should at the very least rebound off the low of Q2, as the new product is now in thousands of additional stores (plus Amazon). It is completely rebranded with better app integration and they are spending more than ever on marketing. We concede that if there isn't a snapback in Q3, it makes this catalyst very hard to declare victory on. A pessimist would say management has been indicating another weak quarter of gross ads to investors, and they are reacting. We would argue that while that caps some upside, the stock is still significantly undervalued even if the GO sales don't take off.



2) "Any app monetization initiatives" - The application monetization efforts were delayed, another reason for the negative sentiment. They are working hard on "app quality" initiatives, and just didn't feel they had gotten the quality to where they wanted it before they felt justified charging for it. Their strategy is to use the Application users as a way to drive sales to the core business, plus initiate new revenue streams from the App itself, including unlimited texting while not requiring peer to peer (e.g. it doesn't matter what platform you're on, Android or Apple.). From the COO:

> "We expect to sell both international calling as well as an integrated voice and app to carrier texting service on our app in the second half of the year. We will also provide desktop to carrier texting. I should note that we do not require changes to our existing platform to be begin to generate app related revenues. We will be releasing features on our existing platform over the coming months."

We are not modeling in any revenue from this, but do believe it could add material, high margin revenue that could also result in higher customer retention if they can get it right.

3) "Any international sales through our partnership with Telefonica" - This is perhaps the biggest potential catalyst of all. They are going international, first in Mexico and then in other South American countries. To wit, from the CEO:

> "Now turning to international market expansion and our relationship with Telefonica, on our last call we announced that we had entered into a strategic commercial agreement with Telefonica SA to sell magicJack GO and services in 14 Latin American countries. Initially our agreement called for a pilot trial. But, based on market research over the last six weeks, we and Telefonica now plan to move forward with device sales in Mexico as the first target market in the second half of the year. Telefonica will purchase devices from us, branded as magicJack GO, and sell into 4,000 proprietary Movistar mobile retail stores. It's also anticipated that Telefonica will act as our distribution partner, selling the magicJack GO to an incremental 5,000 third party retail doors such as Walmart and Coppel in Mexico."

In addition to adding 9,000 doors, we've always thought one of magicJack's greatest appeals is its international calling features...e.g. US people living internationally who want to call back home and have a cheap way to do it. We suspect Emerging Market consumers will also appreciate what is by far the lowest cost option. Hopefully a top tier telco distribution partner will execute well. As it stands now, any incremental sales in Mexico or South America are not in in the company's guidance or sell-side's estimates.

We will continue to monitor the incoming facts and would reevaluate our positive opinion if:

- Initiatives appear to not be working and management states they are doubling/tripling down on spending and thus could start burning cash.
- If there is a significantly larger increase in churn for some reason, e.g. existing customers are leaving at a significantly faster pace than they have historically (this also means that all the retention initiatives the new management has put in place are not working and that the recent drop in churn was an aberration).
- If the International opportunity becomes much less valuable than it appears to be now (e.g. it turns out the economics of the deal are worse than expected, or major delays occur, etc.).

Generally speaking, deep value micro cap stocks that are perceived secular decliners have been slaughtered this year, especially those missing on revenue or guiding forward numbers lower. We felt with magicJack that we knew about delays in rolling out the latest product iteration and that the past quarter would be ugly, but apparently we over estimated how widely this weakness was anticipated and the magnitude of the weakness. Next twelve months EBITDA for the company could still easily come in over $35 million putting the valuation at under 2.5x EBITDA. At just 4.0x, the stock would be 35% higher back at $12. If a few of the company's initiatives hit it is not hard for us to conceive a scenario with EBITDA doubling in 2015 and the stock getting some multiple expansion along the way. In sum, we think the market has become overly focused on one negative quarter of performance, there is a decent management team at helm, we're not paying for any of the many growth initiatives and with such a large remaining short interest the stock has become a coiled spring of upside optionality.

We believe that CALL is undervalued by about 35% even if all of these new initiatives completely flame out. If everything fizzles and management is reasonably responsible (which we believe they are), then even with their existing customer base declining at a fairly rapid clip the company can still easily generate enough discounted cash flow to more than justify the current diminutive enterprise value.

Fotregra Financial (FRF):

In the last letter I wrote up another one of our favorite contrarian "platypus" stocks, Fortegra Financial, and pointed out that: "Summit Partners has now been holding their investment in Fortegra for over seven years. With the new slimmed down Fortegra, and the company consistently delaying the execution of its share buyback program, it is highly possible that Summit is currently looking for a liquidity event through a sale to a larger insurance company." A few weeks later an all cash deal was announced at a 39% premium to the previous market close by a larger financial firm, Tiptree Financial. I am more than a bit disappointed in the valuation we are receiving for Fortegra, but you take it when you can get it. Once again FRF proved that within our niche of under-followed illiquid micro-caps that as far as returns are concerned, they're like ketchup in a bottle: none'll come and then a lot'll. We prefer having the psychologically trying (mostly due to endowment effect, sunk cost fallacy, etc.) sell decision made for us by default through cash based M&A. We continue to try and stalk cheap companies that will likely be sold due to large Private Equity owners that are bumping up against the end of their fund life, needing liquidity events via company sale. We have been averaging at least one announced portfolio company takeout per quarter since inception. In at least three instances this year, we were in the middle of researching companies when they were bought out unexpectedly within a whisker of us pulling the trigger and buying aggressively. In multiple other instances we sold out just before a big pop from a takeover offer. When you have as diversified a portfolio as we do and look at as many names as we do this is bound to happen. Even if this perceived phenomenon is just the illusion of near misses or availability bias, it is frustrating given our struggling performance this year and yet simultaneously encouraging as it means our screening process and noses are well-honed for finding these situations as we internally emphasize valuation based on transaction comps/private market value, strategic value of the businesses and brands, as well as shareholder and ownership dynamics.

Nicholas Financial (NICK):

One company that we owned previously and benefitted from an announced sale a few months after they announced they were exploring strategic alternatives is Nicholas Financial (NICK). In that situation as with FRF we were similarly disappointed with the announced buyout valuation and our mediocre IRR, but sold the shares around the $16 deal price (~1.6x book value) and happily moved on. Well fast forward and the deal from Prospect Capital ultimately fell through and the shares have come all the way back down below our original cost basis and below tangible book value. The market is generously offering us a second stab at establishing a position in this top-notch sub-prime auto lender (kind of sounds oxy-moronic) in what is once again an under-followed "special situation." NICK remains a likely takeout candidate, but management is now considering a wider variety of financial options that would return cash to shareholders, such as a levered buyback/tender offer or a hefty one-time special dividend. We were able to re-establish a toe-hold position at a price around 90% of tangible book value for a company that has compounded book value per share at 22.1% since Q4 1997 (with no money losing years and includes a few special dividends along the way). If NICK were to just maximize borrowing on their available revolver they could pay upwards of a $7.00 special dividend and leverage would only be reverting back to slightly above the company's manageable 12-year average of 1.4x debt/equity. NICK is valued ~43% below the next lowest public competitor that is at 1.4x book value, despite or in spite of NICK having way less than half the leverage. If nothing becomes of their current re-evaluation of strategic alternatives, we are comfortable holding the stock at its currently attractive valuation.

Build-A-Bear (BBW):

Since we just finished our third year in business, I thought I would review one of our successes. Build-a-Bear is a large historical winner in the fund, at a 213.8% ROI. We've rebalanced and scaled out as it has ascended, yet kept it a relatively small position. At the time of purchase BBW exhibited many signs of a successful retail turnaround. They had grown the store base too rapidly in the mid-2000s, but were now exiting unprofitable stores (with no cash outlay, via lease expirations and kick-out clauses) and downsizing some locations for cheaper rent. In other words, management was slimming the company down to once again focus on profitability (what a novel concept). One of the greatest things about the BBW investment was that they were already consistently cash flow positive and cheap at the time, providing a nice margin of uncertainty while any traction with the turnaround was a delicious alpha-laden cherry on top. Just like with our successful Chuck E. Cheese (CEC Entertainment, CEC) investment, there's no doubt I creeped out many-a-parent by lingering in the stores and pestering store employees while conducting my boots on the ground scuttlebutt--charge it to the game. I even read the founder, Maxine Clark's enjoyable book titled *The Bear Necessities of Business: Building a Company with Heart* to help me further understand her mindset about building the brand. At the time of our purchase the shares were extremely out of favor (with an EV down around $40 million) due to mixed comp trends and being a mall based retailer with declining traffic (in the quarter of initiating position the transaction count was -6.1%), and the false perception that the Build-a-Bear retail experience as a whole was a fad. BBW consistently scores at the top of national polls for businesses that best utilize social media. This is clearly evidenced by any merchandise picture posted to their Facebook page receiving upwards of 10,000 "likes" and hundreds of comments within a few hours. On top of this, people under the age of 13 cannot even make a Facebook page—there are obvious ways around this, but generally speaking this public display of brand love and loyalty wasn't even from their true core audience. With the overwhelming public admiration and 90%+ brand recognition in the US, I gained comfort in the value and staying power of the brand.

The company showed massively negative net income but, as mentioned had highly positive cash flow with $24 million in annual non-cash depreciation and amortization and they had a nice cash hoard giving them a long operational runway. The concept had actually comp'd up in three of the last four quarters prior to our initial purchase as they lapped easier comparable sales hurdles. Much like our prior investment in PFCB, CEC and our current one in Imvescor Restaurant Group (IRG.to), negative comping retailers and restaurants with washed out sentiment that are still highly cash generative can make for great contrarian value investments, especially if management has a credible turnaround plan in place. At the time of our purchase we were buying BBW at a multiple of 1.66x our pro-forma EBITDA-Maintenance Cap-Ex estimate versus its own historic range of 4-5x. I thought if the multiple doubled, it would still only be half that of other struggling mall-based specialty retailers. Also we felt that closing stores in cities where they have multiple locations could drive traffic to the other stores thereby helping them post strong positive comps (a strategy as currently demonstrated and over-hyped by TUES) and this is a very big sentiment (and unit economics) driver not to be underestimated. A small part of the thesis was if overall revenue and margins just stayed flat, adjusted net income could rise 10% just from the embedded growth in international franchisee fees, which would drop another $500k straight to the bottom line the next year, I thought. Even in hindsight I believe I had no delusions about the potential quality of the business and calculated a potential achievable future return on invested capital of only ~13% using their historic rate of capital turnover.

Some of these same "signals" and characteristics that were exhibited in BBW at that time will be present in other situations, but they will often prove to be false positives. Retail turnarounds are tough and not every situation will work out so nicely. Lastly, I think it is very important to point out that BBW stock went nowhere fast and we were flat for at least the first ten months of our holding period that started in June 2012. It is good to review these things with the benefit of hindsight to remind ourselves that our patient, deep-value investing philosophy and process do work if we stay disciplined and remain focused on the long term.

Conclusion

Quite the opposite of the situation we articulated at the beginning 2014, looking forward we are now much more constructive on micro cap performance relative to large. Despite our previously accurate prognostication, we decided against any tactical market cap allocation decisions and stuck within our micro-to-small niche. The smaller, the more constructive we are generally—as it is the relatively illiquid, cheaply valued nano-caps that never got to ride the speculative frenzy higher yet now have endured the entirety of the recent sell-off. There are a few attractive nano-cap companies under $25 million that we are patiently accumulating stakes in at mid-single digit multiples of un-levered free cash flow. In at least two of these situations we have concrete ideas to present to management to expedite shareholder value realization…only once we have established decent sized positions, on behalf of our Partners, of course.

Independent thinking, thorough first hand research from reading source documents (as opposed to second hand opinion) and paying prices with embedded margins of uncertainty give us the conviction necessary to not get shaken out of our ideas under pressure when our fundamental thesis and estimate of intrinsic value has stayed intact.

Since the inception of Voss, I've strived for intellectual consistency. I strive for persistence of effort, consistency of my deep value, contrarian philosophy, consistency of investment research process, and consistent intention to be the best and offer a true economic benefit to my Partners. This style consistency will lead to periods of substantial underperformance as no single style is always outperforming in the market. In any pursuit, but especially one so prone to randomness in the intermediate term such as stock picking, a mediocre effort can lead to a magnificent outcome and a magnificent effort can lead to a mediocre or worse outcome. You can substitute the word decision for effort and make the same statement. Said another way, a good decision lately has not equaled a good outcome in the near term. All we can control on a daily basis is our process and the decisions it leads us to make. Using what we knew/know, what alternatives we had/have, was/is our analysis accurate? How may our logic be flawed? Are we adapting our view with the incoming information? Did we do the best we could at the time of each decision? The quality of each decision will only be as good as the weakest link in the process and we must continually ferret out the weakest link. As time passes and we are subjected to difficult environments hopefully our temperament, our portfolio management strategy and each link within the investment decision making process will become more resilient in the long run. In the short run, such as this quarter, we can often be on the wrong side of stylistic leadership changes and extreme valuations that worsen, but our conviction remains that the market will eventually resolve such incongruities and when that happens we are poised to once again outperform passive indices by a very wide margin.

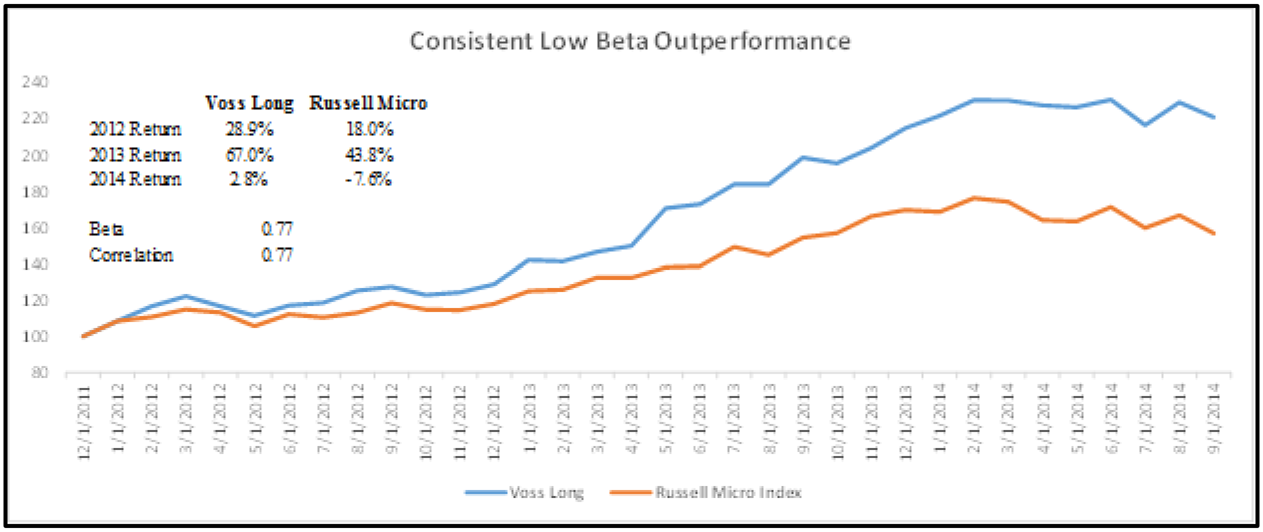
Cecil Day Lewis once said that he did not write poetry to be understood, but to understand. We write letters and research memos for the same reason. We write to clarify our thinking, crystallize our investment theses and have an objective public record of our real-time rationale. Thank you kindly for your valuable attention in reading our lengthy update.

To continued alpha,

Voss

Appendix:

- Inception to date, our correlation to the Credit Suisse L/S Equity Hedge Fund index has been just 0.41.
  - 2014 YTD our correlation to the Credit Suisse L/S Equity Hedge Fund Index has been -0.09.
- Through the first three years, our highest correlation to any single index has been to the Russell Microcap Index, at just 0.40 (long book only correlation is 0.77).
- Our one year correlation to the Russell Microcap Index is 0.16. We seem to be becoming less correlated over time.
- Using monthly returns, our correlation to the S&P 500 Index after three years has been 0.43, with a 0.46 beta.
- Inception to date our Sharpe Ratio is 1.588.
- Inception to date our Annualized Alpha relative to the S&P 500 has been 12.4%.
- Since inception the time weighted return on our standalone short book has been -37%, this compares to the Russell Micro Cap index being up 81% over the same time (and excludes short oriented options trades)
- In each of calendar years 2012, 2013 and 2014 so far the ROI of our long book is at least 10% higher than the Russell Micro Cap Index



All YTD performance figures are unaudited, estimated, and may be subject to subsequent adjustment. A limited partner's actual returns may vary from published fund returns based on the timing of capital and fee arrangements. This statement represents information based on the policies of the fund's managers and general partner. Please contact Travis Cocke, Managing Partner of Voss Capital, LLC, with any inquiries.

[1]: http://www.marketwatch.com/story/why-this-stock-market-will-never-go-down-2014-09-09?dist=beforebell

2: http://www.frost.com/prod/servlet/press-release.pag?docid=272359458

Maxine Clark's book: **http://www.amazon.com/The-Bear-Necessities-Business-Building/dp/0470139056**

Good grid-organized third-party summary/review of VoIP options: **http://michaelbluejay.com/consumer/phone.html**

Disclosures and Notices

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Past performance does not guarantee future results. There is a possibility for loss as well as the potential for profit when investing in the funds described herein. Performance of the Voss Value Fund is presented on both a net and gross basis. Performance information labeled (Net) is net of all fees and expenses and includes the reinvestment of dividends and other income. Performance information labeled as (Gross) does not reflect the deduction of fees. Gross numbers include the reinvestment of dividends and other income. Portfolio characteristics and other information are provided as of the dates set forth herein. Current or future characteristics and other information may vary significantly from those provided herein and the firm undertakes no obligation to notify the recipient of any such variances. Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. The funds consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use. The S&P 500 Index™ is an unmanaged index and a market-capitalization-weighted index of 500 stocks designed to be a broad measure of United States stock market. The HFRX Global Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. THIS SHALL NOT CONSTITUTE AND OFFER TO SELL OR THE SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY FUND MANAGED BY VOSS. SUCH AN OFFER TO SELL OR SOLICITATION OF AN OFFER TO BUY INTEREST MAY ONLY BE MADE PURSUANT TO DEFINITIVE SUBSCRIPTION DOCUMENTS BETWEEN A FUND AND AN INVESTOR.