VOSS CAPITAL

Voss Value Fund, LP

Investor Letter

Q1 2019

Dear Partners,

In Q1 2019 the Voss Value Fund, LP returned 12.3% to investors net of fees and expenses, compared to a 14.6% total return for the Russell 2000 and a 13.7% total return for the S&P 500. The Fund's total gross exposure stands at 112.1% and the beta-adjusted net long exposure is 45.7%. Our top 10 longs have a 56% weighting and our top 10 shorts have a gross weight of -28%.

Voss Value Fund, LP

ESTIMATED NET MONTHLY PERFORMANCE | 2019				
PERIOD	**VVF (Net)**	**VVF (Gross)**	**Russell 2000 TR**	**S&P 500 TR**
JANUARY	7.44%	9.39%	11.25%	8.01%
FEBRUARY	2.97%	3.72%	5.20%	3.21%
MARCH	1.54%	1.95%	-2.09%	1.94%
1st QUARTER	**12.33%**	**15.68%**	**14.58%**	**13.65%**
APRIL				
MAY				
JUNE				
2nd QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
JULY				
AUGUST				
SEPTEMBER				
3rd QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
OCTOBER				
NOVEMBER				
DECEMBER				
4th QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
YEAR TO DATE	**12.33%**	**15.68%**	**14.58%**	**13.65%**

The table below shows the Voss Value Fund's Net Returns compared to some of the relevant indices:

Net Return Comparison as of March 31st, 2019							
					Compound Annual Growth Rate		
	1 Month	3 Month	YTD	1-Year	3-Year	5-Year	ITD
Voss Value Fund, LP	**1.5%**	**12.3%**	**12.3%**	**23.6%**	**18.5%**	**14.8%**	**17.9%**
S&P 500	1.9%	13.6%	13.6%	9.5%	13.5%	10.9%	15.4%
Russell 2000	-2.1%	14.6%	14.6%	2.0%	12.9%	7.1%	13.9%
Russell 2000 Growth	-1.4%	17.1%	17.1%	3.9%	14.9%	8.4%	14.9%
Russell 2000 Value	-2.9%	11.9%	11.9%	0.2%	10.9%	5.6%	12.8%
HFRX Equity Hedge Index	0.8%	6.0%	6.0%	-5.1%	2.9%	0.7%	2.6%

All 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 Kelli Walter, Chief Operating Officer of Voss Capital, LLC, with any inquiries.

The S&P 500 returned 13.6% in Q1. If you were fortunate (or wise) enough to not check the market indices from last November through today, you would have never known a steep, panicky correction occurred. The market has snapped back as quickly as it fell, creating a near perfectly symmetrical v-shaped rebound. As we suspected and laid out reasoning for in the previous quarterly update, the market swoon in December 2018 proved ephemeral in nature and was a sentiment driven correction as opposed to the start of deeper bear market. Alas, the gears of global economic growth did not immediately grind to a complete halt as many panicked over at the time. In fact, growth numbers have been relatively good and reaccelerated as Q1 progressed.

In a time of cataclysmic happenings in the market (e.g. technical driven sell offs), courage (and luck) counts for more than analytical rigor in making money from a forceful change in trend. In December it was a time to buy and many high-quality businesses are up 50% or more from their late December bottom. Many low quality, expensive stocks are up much, much more than that—something we felt on the short side. Trading liquidity has been one of the best performing factors or attributes YTD. In fact, our biggest laggards on the long side this year have been our least liquid names. Not unlike Linus instinctively clinging to his security blanket, we have once again raised our cash levels above our historical norm here in early May just as we had in November last year.

Just as we had unwound a long, knotty string of evidence in late Q4 and had woven what we felt was a clear-eyed market view (leading us to be extremely bullish), the pricing dynamics have once again coiled into a chaotic clutter with no obvious conclusions on the most likely path forward. We are now party to the market's ongoing struggle to turn a disjointed deluge of data into a coherent chronicle. We have no strong view on the market's near-term direction. It does feel as if the market's most likely path once again will be a steady grind up until we reach some sort of euphoric peak. If something is discussed regularly in mainstream media, it lessens and nulls its market moving power. It is possible there are not enough large negative fundamental developments that will surprise enough market participants to drive an outsized downturn and, needless to say, valuation does not matter in the short term for the vast majority of fund flows and investors.

This all adds up to a puzzling yet unmistakable dichotomy that has emerged in the market from our vantage point. On the one hand, we can point to euphoric sentiment and numerous palpable absurdities at the micro level judging by the many bubbles within individual stocks and industries. On the other hand, there remains a thick skepticism of the market indices overall with many individuals and professional investors holding a lot of cash and keeping exposures down, and the forward P/E on the S&P 500 being only ~17x. Fund flows are also not in line with previous euphoric peaks, yet median stock valuation levels are, and in many cases, exceed previous market peaks. For example, despite the S&P 500 being up 3.8% in the month of April and setting a record high, total equity fund *outflows* were $3.7 billion for the month and have exceeded $30 billion YTD[1]. Regardless of negative fund flows, the current market now feels much more speculative and complacent than it was just back in September before the quick 20% correction. If you look at many money losing growth companies, their valuation multiples are now 20-50% higher than they were prior to the correction. The pullback was simply a pause that renewed an explosive move higher.

An area of renewed interest for us on the short side is the flood of high-profile IPOs of mature companies that are *still* cash incinerators. For example, a fake meat company that has been around for over 10 years and still loses money is up ~4x from its IPO price about a week ago and now trades at >50x trailing revenues. This is as sure a sign of building late cycle optimism as there is. However, to put into context the magnitude and scale of IPOs we point out that the actual dollar amounts being raised in aggregate in initial offerings this year pales in comparison to share buybacks and cash M&A. There is estimated to be ~230 IPOs this year that will raise in aggregate somewhere in the ballpark of $120 billion of fresh equity capital[2]. This only amounts to less than one half of one quarter's worth of share buybacks at the Q4 2018 or Q1 2019 rate. In addition to buybacks, when considering cash M&A, IPOs and follow-on equity offerings the overall supply/demand equation for equities is still solidly in favor of bulls. The recent and upcoming crop of cash burning IPOs promises to be fertile hunting grounds for Voss for tactical shorts in 2H 2019 as their insider share lock-ups expire.

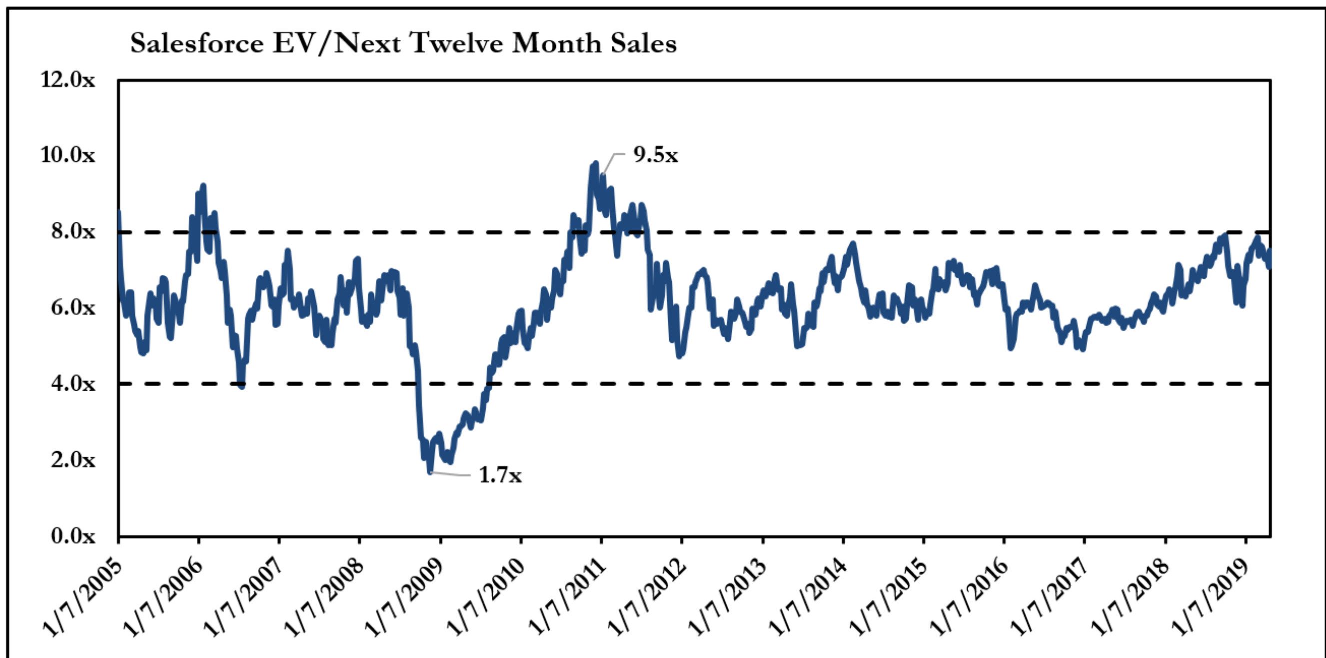
Many investors posture themselves as either pure growth or pure value investors, but we actually believe the two aren't separable. We always say that value is partly a function of growth, or growth is an input into our value calculation. We most certainly want to buy growing companies, but we want to pay a bargain basement price for them. History no doubt demonstrates that companies with great growth potential are worth paying up a bit for. The problems come when you pay too much for a given level of growth and/or future growth never materializes in the manner that the market expects. On the short side of the book, we will continue to dig into companies that are burning cash and have high multiples if we think the growth may not pan out quite as expected.

Software Valuation

One area where this rings true is the increasingly frothy world of enterprise software. Make no mistake, at Voss we love software stocks. The recurring revenue model with low churn, extraordinarily high incremental margins, and disruptive nature of software is something that fits cleanly into our investing philosophy and is an area that consistently gets a large weighting in our portfolio. However, we see software sentiment as so euphoric that we are concerned about a major correction.

To -contextualize the current state of sentiment within software, we would like to turn our attention to the "original" software as a service (SaaS) company, salesforce.com (CRM). Although we have no position in CRM, we believe looking at it from a historical perspective is helpful in gauging today's sentiment.

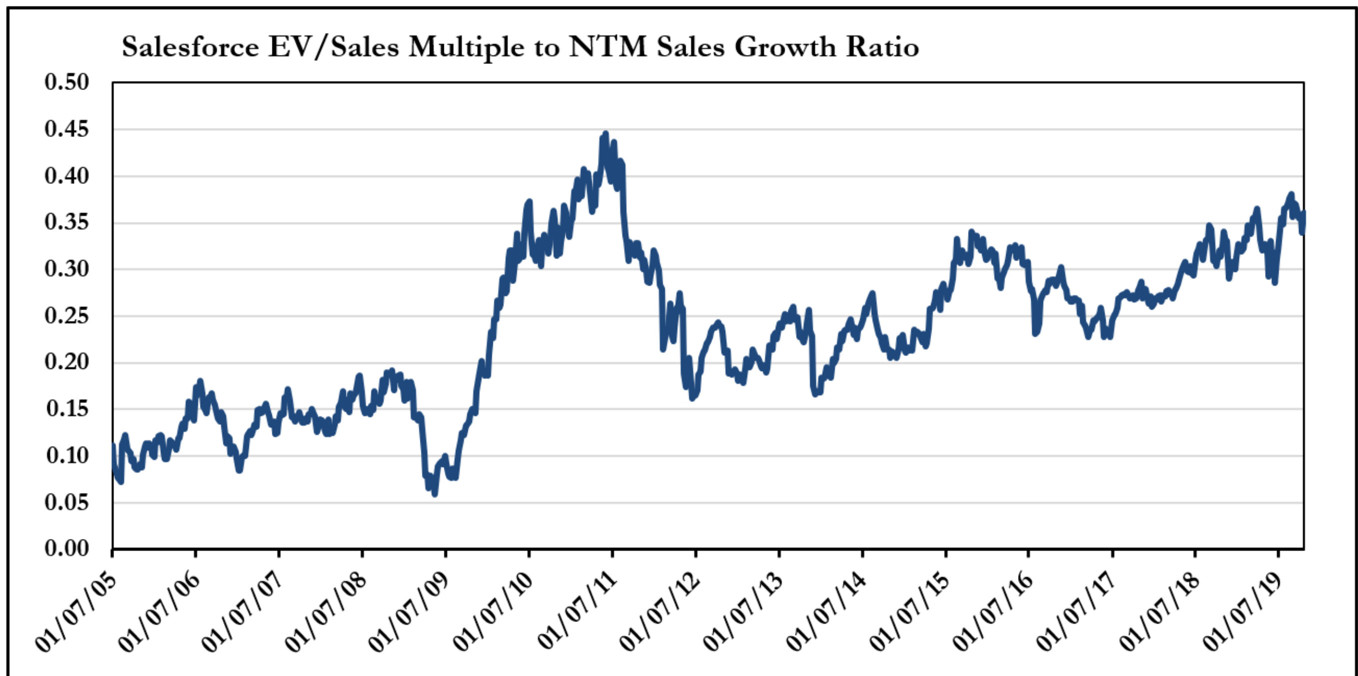
CRM has been an extraordinary success story, as far as revenue growth and stock price appreciation go. Since the beginning of 2005 the stock has had a total return compound annual growth rate (CAGR) of 28% driven by a sales CAGR of close to 40%. When looking at just the timeframe after the Great Recession (the last ten years), CRM's organic sales CAGR is closer to 25%.



Despite CRM's disruptive and controversial nature, its EV/NTM Sales multiple has been in a relatively tight range, vacillating between 4x and 8x and really coalescing around 6x. One major outlier was during the Great Recession when it briefly dipped to 1.7x. (Those were the days…)

We believe this relatively consistent valuation range has contributed to good long-term returns for CRM, as the market did not frequently jump way ahead of the company's fundamentals.

Of course, the chart above does not take revenue growth into account, which is a critical input for sales multiples. If we growth adjust CRM's multiple by taking EV/Sales over projected sales growth (a Sales PEG, so to speak), we get a better sense of how CRM has gotten more expensive over time, on a growth adjusted basis.



From 2005-2006, CRM was growing sales at 60-70%, and traded in the 6x-8x sales multiple range. Currently, at present the growth is closer to 20% yet the stock still maintains that same multiple. Part of this is certainly explained by rising margins, but in reality CRM's true EBITDA margins have only moved from ~6% in 2005 to around 12% now if we add back stock based compensation to their reported Adjusted EBITDA.

As a final exercise to try and get an apples-to-apples comparison, let's compare a current group of "high flier" software stocks to CRM when it was at a similar operating scale. Here are nine enterprise software stocks we feel are representative:

Current High Multiple Software Stocks

Ticker	EV	Sales LTM	Sales NTM	NTM Sales Multiple	NTM Sales Growth	Sales Multiple to Growth Ratio
ZM	$20,000	$396	$691	28.9x	75%	0.39
ZS	$8,900	$265	$360	24.7x	36%	0.69
OKTA	$13,309	$433	$576	23.1x	33%	0.70
MDB	$8,500	$292	$398	21.4x	36%	0.59
COUP	$7,000	$277	$347	20.2x	25%	0.80
ESTC	$7,000	$267	$366	19.1x	37%	0.52
AYX	$6,800	$285	$386	17.6x	35%	0.50
PLAN	$5,700	$258	$335	17.0x	30%	0.57
SMAR	$4,700	$197	$279	16.9x	41%	0.41
Median	**$7,000**	**$277**	**$366**	**20.2x**	**36%**	**0.57**
Salesforce when at $300 - $400 million in revenue				**5.9x**	**55%**	**0.10**

When Salesforce was in the $300 million sales range, it traded on average at 6.0x forward sales along with 55% estimated forward growth, compare to a median 20x sales multiple for this basket of stocks that are projected to have a median 36%

forward growth rate. Additionally, these high fliers have, at the midpoint, *28% worse EBITDA margins than CRM did* back when it was at a similar scale. In today's market environment investors are paying nearly 6x the growth adjusted multiple that Salesforce was getting back in 2005, with materially higher multiples overall and materially worse margins. In its entire history, Salesforce has never traded as high on a growth adjusted basis as the average of this basket of software stocks. Framed in one other way, a stock like COUP, assuming it compounds sales at 25% the next six years, is trading at 6x 2025 sales, meaning the stock is six years ahead of CRM in valuation.

We would also note that Salesforce is an outlier. How many of the names above are truly "the next Salesforce"? How many will truly be able to maintain 20-30% growth for a decade to come? Salesforce has accomplished that growth over the last decade by becoming a behemoth in the market and has done so with the aid of some material acquisitions. Most of these other firms occupy niches with total addressable markets that are a fraction of the size of CRM's and have more competition thanks to an endless flood of venture capital that has an unclear return hurdle and a disdain for profitability.

Does this mean any of the names above are immediately screaming shorts? Most certainly not. We are very aware that euphoric valuations can last for years and that catalysts are needed to bring the names back to economic reality. Additionally, bulls are likely betting on the consensus forward sales estimates being way too low, as large revenue beats have been common in the group. The catalyst for the group to decline will likely be when the beats start normalizing and it gets harder and harder to dream up infinite growth.

For our portfolio, this means we are spending more time investigating these companies and many other software firms that are being pulled up in sympathy, along with increasing our allocation to bearishly oriented options trades for the group. We are also shifting some long exposure away from software while maintaining material positions in our few core long software stocks.

While lately the path to good returns in equities seems to have been blazed by blind optimism and wild speculation, historically speaking it was paved with critical skepticism and lit by the spirit of objective inquiry. 11th century Chinese philosopher Chang-Tsai (aka Zhang Zai) said "If you can doubt at points where other people feel no impulse to doubt, then you are making progress." Now is certainly one of those times to doubt the continuation of the pace of software stock appreciation and multiple expansion.

There was an early 2000s BBC series called Bodies that is a medical drama. In the first episode a new surgeon performs an operation on a patient with complex conditions and she subsequently dies. A rival doctor says to him: "The superior surgeon uses his superior judgment to steer clear of any situation that might test his superior ability." In other words, he avoids difficult cases as a way of maintaining his success rate. While we are never ones to shy away from a challenging analytical situation if we believe there is alpha to be had, there is some wisdom in the fictional doctor's statement as it pertains to investing. It is similar to the conclusion of the military supercomputer in the movie War Games. After it plays Tic Tac Toe with itself and then turns is focus to scenario analysis of a nuclear war, it applies its learning of the concept of futility to avert mutually assured destruction in a potential WWIII and ends with the quip: "Strange game. The only winning move is not to play." In the strange game of investing, we also run iterative analysis and consider multiple scenarios and do not have to swing at every pitch or have a view on every stock. We can work to cultivate superior judgement and use it to decide when to play the game and rest assured, we aim to wait until the odds heavily favor winning.

To Continued Alpha,

Voss Team

Citations:

1: Source: Jefferies Equity Strategy report, May 2nd, 2019
2: Source: Renaissance Capital IPO research

Disclosures and Notices:

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The S&P 500 Total Return Index is a market cap weighted index of 500 widely held stocks often used as a proxy for the overall U.S. equity market. The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index. The Russell 2000 serves as a benchmark for small-cap stocks in the United States. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price/book ratios and higher predicted and historical growth rates. The Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower expected and historical growth values. Using only liquid securities, the Credit Suisse Long/Short Liquid Index seeks to reflect the return of hedge funds as represented by the Long/Short Equity sector of the Credit Suisse Hedge Fund Index. The Credit Suisse Hedge Fund Index is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 9,000 funds and consists only of funds with a minimum of US $50 million under management, a 12-month track record, and audited financial statements.

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