Viemed Healthcare (VMD:TO, VMD)

Price (12/31/19):	$8.13 CAD	Market Cap (12/31/19):	$309 million CAD
Stock Gain (2019):	+55.4%	Portfolio Weight:	29.7%

Description

Viemed is a healthcare company operating in the US market. Viemed's main focus is ventilators, particularly non-invasive ventilators that are provided in the home for late-stage COPD patients. Viemed trades on the Toronto Stock Exchange in Canadian Dollars (CAD), and with its dual-listing in August, now trades on the NASDAQ in US Dollars (USD) as well.

Growth

Viemed has continued to grow at a rapid clip, with Active Vent Patients up 36% year-over-year to 7,421, as of September 30, 2019. Revenue over the last twelve months (through Q3 2019) is up 41%, and they have reinvested almost all of their cash flow back into the business to support their torrid growth, mostly by purchasing more ventilators to support their growing patient base. Margins, however, were down as they built out the infrastructure for coming growth. They invested in technology for remote patient monitoring (still in pilot stage), a new workflow and billing system with tablets for all the respiratory therapists, and added substantial back-office staff. Over the past twelve months, Viemed went from being licensed in 28 states and doing business in 25 to being licensed in 47 states and doing business in 31, as they prepare for nationwide expansion due to CMS's (Center for Medicare and Medicaid Services) Competitive Bidding program. Viemed also added 40 new sales reps and increased total staff from ~250 to more than 400, and they signed 140 new payer contracts with commercial insurances as well as making progress towards winning business with the VA, which is now funding a study on Viemed's ventilator treatment model with COPD patients in the VA system.

Stock-based Compensation and Phantom Share Program

One issue that has been depressing margins and reducing flow-through of revenue growth to the bottom line has been Viemed's extremely high amount of stock-based compensation as well as the

company's phantom share program. Their stock-based compensation, which includes both stock options and restricted stock units, eats up close to 28% of adjusted net income, which, needless to say, is an unconscionable amount to maintain on a long-term basis. In addition to these two programs, Viemed also has a bonus phantom share program. Phantom shares are when employees are awarded "shares" as bonuses for reaching various benchmarks, but upon vesting are paid in cash value instead of actually issuing new shares. Unlike stock options and restricted stock units, phantom shares are marked to market each quarter, which can cause large swings in reported quarterly results, especially with a stock as volatile as Viemed's. Because Viemed's stock price rose substantially over the last twelve months, the company incurred significant mark-to-market charges due to the program, which are likely to become actual cash payments when vesting. We estimate that over the past twelve months, Viemed has seen an accounting impact of ~$5 million from the phantom share program, more than their entire stock-based compensation. Together, stock-based compensation and the phantom share program have eaten up ~47% of adjusted net income! The company has indicated that it may change the program somewhat, and we remain watchful to see if the company brings bonuses and incentive compensation down to a more reasonable level.

Competitive Bidding

CMS has officially added ventilators to the competitive bidding program, and barring any last-minute legislative action, which we consider unlikely, ventilators will be subject to competitive bidding when the program restarts in 2021. Viemed has accelerated their plans for nationwide expansion to take advantage of the potential to win competitive bidding contracts. Presently, Viemed is doing business in 51 out of the 130 CBAs (Competitive Bidding Areas), which account for ~25% of their revenue. The bid window closed in September, and Viemed has submitted bids for 124 CBAs, and in our opinion, is likely to win most of them, due to the way CMS evaluates bids. CMS takes into account financial strength in determining whether a bidder can indeed provide the capacity it claims, which favors Viemed's size and strong balance sheet. In addition, CMS caps a bidder's estimated capacity at 20% of the required capacity, thereby ensuring that at least 5 bidders win a contract in each CBA. With Viemed the third-largest ventilator provider in the country (after Apria and Lincare), we consider it unlikely for them to be frozen out of the CBAs entirely. Indeed, the competitive bidding program may end up benefitting Viemed by accelerating their growth and increasing the volume of business in CBAs that they do win a contract for.

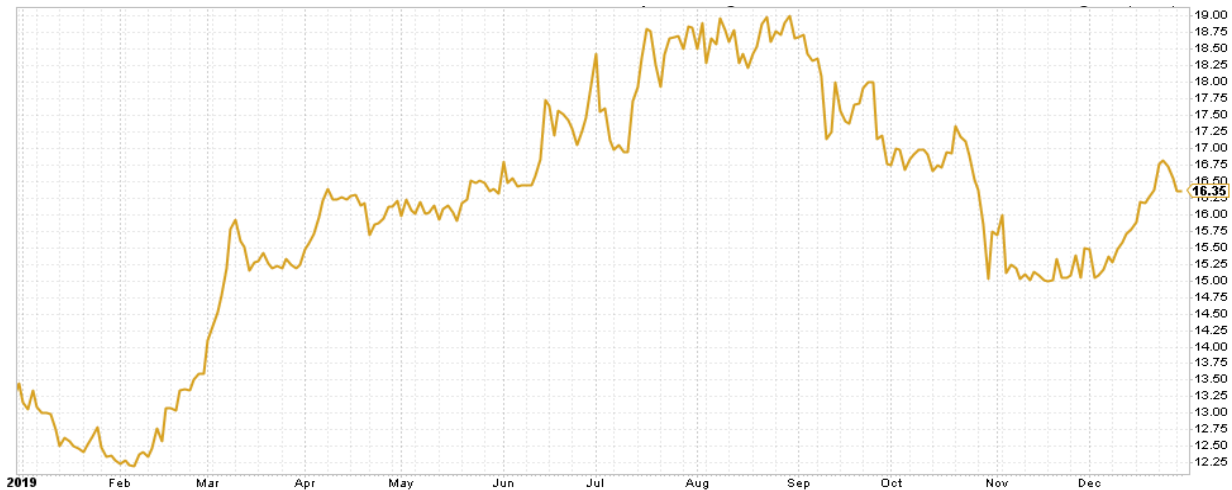
As for the potential for rate cuts from competitive bidding, CMS made a key change from previous bidding rounds by linking reimbursement to the clearing bid, instead of the median bid. This means that reimbursement will match the highest bid necessary to fill the required capacity (after limiting each bidder's estimated capacity to no more than 20% of the required capacity, as mentioned above). It is even theoretically possible for reimbursement rates to increase, rather than decrease. Although it is impossible to be certain, we do not expect a significant cut in reimbursement rates. Even if there is a significant rate cut, we believe that Viemed can recover from it and come out stronger than its competitors, as it did from the 2016 rate cut.

CMS is presently scheduled to announce reimbursement amounts in Summer 2020 and the actual winning contract suppliers in Fall 2020. We expect these announcements to be market moving for Viemed's stock.

Valuation

Despite its high growth rates and large and growing potential market, Viemed trades at a P/E of just 25. We believe that Viemed deserves a higher P/E due to its sustained high growth and profitability. But any multiple expansion is icing on the cake, as the stock price should follow net income growth even without any multiple expansion. We continue to see Viemed as being deeply undervalued, and we are excited about its future.

Lindblad Expeditions (LIND and LINDW)



Price (12/31/19): $16.35 | Market Cap (12/31/19): $811 million

Stock Gain (2019): +21.5% | Portfolio Weight: 24.0%

Description

Lindblad is a small-ship cruise company focused on the expedition market. Lindblad primarily offers nature-oriented cruises to exotic locales such as Antarctica, the Arctic, the Galápagos Islands, and similar regions. These cruises are more expensive and profitable than the standard fare offered by mainline cruise companies.

Growth

Lindblad has continued to steadily execute on their game plan, commissioning new ships to grow their capacity and revenues. Over the last twelve months (through Q3 2019), revenue and net income have both continued to grow steadily, with revenue up 12%, and net income up even more. The growth has been broad-based, across geographies and ships. Their land-based subsidiary, Natural Habitat, has also grown rapidly over the last twelve months, with revenue up 16.6% and operating income up 40.3%. Nat Hab and Lindblad have continued to increase their cross-selling across their combined customer bases, with Nat Hab customer bookings of Lindblad cruises up 80% in 2018 and up a further 40% over the first nine months of 2019.

Lindblad's latest ship, the NG Venture, launched at the end of 2018, joining its sister ship, the NG Quest, as well as Lindblad's older ships, the NG Sea Bird and NG Sea Lion, in the Alaska region. Despite the significant increase in inventory from new ships (up from 124 berths in Alaska to 324), occupancy and net yields have actually increased from the prior twelve months, with occupancy rising to 91.6% (up from 89.8%) and net yields reaching $1,063 (up from $1,013).

Similarly, Lindblad's new polar class ship, the NG Endurance, which is slated to embark on its inaugural voyage in April 2020, has seen strong bookings for 2020 and 2021, without cannibalizing their existing ships. Partially to avoid direct overlap with their present itineraries, Lindblad is positioning the NG

Endurance to take full advantage of its PC5 ice class rating by beginning the Arctic season earlier and forging unique routes, impassable with their present ships.

The strong demand for new ships continues to be a strong confirmation of our basic underlying thesis that demand for Lindblad's expedition-style cruises significantly outstrips supply. Nevertheless, there is a surge of shipbuilding throughout the expedition and specialty cruise segments, and we remain vigilant for any signs of overbuilding capacity in the industry.

Warrants

In June, Lindblad initiated the process to convert the 10.1 million outstanding warrants into regular shares at a ratio of .385 shares per warrant, and effected the conversion in July. Although this represented an approximately 3.5% premium over what the warrants were trading for at the time, the conversion had the beneficial effect of reducing overhang from future dilution. As holders of warrants as well as shares, we stood to gain more without the conversion, but we do recognize the conversion as beneficial from a shareholder perspective and the correct move for management to have made.

Valuation

Lindblad is an example of a company where you need to work to understand the value. Simple screens will show the stock to appear quite expensive, with a P/E of ~76 (!). But there is much value hidden in the accounting if you pay careful attention. When you deduct non-cash, non-economic expenses (such as the depreciation of their National Geographic relationship, which is growing in value not declining, and the $2.7 million deemed dividend in connection with the warrant conversion), the P/E is really a much more reasonable 39. Although still elevated, we believe their clear and steady growth compensates for this, and we believe Lindblad has a bright future ahead of it.

Lending Club (LC)

Price (12/31/19):	$12.62*	Market Cap (12/31/19):	$1.1 billion
Stock Loss (2019):	-4.0%	Portfolio Weight:	12.3%

*Price reflects 1-for-5 reverse stock split on July 8, 2019

Description

Lending Club is a marketplace lending platform, connecting people seeking to borrow money with investors seeking to lend money. Lending Club qualifies the borrower, sets the interest rate, and funds and services the loan, which is then sold to various investors, in whole or split into pieces. Lending Club's main focus at present is unsecured personal consumer debt, and they are the leader in marketplace lending for this space.

2019 – Responsible Growth: The Transition to Profit

Having successfully navigated through their crisis in 2016 and 2017, 2018 was a year where Lending Club could begin to put the scandal behind them and rededicate themselves to growing the business. 2019 continued this growth path upwards both in loan originations and revenues, and even more so in profit. Over the last twelve months (through Q3 2019), loan originations were up 15.6%, revenues were up 12.2%, and contribution (the loan industry equivalent of gross profit) was up 18.0%. This was despite Lending Club continuing to tighten credit policy throughout the year, as we possibly approach the end of the credit cycle.

Arguably more important than Lending Club's continued growth in 2019, was their focus in 2019 on responsible growth, managing their expenses and their bottom line to bring the business to profitability. Expenses were wrung out of every area of the business – marketing, origination, servicing, product development, and G&A. Part of this improvement was from increased scale, enabling revenue to grow 12.2% while expenses grew only 7.9%. A major portion, however, was from a specific focus on expenses throughout 2019, much of which effect has not yet fully appeared in the annual financials. Looking at the most recent quarter, the difference is much starker, with margins in Q3 2019 being substantially higher than a year prior in Q3 2018. The Adjusted EBITDA margin in Q3 2019 reached 19.5%, up from 15.2% a year

prior, and management sees a clear line of sight to reach Adjusted EBITDA margins of 25% over 2020 and 2021.

On the bottom line, Lending Club turned profitable on an adjusted basis in Q3 2019 and came close to breakeven on a GAAP basis, with Adjusted Net Income of $8.0 million and a GAAP Net Loss of just $392,000. (The difference between the adjusted numbers and GAAP numbers are basically some remaining one-time legacy legal expenses from the scandal's aftermath as well as one-time personnel costs related to their relocation discussed later.) We expect Lending Club to turn GAAP profitable in Q4 2019 or H1 2020 and to continue growing from there. The company has not yet released guidance for 2020, and it is difficult to estimate legacy expenses with any accuracy, but we are cautiously anticipating GAAP Net Income of ~$20 million for 2020.

Lending Club's main initiatives on the cost side consisted of two programs. Firstly, they have transferred certain back office and servicing work to third-party contractors, bringing costs down and converting fixed costs to variable, which positions them to be more resilient to weather any downturns in the credit cycle. Secondly, they have opened a new location in the Salt Lake City area and have relocated a substantial percentage of employees to the new facility from San Francisco, a particularly high cost area. This relocation brings a 50% reduction in rent per square foot as well as a 25% reduction in salaries. By the end of Q3, 48% of their total workforce (including both direct and indirect employees) has been relocated out of the San Francisco area.

Continued Innovation for Borrowers and Investors

Lending Club has continued to innovate for both borrowers and investors. On the borrower side, Lending Club has streamlined their approval process, to the point that 71% of applications receive approval within 24 hours, up from 46% a little over a year ago. They have also expanded their balance transfer program, where borrowers who are seeking to consolidate debts can have Lending Club pay off their credit cards and other debts directly, lowering the risk on their loan and thereby enabling a lower rate for the borrower. They have also begun piloting a credit monitoring program where they offer to monitor borrowers' credit ratings, tracking their improving credit over time and offering them further opportunities to use Lending Club to continue improving their credit.

On the investor side, Lending Club has developed and tested their auto loan credit model, and they have started accepting outside investors for this program in Q3. Although the auto loan program is growing at a faster trajectory than their main unsecured personal loan program, and with substantially less investment needed, it is still not expected to contribute materially in the near to medium future, as both Lending Club and outside investors cautiously build and validate their credit models. Lending Club has also launched Select Plus, where investors with their own proprietary credit models can choose to invest in loans that Lending Club's own credit models now reject. They have started with one investor for Q3 and another onboarding in Q4, monetizing some of the applications that Lending Club has until now been unable to. In the securitization arena, Lending Club has started offering Levered Certificates to join their CLUB Certificate program. CLUB Certificates are whole loans packaged in a security wrapper, opening the asset class to many more fixed-income investors. Levered Certificates take these same loans and split them into two components, a fixed-rate note and a more equity-like residual. Lending Club has found great success

with their rapidly growing securitization programs, which are responsible for about a third of their recent volume as well as many new investors being introduced to the platform.

Catalysts: Looking Forward to 2020

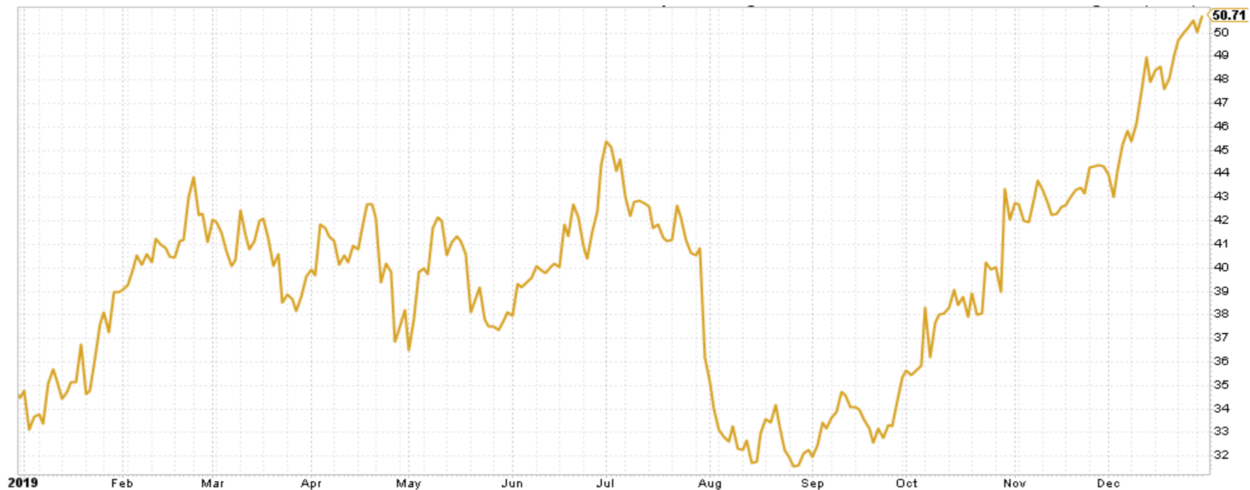
Looking forward to 2020, we see many upcoming positive catalysts. As noted earlier, we expect Lending Club to turn GAAP-profitable in Q4 2019 or H1 2020, and we cautiously anticipate GAAP Net Income of ~$20 million for 2020. We await Lending Club's full-year guidance (generally accurate, with a slight conservative bent), which they will release together with Q4 2019 results, and we believe guidance and accompanying commentary may serve as a catalyst for reconsideration from many who have abandoned Lending Club for dead.

Although legal matters cannot be predicted with any accuracy, we expect the FTC lawsuit (see 2018 Portfolio Update for details) to resolve in 2020, with minimal effect on the business. Additionally, there will likely be progress announced towards Lending Club receiving a national bank charter, although we don't expect that to fully come to fruition in 2020. A national bank charter will lower their cost of capital (especially for the warehouse line of credit they presently use to fund much of their securitization program while inventorying loans for upcoming securitizations) as well as recapture some of the revenue that is presently going to their partner banks. (They will still continue with the marketplace lending business model, precisely as they do now, just with a bank charter to make the loans being sold to investors, instead of needing to rely on partner banks.)

Valuation

With a market cap of ~$1.1 billion, net cash and securities of ~$900 million, and a pristine balance sheet, the market is valuing Lending Club's business at ~$200 million. We consider this to be an extremely low figure, especially considering the resilience that the company has demonstrated in weathering this storm while keeping its balance sheet in good condition, returning to growth, and transitioning to profitability. We expect Lending Club to have GAAP Net Income of ~$20 million for 2020, and we do not consider it a stretch at all for the company to reach a run-rate profitability of $100 million a year over the next few years. Long-term, they have even greater potential than that, and we see the downside as limited. We are happy to be invested in Lending Club at this level and are excited for its future.

Silicon Motion (SIMO)



Price (12/31/19): $50.71 Market Cap (12/31/19): $1.8 billion
Stock Gain (2019): +47.0% Portfolio Weight: 23.8%

Description

Silicon Motion designs and sells controllers which manage the NAND flash memory ubiquitous in modern computing. Wherever there is NAND flash, there must be a controller, often one from Silicon Motion. SIMO is an ADR (American Depository Receipt) trading on the NASDAQ.

2019: A Mixed Bag

2019 was a mixed bag for Silicon Motion, starting off very weak, but recovering towards the end of the year. Although we had expected Silicon Motion to benefit from the weakness in NAND flash pricing prevalent throughout 2019, three issues combined to hurt their revenues and profits for the year.

Firstly, although generally benefitting from dropping NAND flash prices, Silicon Motion was hurt by the speed of the drop. The volatility of prices caused a number of their customers (mainly the module makers) to hold back on purchasing NAND flash for fear of being stuck with high-cost inventory, which had an accompanying knock-on effect of hurting sales of Silicon Motion's NAND flash controllers. This hurt growth in their client SSD segment in the end of 2018 and the first half of 2019, and although this segment did grow for the year, it performed weaker than expected until the second half of 2019.

Secondly, SK Hynix's shift from eMMC (where they use Silicon Motion's controllers) to UFS (where they design their own controllers in-house) continued to weigh on Silicon Motion's eMMC+UFS segment, together with ongoing weakness in the Chinese mobile phone market and a globally flat smartphone market. This was partially balanced out by growing UFS sales to Micron as well as growing eMMC sales to Chinese module makers, and this segment returned to growth in the second quarter of 2019 (from its reduced Q1 2019 base) and is expected to grow in 2020 for the first time since 2016.

Thirdly, the SSD Solutions segment had a terrible year, particularly the Shannon division, which was close to decimated. Although this segment started recovering in the second half of 2019 (albeit from the

now very small base), and it may yet become a major contributor to the company, its overall performance for 2019 was dismal, and it will be a while before we can see if it will achieve sustained growth at volume.

Overall, revenue for 2019 was down roughly 15%, with operating income dropping roughly 45%. The steeper drop in operating income is partially due to lower scale, with reduced revenue on a similar fixed cost base, but mostly due to lower margins and write-downs for the Shannon segment. Despite the bad news, 2019 ended on a very strong note, with all segments growing sharply, renewed business visibility, and increasing management confidence. Although at the start of 2019 management uncharacteristically refused to provide quantitative full-year guidance, citing reduced business visibility, starting in the second half of the year visibility picked up and management guidance and commentary have been very positive since then, including positive commentary for 2020. The Board also announced in October a 17% dividend raise to $1.40 per ADS a year (up from $1.20), further telegraphing confidence in the future. I additionally emphasize that even under the worst conditions over the past few years, Silicon Motion has remained profitable every quarter throughout, has continued to invest in their business and innovate through downturns, and has retained its pristine balance sheet, with a hefty amount of cash and no debt. Management has also shown above-average capital allocation skills, opportunistically buying back shares, including twice during 2019 near year lows in the share price.

Client SSD

Despite the headwinds from volatile NAND flash prices depressing orders from module makers, the client SSD segment grew roughly 25-30% in 2019, reaching an all-time record revenue of ~$65 million in Q3 2019, with further growth expected in Q4 and through 2020. The market for SSDs continues to grow, with the ~200 million client HDDs sold annually expected to convert to SSDs over the next few years. PC OEMs are expanding the use of SSDs throughout their lineup, even on the low end, and both the new Xbox and the new Playstation launching in late 2020 will be including SSDs in place of the previous generation's HDDs. In addition to the overall SSD market growing, Silicon Motion continued to grow its market share to about 33% of all client SSD controllers, and they expect over time to grow their market share to 40%+, as they continue to grow their share of design wins for upcoming projects.

An illustration of their desirability as a controller supplier can be seen in the example of Kingston. Kingston is the world's largest module maker for SSDs and supplies a little more than 10% of the market. Kingston is also a long-time partner and investor in Phison, a competitor of Silicon Motion, with Kingston owning ~7% of Phison's shares. Despite Kingston's long-time partnership with Phison and their long-time exclusive preference for Phison's controllers, in Q4 2018, Kingston started using Silicon Motion's controllers for the first time. Silicon Motion has grown its design wins with Kingston over 2019, and although Kingston-related revenue for 2019 was small, Silicon Motion's share of design wins with Kingston is far greater than their present share of controllers with them, with design wins covering the gamut from low end to mainstream to high end and even enterprise models, boding well for growth in 2020. We believe that the growing use of Silicon Motion controllers by Kingston is a strong endorsement of their value.

Another potentially lucrative source of future growth (above and beyond all the growth outlined above) is Samsung. Samsung is the only major NAND flash manufacturer that exclusively designs its own in-house controllers for the SSDs that they sell directly. This blocks off a large segment of the controller market from merchant controllers, as Samsung supplies about 30% of the market for SSDs. Recently, in a few investor presentations, Silicon Motion has indicated that Samsung is considering using Silicon Motion's

controllers for a portion of their lineup, possibly as soon as 2020. Nothing final has been announced, and any agreement would probably ramp slowly with most of the benefit in 2021 and beyond, but if this partnership occurs, it would be a major additional boost to Silicon Motion's SSD segment and another endorsement of the value offered by Silicon Motion.

SSD Solutions

Silicon Motion's SSD Solutions segment consists of Shannon and Ferri. Shannon is their Chinese subsidiary which provides custom integrated SSDs (NAND flash + controller) for hyperscale data centers in China (at the moment, specifically Alibaba and Baidu) on a bespoke basis, and Ferri is their division which provides integrated SSDs for the industrial, commercial, and automotive markets globally. Both divisions suffered greatly from the volatile NAND flash pricing, because in this segment Silicon Motion itself purchases the NAND flash, packages the flash with its own controllers and firmware, and resells it. This puts Silicon Motion in the position of shouldering the risk of NAND flash price declines while in inventory. Because of the volatile NAND flash prices, Silicon Motion's gross margins for Shannon dropped from ~20% to just above break even, and they furthermore had to take a $5 million write-down on NAND flash inventory in Q2 2019. Volume was also down sharply as they declined to aggressively pursue non-profitable business.

Worse than the NAND flash pricing issues, were execution misses on Shannon's new-generation product, the world's first commercial deployment of open-channel SSDs. They badly underestimated the time it would take to tweak and refine their new offering, slipping the timeline by about a year from Q2 2018 to Q2 2019. In the meantime, their previous-generation datacenter product (which was not an open-channel SSD) was no longer competitive, causing sales in 2019 to dry up almost completely, with the little revenue that did come being sold at just above breakeven. Due to these Shannon issues and concerns about the future potential for profit, Silicon Motion took a $16 million write-down on the goodwill from their Shannon acquisition (with $17 million of goodwill now remaining).

As previously mentioned, SSD Solutions (both Shannon and Ferri) recovered sharply in the second half of 2019, albeit from a much reduced base. Going forward, Silicon Motion is changing their agreement with Alibaba over the first half of 2020 to move to a consignment model (where Alibaba purchases the NAND flash themselves and consigns it to Silicon Motion to make the integrated SSD), removing the NAND flash price risk from Silicon Motion and guaranteeing them a profit for their controller work. This will reduce the revenue recognized by Shannon by ~80% (as the NAND flash represented about 80% of the SSD cost and the controller represented about 20%), while gross profit, which is what matters, will remain about the same. This is highly advantageous for Silicon Motion and should go a long way to avoiding a repeat of the disaster that was 2019. They're starting this new business model with Alibaba in H1 2020, and they will presumably seek to transfer their other major customers to this model as well.

Looking forward to the future of the Shannon segment, Silicon Motion believes that their learning curve on this first-generation open-channel SSD will greatly improve the development speed for the upcoming second-generation open-channel SSD in 2020. For a short time in 2016, Shannon was at a run-rate of ~$65 million annually with a gross margin of ~20%, and Silicon Motion expects to return to that level of profitability (with lower revenue, due to the new consignment model) in 2020, which would represent another ~5% boost to overall profit. At their height, Silicon Motion was only supplying ~1% of Alibaba's total procurement of SSDs, so if Shannon does prove successful, there is plenty of room to grow,

both with Alibaba and other hyperscale data centers. In addition, Shannon has begun supplying similar enterprise-grade SSDs (in a PCIe NVME variant, not open-channel SSDs) to a few US enterprise customers on a pilot basis. We await news on Shannon and hope for its success, but it is essentially additive to the underlying thesis of our investment.

Looking Forward to 2020

After the past few years of struggles, 2020 is looking to be a bumper year for Silicon Motion. Their client SSD segment, which is by far their largest segment, is continuing its path of rapid and sustained growth. eMMC+UFS is also set to grow in 2020 for the first time in several years, with the risk of SK Hynix's transition now basically behind them. Ferri is poised for continued growth, and Shannon seems more likely than not to be perform decently in 2020, with a new derisked business model. Additional upside remains possible both from the Shannon division and from the possibility of design wins with Samsung.

Valuation

SIMO the stock had a very good year, up 47% over the year, despite some volatility along the way. Nevertheless, we continue to believe that Silicon Motion remains quite undervalued. With its strong balance sheet and highly profitable margins, Silicon Motion has an attractive business model, it has shown that it can weather industry and company-specific issues while still investing in the business and remaining profitable throughout, and it is back on the growth path, with substantial incremental upside potential from Shannon and Samsung. Final fourth quarter results have not yet been released, but using our estimates for Q4 EPS (based on preliminary results) and deducting the ~$12 per share of cash and highly-convertible-to-cash assets on the balance sheet, we estimate Silicon Motion to be selling for a P/E of 16.4. We are quite happy to own Silicon Motion at these levels, and we expect the Fund to benefit significantly from its ownership of Silicon Motion in the coming years.