Silicon Motion (SIMO)

Price (12/31/21):	$95.03	Market Cap (12/31/21):	$3.3 billion
Stock Gain (2021):	+97.4%	Portfolio Weight:	30.7%

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.

Pounding the Table

Just last quarter, we shared our thinking on Silicon Motion and why we believe it is incredibly undervalued. In short, Silicon Motion is the perfect trifecta. Highly profitable, very high growth, yet a cheap valuation. All while risk is significantly lower as competition exits the market, ceding the playing field to Silicon Motion. In every one of their major segments, eMMC, UFS, and Client SSD (which together comprise ~90% of their revenue), they are experiencing extreme growth. This growth is not temporary pandemic-based end market growth, but rather *permanent* market share gains from sticky, long-term customers with years of roadmap visibility. In 2021, despite manufacturing supply constraints, they still managed to grow their revenue more than 70%! And despite pricing pressures on the manufacturing side, they maintained gross margins and actually expanded operating margins significantly, from 20% to 27%. For 2022 and beyond, we expect continued market share growth and margin expansion, with revenue for 2022 up at least 30%−40% and further growth in the years ahead.

Since October when we shared our view on Silicon Motion, the shares have been on a tear, with the stock up around 40% in a very short time. With an ex-cash P/E that is still under 15, Silicon Motion has now moved from incredibly ridiculously cheap to just ridiculously cheap. We believe that 2022 will likely be a great year for Silicon Motion and a catalyst for the stock price re-rating. Next week, Silicon Motion will give formal guidance for the year, and between the guidance and the actual results over the year, we believe the market will begin to realize the extent and staying power of Silicon Motion's market share gains.

Reduced Competition

The key to understanding Silicon Motion's present position is to understand that the major risk that has always faced them—namely competition from in-house controller teams—has sharply diminished. Competitors are exiting the market, and manufacturers are increasingly outsourcing their controller needs to merchant controllers, specifically Silicon Motion. Over the years, we have seen Marvell exit the market for Client SSD controllers due to overwhelmingly successful competition from Silicon Motion. More recently, Kingston—which in the past exclusively used Phison controllers through a joint venture with Phison—has switched to using Silicon Motion controllers. With each passing year, Silicon Motion has won increasing design slots and market share with Kingston. And most recently, in mid-2021, Samsung decided to exit the eMMC controller market, leaving Silicon Motion as the only major supplier of eMMC controllers for this significant segment of the market, which has a long tail of growth ahead for the low-end smartphone and IoT market.

Just to illustrate what this diminishing competition does for Silicon Motion, I draw your attention to their eMMC+UFS segment. For the first half of the year, this segment grew about 50% year-over-year, quite attractive growth. In the third quarter, however, their eMMC+UFS segment more than *quadrupled* year-over-year. We believe that much, if not most, of the difference is attributable to Samsung's exiting from the eMMC controller market in the second quarter. The wonders of diminished competition!

Presentation

We recently presented on Silicon Motion at the MOI Global Best Ideas conference, which took place last week. Anyone who wishes to view our presentation, please reach out to us and we will send you a link.

Conclusion

Rarely do we see such an incredible investing opportunity as we are seeing right now in Silicon Motion. The Fund has been invested in Silicon Motion since 2014, and has reinvested several times over the years. We know Silicon Motion well, and we have never seen such a mouthwatering opportunity as presented by the events of this past year. We expect great things from Silicon Motion and we are excited for its future.

Burford Capital (BUR, BUR:LN)

Price (12/31/21):	$10.56 USD	Market Cap (12/31/21):	$2.3 billion USD
Stock Gain (2021):	+9.2%	Portfolio Weight:	24.5%

Description

Burford is a global litigation finance company, which in essence means that they fund and otherwise monetize commercial lawsuits in exchange for a portion of the proceeds received. Burford trades both on AIM (the junior London stock exchange) in Great British Pounds (GBP) and on the New York Stock Exchange in US Dollars (USD).

2021 – Back to Business as Usual

In the beginning of the pandemic, Burford sharply cut back on committing to new business. With courts shut down, much of the world in lockdown, and general uncertainty, Burford found it prudent to wait for further clarity before investing anew. Business quickly returned to usual levels. Already in the second half of 2020, new commitments reached prior levels. In 2021, they broke their records for new commitments and deployments, which constitute the leading harbinger of returns and income in the years to come.

As for their existing legal investment portfolio, timing of returns remains lumpy and unpredictable as usual, as the cases wind their way through the legal system. Their ROIC and IRR, measures of how well their investments are paying off, remain very high, actually increasing slightly over the year. Some cases, especially ones requiring jury trials, are experiencing delays due to the pandemic. This often impacts settlements as well, as the surest impetus for a settlement is often a firm trial date. Burford estimates that about 43% of their cases experienced some pandemic-related delay. Note, however, that these are only temporary delays, and often the contracts provide that Burford is compensated for delays with higher returns for Burford over time.

YPF Litigation – Trial Upcoming in 2022

The market understandably has intense interest in the Petersen vs. Argentina YPF litigation, which has the potential to return to Burford multiples of its market cap. The various pandemic-related delays surrounding discovery and depositions as well as sundry other delaying tactics used by Argentina are mostly

behind us, with the matter most likely coming to trial in the latter half of 2022. We have a good chance of seeing a ruling (or, possibly, a settlement) on the matter this year or early next year. And although the matter will be subject to appeal no matter the ruling, we do expect the stock price to react to any substantial news on the case, whether positive or negative. We do not believe the present stock price is properly accounting for the likelihood of a significant windfall for Burford, and as previously discussed, we believe that Burford is undervalued even if they entirely lose this case. We await the trial and ruling together with everyone else.

Capital Markets Day – Internal Model

In early November, Burford hosted a Capital Markets Day in New York City, where they walked analysts and investors through various aspects of the business. I attended the event and found it quite edifying. Of particular interest was the presentation given by Jon Molot, Burford's Chief Investment Officer, who unveiled for the first time Burford's internal model of future returns from their present portfolio. Since mid-2017, Burford has been modeling their cases and predicting what future returns would be, adjusting their model every quarter as cases progressed, based on various public and proprietary data sets as well as case-specific underwriting expertise. Their internal model has proven itself quite accurate over time, with the resolution of cases that were modeled and later concluded falling between 89% and 106% of their internal model's predictions each quarter. For cases that were modeled from inception and later concluded, the model projected 94% of the resolutions that ultimately came in, i.e., the internal model was actually slightly conservative.

So what does the internal model say for Burford's present portfolio? Burford revealed that from current definitive commitments, excluding YPF-related litigation and excluding future investments yet to be made, the model predicts recoveries of $3.4 billion on ultimate deployments of $1.4 billion, for a net modeled gain of $2 billion. Just to illustrate the value here with a back-of-the-napkin valuation, after subtracting the $1 billion of long-term debt that Burford owes, the ultimate net value of $2.4 billion would still exceed the present market cap of approximately $2.3 billion. And that is not counting anything from the YPF litigation, which can itself return more than the present market cap, and is also not counting any future business that Burford will continue to invest in, rather valuing Burford's present portfolio purely on a run-off basis.

Most crucially, the above calculation does not count anything for Burford's third-party fund business, a segment of the business that we believe investors are consistently undervaluing. In his presentation, Jon Molot shared that Burford models their present third-party portfolio to ultimately return performance fees to Burford, upon winding down of the present legal investments, of $360 million! We have long held that this segment has yet to show its true value, and we are happy to see Burford sharing more information to investors on this important segment. Again, this does not account for any future investments made in their third-party fund business nor any management fees from the third-party fund business, let alone future growth of the segment as they raise more third-party capital.

Conclusion

Burford continues to win cases and bring in very solid returns. They are by far the largest player in the litigation finance space, able to take on bigger investments and make bigger bets while still conservatively diversified. The possibility of a major windfall from the YPF litigation is a very sweet cherry on the top, but whatever happens with the YPF litigation, we expect continued growth and solid returns from Burford's diversified portfolio, both that owned by Burford and that managed for third parties.

Viemed Healthcare (VMD, VMD:TO)

Price (12/31/21):	$5.22 USD	Market Cap (12/31/21):	$207 million USD
Stock Loss (2021):	−28.9%	Portfolio Weight:	13.0%

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 both on the Toronto Stock Exchange in Canadian Dollars (CAD) and on the NASDAQ in US Dollars (USD).

Core Business Continues to Show Muted Growth

Although Viemed took advantage of the pandemic to provide ventilators and supplies to hospitals, substantially raising their revenue and income in 2020, nevertheless, their core business took a hit during the pandemic. With hospitals and clinics under lockdown, there was limited access for third-party providers, hurting their sales referral efforts. In 2021, their core revenue growth actually slowed down further from 2020, growing only about 12% for the year. Although 12% is decent growth in an objective sense, this is lower than their 21% core revenue growth in 2020, and it is a far cry from their pre-pandemic growth levels of 30%−40%. Much of this growth is from ancillary respiratory services (sleep apnea, oxygen, etc.), as their vent patient count is frankly poor, having grown only a little more than 5% in total over the last two years.

Viemed is cautiously projecting that they are beginning to turn the corner and return to their prior growth rates. The pause in growth is mostly a function of the pandemic and hospital lockdowns and is mostly beyond their control, but with Omicron peaking as we speak, and much milder to boot, we believe it is likely that business should begin to return to normal over 2022.

Philips Recall

There were two major events this past year specifically impacting Viemed's business. The first was Philips' recall of their popular CPAP machines due to a piece of foam that may degrade over time. Philips supplies about half of the market for CPAP machines, so this recall was quite disruptive to supply.

Nevertheless, this recall did not really affect Viemed significantly. Their main business line of vents continued to operate normally despite the recall (due the necessity of the life-saving equipment), and the vents are being upgraded in the ordinary course of maintenance. As for CPAPs, used mostly for sleep apnea patients, Viemed was able to successfully source necessary equipment from other manufacturers, due to their scale and prior relationships. As for the costs of the recall itself, Viemed has indicated that the entire cost of fixes and upgrades is being borne by Philips.

OIG Review of Viemed Medicare Claims

The second event impacting Viemed's business is of a more serious nature, but we expect this, too, to ultimately blow over without real harm. In May, the Office of Inspector General (OIG) of Health and Human Services released an audit of Viemed's 2016 and 2017 Medicare NIV (Non-Invasive Ventilator) claims. OIG selected 100 claims more or less at random and determined that 98 out of the 100 (!) were ineligible for Medicare coverage because they were "medically unnecessary". By extrapolation, they determined that Viemed should reimburse Medicare to the tune of $29 million. In line with this report, CMS indeed initiated procedures to reclaim $9 million worth of payments previously made to Viemed. (The difference between the $29 million in the OIG's report and the $9 million sought by CMS is based on the statutory four-year look-back period for which CMS can reclaim money already paid out.)

Both OIG's report and Viemed's response are matters of public record. Viemed's position is that OIG is applying made-up standards that are not in Medicare guidelines to decide what is "medically necessary", and that they are replacing the medical judgement of the doctor who examined and diagnosed the patient with that of someone who simply reviewed the medical chart a few years later. In particular, Medicare guidelines for eligibility for NIV require a diagnosis of chronic respiratory failure pursuant to COPD. The OIG reviewer, however, insisted that one needs to have specific objective criteria and tests in the medical record, which OIG then ignored even when those tests *were* in the medical record and insisted on the need for different tests instead. This is not standard clinical procedure, is nowhere in Medicare guidelines, and is not the practice of any Medicare provider. The OIG reviewer also insisted on the need to have positively ruled out the potential use of bi-PAPs as a treatment option. Bi-PAPs are not FDA-approved for use with chronic respiratory failure pursuant to COPD, are not recommended for such by the manufacturers, and would constitute off-label use if used in such situation.

Although regulatory actions can obviously be a major source of risk, we have seen this movie before with Viemed with previous Medicare audits, and we expect Viemed to ultimately prevail as they have done in each of their previous audits, most recently in the beginning of 2018. It is noteworthy to point out that 42 of the 98 claims that OIG now rejects have been previously audited by a Medicare contractor and were approved based on a review of the medical record. There are multiple layers of appeal in this process, so it may take some time, but we expect Viemed to ultimately prevail, based on their prior history and the specific facts in the report.

Concerns

We do have a few concerns we wish to highlight about Viemed. First, in our previous Portfolio Updates, we drew attention to excessive stock-based compensation and phantom share programs as an area of concern with Viemed. The issue continues to concern us, with these two programs combining to about 55% (!) of adjusted net income, an unconscionable percentage by any measure, with no sign of the issue

ameliorating over time. Ultimately, this may prove to be a sticking point for us, as we only want to be invested in companies where we can be confident that management will do right by the shareholders.

Second, we are starting to grow concerned that management may be losing their laser focus on the core of the business, non-invasive ventilation, as they chase other short- and long-term opportunities. During the pandemic, they opportunistically took advantage of their unique positioning to supply needed ventilators, equipment, and knowhow to hospitals across the country. We do not fault them for that, and they pulled in a lot of extra income for the company by doing so. That said, managing call centers for various states (which they have done and are continuing to do) seems quite a bit afield from their core competencies. In addition, over 2021 they have launched Viemed Clinical Services (which provides social workers for their patients to deal with depression and end-of-life counseling), Viemed Healthcare Staffing (to provide internal as well as external recruitment services for healthcare staff), and Engage and View remote patient monitoring. While in theory it is nice to grow revenues, we believe these various efforts which are far afield from their core competencies may be reducing focus and management attention from their main bread-and-butter NIV business. Management has also indicated that they are actively considering acquisitions, and we are nervous that management will overspend or spend unwisely to acquire competitors or tangentially related businesses.

Conclusion

We remain cautiously optimistic about Viemed's long-term growth potential and hope to see their rapid growth begin to resume as the pandemic and associated hospital lockdowns wind down over time. Nevertheless, we are seeing some areas of concern and are continuing to monitor the situation.

Lindblad Expeditions (LIND)

Price (12/31/21):	$15.60	Market Cap (12/31/21):	$930 million*
Stock Loss (2021):	−8.9%	Portfolio Weight:	0.0%

*Market cap is adjusted for potential conversion of preferred shares

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.

Lindblad Post-COVID

Starting in June, Lindblad started resuming cruise operations, building up over the summer and the rest of the year. By the end of the year, Lindblad was back in business on almost all their ships, including their two brand-new ships, the NG Endurance which was delivered in March 2020 (but which had its inaugural voyage delayed until July 2021) and the NG Resolution which was delivered in September 2021. Despite being back in business, Lindblad's revenue, income, and margins all still lag their pre-pandemic levels. This is from a combination of lower guest night availability, lower occupancy, increased costs, and lower revenue to cover the fixed costs. Some of the increased costs is from temporary expenses incurred in re-starting the ships, but we fear that a decent chunk of the increase is here to stay.

Exited Our Position

We exited our position in Lindblad at the end of the year. There were three main reasons behind our decision to exit, all of which we believe limit the potential upside of continued investment while increasing risk.

First, as we mentioned in our 2020 Portfolio Update, Lindblad raised money during the pandemic at disadvantageous terms, which gave away about 20% of the company and future upside for a relative pittance. This, of course, limits the upside we could expect to see for our position.

Second, we believe the pandemic and the resulting disinfecting, testing, and related protocols are shaping up to semi-permanently raise their costs. Even at similar revenue levels, their costs will be higher and their income reduced.

Third, we believe inflationary pressures risk raising their cost base even further. Coupled with their understandable reluctance to quickly raise already premium prices, this squeezes margins even further.

Postmortem

In our 2020 Portfolio Update, we indicated that Lindblad was a candidate for being sold by the Fund. In retrospect, we believe we should have sold Lindblad sooner, towards the beginning of the year rather than the end of the year. In the end, as risks continued to grow and we did not see substantial additional room to grow, we cut Lindblad loose. In addition, we also wanted to make room for a new position which we consider much more advantageous, a position we hope to share further information about in the coming months.