FRANK VALUE FUND

UNCONSTRAINED INVESTING IN US EQUITIES

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Frank Capital Partners LLC

Q1 19 LETTER TO SHAREHOLDERS

The Frank Value Fund Investor Class returned 1.44% in Q1 2019 compared to 13.65% for the S&P 500 TR Index. Please see the end of this letter for more performance information.

The Federal Reserve responded to public and political pressure by pausing its path of interest rate hikes and signaling an end to its balance sheet reduction in late 2019. Rather than interpret this a sign of economic weakness, investors carted out the morally hazardous "fed put," meaning asset prices can only temporarily decline before the Fed steps in and saves investors from price discovery. The last two recessions and stock market collapses in 2000 and 2008 have also been preceded by a false belief in the fed put but most participants appear to be betting their clients' portfolios that this time is different. The most important point for long-term investors is this: valuations remain at record high levels yet fundamentals like profit margins are in decline. From a historical and absolute-value perspective this remains an extremely risky time to buy most stocks.

Ride-sharing company Lyft completed its initial public offering in the first quarter, and a closer look at this company, its valuation and its competition do a better job illustrating the future low return environment than any discussion of the macro economy. I lived in New York city for nearly fifteen years, accumulating hundreds of taxi trips over that time. Professional driving has always been a fascinating job to me, and the added triumph over Manhattan's chaotic traffic makes for an interesting discussion with the drivers. I have met immigrants holding advanced degrees in science and medicine, native New Yorkers who have driven their entire adult lives, and everyone in between. The common thread is an entrepreneurial spirit. Though the drivers needed to rent a car and a taxi medallion, they were always aware of how much money they could make driving a limo, private, car, or anything else.

Thanks to clever use of smart phone GPS, inflated taxi prices, and nearly unlimited venture capital funding, Uber and Lyft have expanded at unprecedented speed. According to Lyft's IPO Prospectus, the company is already in more than 300 markets in the US and Canada and accessible to over 95% of the US population just seven years after its launch. In 2018 Lyft generated $2.1 billion in revenue and ran an operating loss of $977 million before interest and taxes. Though revenue doubled from 2017 to 2018, losses increased, as the company increased expenses like research and development at a faster pace than sales.

Underwriting banks exceeded expectations, raising the IPO price from $70 to $72. This is a market capitalization of $20.8 billion and stuffs the Lyft balance sheet with $2.7 billion of cash and no debt. Analysts, many of them employed by the same underwriting banks, are expecting 58% revenue growth in 2019 and 33% in 2020. Analysts are typically over-optimistic, yet if achieved, Lyft still trades at a very high valuation of 4.6x 2020 sales. Contrast that to Alphabet (Google) which trades at 5.2x 2019 expected sales yet has a 30% EBITDA margin where Lyft's losses make its margins negative.

According to CNBC.com, Lyft's larger competitor Uber is expected to file its IPO Prospectus this April. The expected valuation on Uber is $120 billion, roughly 5x larger than Lyft. A valuation that high would make Uber "more valuable than 3M, 21st Century Fox, Nvidia, and other established names that have been raking in profits for years.[1]" As a student of markets, when I see a high valuation, I try to understand what growth prospects participants are seeing. For many high quality companies trading at high valuations, it is easy to see their competitive advantages. Amazon has Prime and AWS which are best in their fields, Google has search, which after a week of using Bing you will come to appreciate even more, and Apple has its ecosystem and iPhone, which Android does its best to replicate yet millions and millions of users continue to be locked in to the Apple platform. What exactly are Uber and Lyft's competitive advantages?

The best I can come up with is "first mover advantage" where often, but not always, the first entrant to a new market vertical has a steep growth curve and advantage. This creates network effects, in this specific case the more drivers that work for Uber and Lyft, the faster you can get a car, plus the more users on the applications the more work for drivers. However, networks are only as valuable as they are difficult to switch from. Think switching to Google Docs from Microsoft Office, or Bing from Google, or Android from Apple. You could do it, but the benefits are low and the hassles are high. Most drivers I meet already work for both Uber and Lyft! Their entrepreneurial ways continue, checking both apps (as I do as well) for the best rides and prices. For me, I cannot tell the difference between a Lyft, Uber, or other professional driver, as they can often be the same person! Yet I can instantly tell the difference between the aforementioned tech companies' products. There is no cost to having numerous ridesharing apps on your phone. This appears to be a competitive disadvantage that will result in driving all the profits out of the industry.

Right now, as ridesharing functions on cheap capital from Silicon Valley and Wall Street, they can charge less for rides than traditional taxi companies. This is not a sustainable business model as the capital will be spent and the businesses must produce profits. Eventually, Uber and Lyft may have to raise prices, especially as they saturate the US and other markets. Driver scarcity is also a problem. Currently, both platforms charge drivers a roughly 25% commission to connect drivers with fares. Drivers can freely move to whatever service treats them best, and this has a twofold impact by increasing costs and reducing the amount of drivers on the lower-paying service. If ridesharing needs to raise prices to generate profits, users will flock to taxis or other companies, and if one platform lowers its driver fees, drivers will migrate there. Either way, as companies compete on price and commissions, it may be difficult for profits to materialize.

Will this happen right away? Absolutely not. Lyft now has $2 billion more to burn while growing revenue and benefiting from the migration from taxis to ridesharing. Does this make these companies slam-dunk short sales? No again. Silicon Valley has made the average person excited over technology, and companies talking about artificial intelligence, self-driving cars, and other breakthroughs are given lots of rope. Furniture seller Wayfair comes to mind, (NYSE: W) awarded nearly a half a billion of cash for its 2014 IPO but has yet to generate a profit. Investors giddily bid up the stock on sales growth, but dividends, share repurchases, and other shareholder rewards require profits, not sales. Both Wayfair and Lyft will only generate modest losses, able to continue to operating thanks to the cheap capital infused by their early backers and IPO investors. Long-term returns, however, are based on profits, and profits are nowhere in sight.

These new technology "unicorn" companies have been valued as if they are already profitable concerns in winner-take-all markets. Even if they end up winning, the upside at these valuations appears to be minimal. However, if capitalists compete for profits, which is how the system has worked since the beginning, and competitive advantages are weaker than the "old" technology companies, downside on several of these issues could be approaching 100%.

Thank you for your investments.
Sincerely,
Brian Frank
Frank Value Fund Lead Portfolio Manager

1 https://www.cnbc.com/2019/03/15/ubers-eye-popping-valuation-worth-more-than-nvidia-and-paypal.html

Performance as of 3/31/19	Total Return	Average Annualized Total Returns					Total Return
	6-month	1 Yr. %	3 Yr. %	5 Yr. %	10 Yr. %	Since 7/21/04 %	Since 7/21/04 %
Investor Class (FRNKX)	-1.53	-1.92	-1.03	-0.65	11.12	5.76	127.53
Class C (FNKCX)	-1.92	-2.66	-1.77	-1.38	10.37*		
Institutional Class (FNKIX)	-1.32	-1.63	-0.78	-0.39	11.37*		
S&P 500 Total Return	-1.72	9.50	13.51	10.91	15.92	8.85	247.83

* Represents an estimate based on the performance of the fund's oldest share class, adjusted for fees.

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