

## Nicoya Fund's Investment Thesis on Nicholas Financial

*This article is authored by MOI Global instructor Rimmy Malhotra, portfolio manager at Nicoya Capital, based in Menlo Park, California.*

In late August [2019] I had the opportunity to travel to Florida to meet with Doug Marohn, the company's CEO and attend the annual shareholder's meeting. I am glad I did. What was palpable when meeting Doug and the board is that all the hard work and cleanup over the last two years is finally bearing tangible results. I'll refer you to Doug's excellent shareholder letter for the details but in summary:

- The company has refinanced its credit line with a lender whose structure and terms are more amenable to the company's current posture and needs
- The company has re-centered the field offices to their former culture and strategy - which is to focus on the independent used car dealer, match on price and then use their local presence to win deals on service
- They have implemented a modernized loan servicing platform that will allow them better analytics that support the business from multiple dimensions e.g. legal, compliance, finance, and strategy
- The legacy loan book has substantially burned off and newer credit vintages are performing in line with historical metrics
- The company is finally playing offense, and recently completed its first acquisition in history
- The company initiated a one million share buyback (12% of shares outstanding)
- The board and insiders own in excess of 30% of the company and are adding to their stake at a rapid pace

In a business such as this I believe that the loan KPI's are an excellent leading indicator to future financial performance, so let's take a moment to examine an excerpt from their most recent press release.

*Table 1:*

Key Performance Indicators on Contracts Purchased  
(Purchases in thousands)

Fiscal Year /Quarter	Number of Contracts Purchased	Principal Amount Purchased	Average Amount Financed*^	Average APR*	Average Discount%*	Average Term*
<b>2020</b>	<b>3,903</b>	<b>\$ 39,158</b>	<b>\$ 10,034</b>	<b>23.5 %</b>	<b>8.1 %</b>	<b>47</b>
2	2,011	20,104	9,997	23.5 %	7.9 %	46
1	1,892	19,054	10,071	23.4 %	8.3 %	47
<b>2019</b>	<b>7,684</b>	<b>\$ 77,499</b>	<b>\$ 10,086</b>	<b>23.5 %</b>	<b>8.2 %</b>	<b>47</b>
4	2,151	21,233	9,871	23.5 %	8.0 %	46
3	1,625	16,476	10,139	23.5 %	8.1 %	47
2	1,761	17,845	10,133	23.5 %	8.4 %	47
1	2,147	21,945	10,221	23.7 %	8.3 %	48
<b>2018</b>	<b>9,767</b>	<b>\$ 109,575</b>	<b>\$ 11,219</b>	<b>22.4 %</b>	<b>7.4 %</b>	<b>54</b>
4	2,814	29,254	10,396	23.3 %	7.9 %	50
3	2,365	27,378	11,577	21.7 %	6.9 %	54
2	2,239	25,782	11,515	22.0 %	7.3 %	55
1	2,349	27,161	11,563	22.3 %	7.6 %	55

Table II:

	Three months ended September 30,		Six months ended September 30,	
	2019	2018	2019	2018
Revenue:				
Interest and fee income on finance receivables	\$ 15,585	\$ 19,404	\$ 32,226	\$ 38,163
Expenses:				
Operating expenses	8,927	7,966	17,898	16,767
Provision for credit losses	4,000	8,374	8,385	13,801
Interest expense	2,298	2,386	4,786	4,926
Total expenses	15,225	18,726	31,069	35,494
Income before income taxes	360	678	1,157	2,669
Income tax expense	92	96	298	669
Net income	\$ 268	\$ 582	\$ 859	\$ 2,000
Earnings per share:				
Basic	\$ 0.03	\$ 0.07	\$ 0.11	\$ 0.25
Diluted	\$ 0.03	\$ 0.07	\$ 0.11	\$ 0.25

Table I illustrates key loan origination KPI's since Doug's return. Across every metric Doug has dramatically increased the *quality* of loan originations by decreasing size and term, while at the same time increasing rate and dealer discount. These loans will return the principal outlay quicker thus reducing the company's risk. What you don't see in these numeric KPI's are the qualitative factors behind these borrowers. These loans are made to vetted borrowers who are looking to finance basic transportation to and from work. This means the borrower has documented income, is financing a much more modest car and needs that car to provide for themselves. I could bore you with the loss curves by vintage demonstrating post and pre-Doug's reign but rest assured Doug has returned Nicholas to its underwriting roots, and we are seeing that in a dramatic reduction in credit losses as evidenced in Table II above. Credit reserves as a percentage of outstanding receivable have dropped 40%, and we see an acceleration of this metric. We believe that the legacy portfolio which continues to burden the financial statements will be completely eliminated by June of 2020 allowing investors see that the new "Nicholas" is an earnings story.

I am convinced that the foundations of the operational turnaround are firmly in place, the capital structure is stable and incentives all-around are completely aligned. The company is

finally growing volumes albeit modestly. When loan volumes do increase, we see a clear path to \$2.50+ of EPS using modest assumptions. Assigning any reasonable multiple to this earnings stream leads to a stock price *three times* the current. Finally, with the stock trading at 65% of liquidation value and with very modest leverage, the downside is extremely well covered. It's been a long road, but Nicholas Financial represents a compelling company that we're excited to be owners of.

*Important Notes: This report is being furnished by Nicoya Capital LLC ("Nicoya") on a confidential basis and does not constitute an offer, solicitation or recommendation to sell or an offer to buy any securities, investment products or investment advisory services. This report is being provided to existing limited partners for informational purposes only, and may not be disseminated, communicated or otherwise disclosed by the recipient to any third party without the prior written consent of Nicoya. An investment in the Fund ("Fund") involves a significant degree of risk, and there can be no assurance that its investment objectives will be achieved or that its investments will be profitable. Certain of the performance information presented in this report are unaudited estimates based upon the information available to Nicoya as of the date hereof, and are subject to subsequent revision as a result of the Fund's audit. The performance results of Fund include the reinvestment of dividends and other earnings. Past performance is not necessarily a reliable indicator of future performance of Fund. An investment in Fund is subject to a wide variety of risks and considerations as detailed in the confidential memorandum of Fund. References to the S&P 500, NASDAQ Composite and other indices herein are for informational and general comparative purposes only. There are significant differences between such indices and the investment program of Fund. The Fund does not invest in all or necessarily any significant portion of the securities, industries or strategies represented by such indices. References to indices do not suggest that Fund will or is likely to achieve returns, volatility or other results similar to such indices. This presentation and the accompanying discussion include forward-looking statements. All statements that are not historical facts are forward-looking statements, including any statements that relate to future market conditions, results, operations, strategies or other future conditions or developments and any statements regarding objectives, opportunities, positioning or prospects. Forward-looking statements are necessarily based upon speculation, expectations, estimates and assumptions that are inherently unreliable and subject to significant business, economic and competitive uncertainties and contingencies. Forward-looking statements are not a promise or guaranty about future events. The information in this presentation is not intended to provide, and should not be relied upon for, accounting, legal, or tax advice or investment recommendations. Each recipient should consult its own tax, legal, accounting, financial, or other advisors about the issues discussed herein. The table above shows the performance of the Nicoya Fund LLC for various periods since the inception of the Fund on February 25, 2008. All Nicoya figures include the reinvestment of dividends. The Net Return includes the impact of the standard management fees and expenses, but does not include incentive-based fees. Monthly and year-to-date figures are estimates and un-audited. Inception to date figures incorporate audited results from prior years and un-audited results from the current year. Results prior to July 2012 incorporate returns of the GRVLX mutual fund, the predecessor vehicle to the Fund, managed by the principals of Nicoya Capital. See the section entitled "Important Notes" at the end of this letter for more information.*