COMMENTARY

March 23, 2018

Dear clients and colleagues,

With the persistence of relatively low interest rates, the hunt for return continues. Public markets remain accepting of high forward price-to-earnings ratio concept stories, which is creating market exuberance, as noted in our February 9th weekly. The Russell 2000 Index has beaten its value sibling, the Russell 2000 Value Index, consistently over the last 5 years. The typical 1% spread in returns between the two indexes reached 7% in 2017. We remain diligent in our estimates of future commercial markets and continue to evaluate capital progression in early-stage sectors and companies.

We recently attended the Roth Capital Conference, a leading forward-thinking conference for small cap investors. The opening event panel was on blockchain and cryptocurrency. The moderator was an 18-year-old with a promising career in front of him, and was selected to lead the discussion for his ability to interact with the 30-year-old tech entrepreneurs on the panel. The age of the panel members is noteworthy: most would have been merely observers to the 2008 financial crisis.

Why do we mention the 2008 financial crisis? In 2008 world economies came close to collapse because we misunderstood real estate securitization. If you think real estate is hard to value, blockchain technology vows to securitize anything that can hold value for more than a weekend. Blockchain entrepreneurs are feverishly dreaming up exchangeable tokens in all sectors of the economy. These tokens represent the transformation of an asset into an easily exchangeable security, thus securitization. It certainly feels a bit like the internet domain "land grab" of the 1990s. However, as with the internet, blockchain technology is real. Fortune 500 companies are starting to embrace the technology, using it internally in an attempt to increase efficiencies in the workplace. We will continue to look for investable opportunities as the technology evolves. However, our exposure to this sector will most likely be via investment in an established company leveraging blockchain technology.

With market exuberance comes the potential for entrepreneurship vanity (or the self-fulfilling prophecy concept) where capital expenditures can provide risk-adjusted returns but not before large investments and outlandish valuations are made.

Market exuberance also brings a higher impact risk of fraud (or the self-survival concept) where insecure corporate managers will go to any lengths to succeed, or simply for self-preservation. At one end of the spectrum there is valuation fraud, which is legal but still fraudulent to investors. Valuation fraud includes overstatement of addressable markets, drilling exploration holes right next to an existing hole, conducting a clinical trial with a good outcome but no real new findings, as well as an entire array of accounting shenanigans, just to name a few. At the other end of the spectrum there are the illegal efforts, as shown in the Matthew McConaughey movie Gold, a parody of the Bre-X scandal where gold dust was peppered in samples.

Following the Bre-X disaster, Canadian regulators recognized there was a lack of scrutiny in mining exploration, and they instituted requirements for greater independence of external consultants. Outsourcing to independent consultants diminishes the risk of foul play. Independence and outsourcing relationships are

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topics that are regularly investigated during our due diligence of companies. Outsourcing also remains a key thematic at Global Alpha.

Another example is biotechnology company Theranos Inc. Recently, the SEC declared Theranos a massive fraud. Similar to Bre-X, the fraud took place at the R&D level. The only way to significantly attempt to prevent these cases is to run 100% outsourced and independent R&D or exploration programs.

You would think that the very public collapse of Theranos, which began in late 2015, would have cooled investment in biotechnology firms. Far from it—private biotechnology firms raised nearly $9 billion last year (a record) and raised approximately $3 billion in the first two months of 2018, according to data from Pitchbook, which tracks such deals. US small cap managers also had to deal with a much riskier environment in 2017. The four largest biotech companies in the Russell 2000 contributed to 13% of the index's 14.7% return.

The Theranos case supports the outsourcing thematic, adding independence to other outsourcing benefits such as scale and efficiency. Global Alpha is exposed to R&D outsourcing in biotechnology through its investment in German-based Evotec A.G.

Evotec A.G. (EVT:GR, € 15.2)

Evotec is a biotechnology research outsourcing company with key assets in novel drugs. The services it provides range from target identification to small batch productions. The company's business model is to provide scientific expertise via yearly or project-based contracts or by taking royalty-bearing stakes in novel compounds. The company operates five research facilities.

The Evotec story is unique in that it acquired multiple R&D facilities from leading pharmaceutical companies Sanofi, AstraZeneca and Eli Lilly. The purchase of the facilities came with long-term working arrangements with these large companies. The merger of operations also offers cost synergies as specialties are centralized resulting in volume efficiencies.

The company is participating in the development of new drugs, gaining royalties as well as future milestone payments from big pharmaceuticals in excess of $2B. In addition, Evotec is a global leader in stem cell production for both research and therapeutic use, optimizing new clinical models, driving down the cost of developing new drugs and performing important high-value work in therapeutic pancreatic stem cell applications.

Hence, we are exposed to a leading contract research organization in an industry driven by strong outsourcing trends. As well, we are participating in key transformative stem cell technology and a diversified drug pipeline.

Have a great weekend.

The Global Alpha Team

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