Kopion Asset Management

400 W. Louisiana St.
McKinney, TX 75069

214.425.7027

On The Road Again

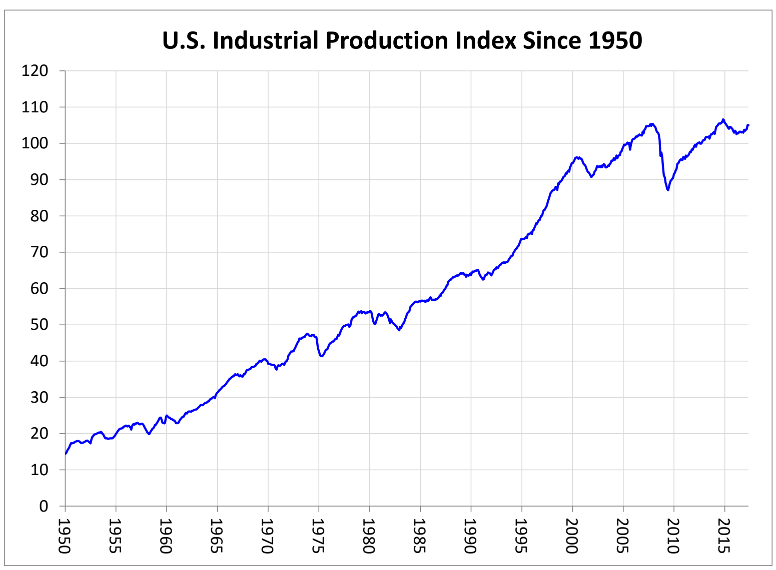
Thursday, July 13, 2017

Dear Kopion Clients,

Our portfolio continued to recover during the first half of 2017, returning 5.8% before fees (5.3% after fees). The S&P 500 and the Russell 2000 returned 9.3% and 5.0%, respectively. While our overall portfolio continued to advance, the returns of our individual stocks varied dramatically as some performed quite well while a few endured renewed setbacks. That combination usually provides an opportunity to add to beaten-down positions, but the setbacks in the first half occurred among stocks that I had already methodically added to from late 2014 to late 2016. In order to manage the risk of the portfolio, I thus concluded that it would be best to be content with the shares that I had already accumulated in that group. This led to an incredibly quiet first half from a trading perspective.

Budding Optimism

In order to understand the current state of our portfolio, it is helpful to remember the magnitude and especially the duration of the economic downturn that followed the 2008 financial crisis. This can be captured through a number of metrics, but I have chosen to use a relatively straightforward one: U.S. Industrial Production. As shown in the chart on the right, Industrial Production's decline after the financial crisis was not only deeper than all of the other declines over the last 67 years, but its recovery has also taken much, much longer. I'd also point out that while the press sometimes claims that the economic expansion has continued unabated since 2009, the industrial economy suffered a significant malaise from late 2014 through early 2016. Indeed, this most recent dip was almost as deep as the one during the



early 1990's recession. The chart above covers a long period of time, which can make it harder to appreciate the protracted and, at times, begrudging nature of the latest recovery. By this particular measure, however, the economy has taken ten years to regain its prior peak. I need to emphasize this point: the recovery has taken so long and been so gradual that after a decade, we are just now returning to 2007's level. This makes the present expansion very different from prior ones, in which Industrial Production increased well above its prior peaks.

A major theme during much of the last ten years has been "uncertainty," which became a frequent refrain in corporate earnings reports and news articles. I believe that the consequences of this uncertainty have been underappreciated. Businesses and households make decisions such as whether to hire new workers or buy a new car, and those decisions lead to economic growth. Faced with so many unknowns after the financial crisis, however, decision-making slowed dramatically. I believe that this greatly contributed to the slow-motion nature of the recovery.

About six months ago, this tone began to change and give way to some budding optimism. This shift has been reflected in economic indicators and the accelerating financial results of many of our companies. These improvements are still somewhat preliminary, but they seem likely to continue for a variety of reasons. For example, the dramatic strengthening of the U.S. Dollar from late 2014 through 2016 created a major headwind for many of our companies. Over the last six months, however, the Dollar has shown fairly convincing signs of stabilizing, and this should remove most of this rain cloud from the affected firms. (Hallelujah!) In addition, many businesses selectively reduced their cost structures throughout the recovery, which should conceptually make the present expansion more durable.

With that as a backdrop, I'd like to transition to discuss two themes that I have observed across our portfolio, both of which relate to the economic context that I've just described. These themes are:

1) Higher Incremental Operating Margins
2) Accelerating Product Adoption

HIGHER INCREMENTAL OPERATING MARGINS

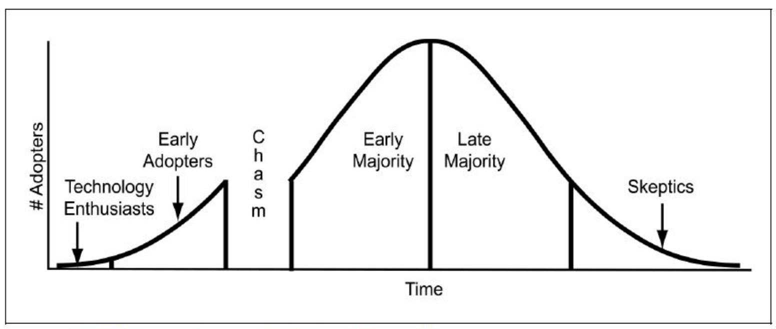
After the financial crisis, several of our companies began to focus on a metric that was seldom, if ever, discussed previously: Incremental Operating Margin. This is a measure of a business' scalability, or how quickly its profits grow compared to its revenues. Early in the recovery, I spoke with the CFO at one of our companies who expressed disappointment at how inefficiently his company had scaled during the mid-2000's. This was due to a range of operational redundancies and inconsistencies that had built up over the years, which encumbered the firm and effectively required it to hire extra staff as it grew. During the recession, they thus embarked on a range of structural changes that were designed to let them eventually grow revenues while holding headcount relatively flat. This management team was increasing is business' future Incremental Operating Margin.

Critically, these types of changes are arduous, multi-year projects that involve significant analysis, planning and operational heavy-lifting. They are the corporate equivalent of an expansive home remodeling project. In most historic recessions, demand recovered relatively quickly, which limited the time available for these types of changes. In addition, businesses in the past had a smaller set of tools available for making these types of improvements. After the financial crisis, however, most companies believed that they needed to adapt to a "new normal." The most proactive ones seized upon various opportunities to reshape their businesses, and the gradual nature of the recovery provided ample time to make these changes. Indeed, some of our companies just kept going with this process and have now undergone multiple iterations of improvement.

For the most part, we are still waiting to see the full benefit of higher Incremental Operating Margins at our companies. In some cases, management teams chose to invest their would-be-savings into growth areas, such as expanding their salesforces or increasing R&D. In other cases, the strengthening of the U.S. Dollar and the industrial economy's weakness in 2015 and 2016 constrained revenues, which masked the benefits of higher Incremental Operating Margins. At this point, however, revenue growth seems likely to improve, and when paired with these more efficient cost structures, this should lead to excellent profit growth.

ACCELERATING PRODUCT ADOPTION

In recent quarters, I have also been encouraged by signs that some of our companies' products are beginning to get more traction in the market. The diagram on the right illustrates a classic business framework called the "Technology Adoption Lifecycle," which describes the general process by which new technologies become accepted in the marketplace.[1] The key insight of this framework is that Early Adopters are more resourceful and less pragmatic than the mainstream users who represent most of the potential market. Consequently, in order to cross the "Chasm" and move into the mainstream, new technologies have to improve in a host of ways that make them more accessible to the Majority. In the real world, this involves a number of nuances that I will not address here, but suffice it to say that a number of our companies are showing signs that the adoption of their products is beginning to accelerate. In a handful of cases, it even appears that they might be nearing the other side of the Chasm. This is encouraging, especially within the context of recent economic improvements, which could advance this trend. Lastly, I'd note that a few of



The Technology Adoption Lifecycle

[1] This framework was first published in 1962 in <u>The Diffusion of Innovations</u> by Everett M. Rodgers. The version shown above is a variant of Rodger's concept and was first published in 1991 in <u>Crossing the Chasm</u> by Geoffrey A. Moore.

our companies are poised to benefit from both faster adoption and higher Incremental Operating Margins.

CONCLUSION

The two trends that I have just discussed have been in the works for years, but our companies' progress down these paths was slowed dramatically in 2015 and 2016. Recent results, however, suggest that most of our companies are on the road again, and I am eager to see how these two themes will develop in the quarters and years ahead.

Thank you for your continued trust and support.

Best regards,

Terry Ledbetter, Jr., CFA

PERFORMANCE DISCLOSURES

Period	Kopion, Gross	Kopion, Net Max Fee	S&P 500	Russell 2000
1st Half of 2017	5.8%	5.1%	9.3%	5.0%
Annualized*				
1 Year	11.5%	10.1%	12.0%	21.3%
3 Years	-5.7%	-6.9%	8.9%	6.7%
5 Years	10.3%	8.9%	14.7%	14.5%
Since Inception†	13.5%	12.1%	13.6%	13.8%

Period	T Ledbetter, Gross	T Ledbetter, Net Max Fee	S&P 500	Russell 2000
1st Half of 2017	5.8%	5.1%	9.3%	5.0%
Annualized*				
1 Year	11.5%	10.1%	12.0%	21.3%
3 Years	-5.7%	-6.9%	8.9%	6.7%
5 Years	10.3%	8.9%	14.7%	14.5%
10 Years	8.8%	7.5%	6.9%	7.1%

*Ending 12-31-16
†Since 8-23-09

Past performance does not guarantee future results. Investments with Kopion may lose value.

Terry Ledbetter, Jr. began managing his first diversified investment account on 2-4-04 while employed by Friedberg Investment Management (FIM). Mr. Ledbetter left FIM on 7-31-09 and founded Kopion Asset Management, LLC (Kopion), which became a legal entity on 8-24-09. Importantly, when Mr. Ledbetter founded Kopion, he continued to manage the same accounts that he had been managing while employed by FIM. The accounts, investment strategy, and investment process all remained the same. The performance information cited throughout Kopion's marketing materials includes all of the diversified investment accounts managed directly by Mr. Ledbetter since 2-4-04, which is when he began managing his first diversified investment account. This information is provided for both Mr. Ledbetter's entire performance history as well as for the portion of Mr. Ledbetter's performance history that occurred after Kopion was founded and became a legal entity.

The performance information cited throughout Kopion's marketing materials has been thoroughly documented, and it has been calculated using normal industry protocols, which are described in more detail below. This information has not, however, been audited by an independent third party. Dividend and interest income in these accounts was reinvested. Returns for these accounts have been asset-weighted to calculate historical returns. Said another way, the accounts were aggregated into a single group and then performance was calculated for that single group. This group includes some sub-accounts and securities that were carved out of larger accounts in order to exclude assets like mutual funds that Mr. Ledbetter did not manage directly. Those mutual funds were managed by professionals at third party firms, and Mr. Ledbetter's involvement was limited to being a passive shareholder of those mutual funds. In addition, some of those mutual funds followed fixed income strategies, which were very different from the strategy used by Mr. Ledbetter when he was employed by FIM and later at Kopion.

Performance information that includes assets like mutual funds that were not managed directly is available, and Kopion will provide it promptly upon request.

Kopion reports its Time Weighted Returns (TWRs). TWRs make adjustments for deposits and withdrawals so that those transactions do not influence performance results. Consequently, deposits do not increase the return, and withdrawals do not decrease the return. TWRs thus allow for performance comparisons between Kopion's (and Mr. Ledbetter's) history and market indices.

Kopion reports both "gross returns" (which are returns before Kopion's management fee) and "net returns" (which are returns after deducting Kopion's management fee). Kopion's management fee schedule is graduated, which means that the fee rate begins to decrease after an account's dollar value exceeds a certain threshold. The label "Net $_{\text{Max Fee}}$" indicates that the net returns being presented reflect Kopion's maximum fee rate for all periods presented. The words "net" or "after fees" without the words "Max Fee" in subscript lettering indicates that the net returns being discussed reflects actual fees.

Kopion has provided the returns of the S&P 500 and the Russell 2000 indices in order to provide the broader stock market context of Kopion's (and Mr. Ledbetter's) returns. The S&P 500 tracks the performance of relatively large publicly traded companies, and the Russell 2000 tracks the performance of relatively small ones. Kopion does not "benchmark" its portfolio against indices in the traditional sense of carefully managing the portfolio for comparison against a specific index. Instead, these two indices are used as broad indicators of the stock market's performance. Mr. Ledbetter has primarily focused on small and medium sized firms, but he has also invested in some large companies as well. This is why Kopion has provided the results of both the S&P 500 and Russell 2000. These indices cannot be invested in directly, but mutual funds and exchange-traded funds that track these indices ("index funds") are available in the market. Kopion's (and Mr. Ledbetter's) investment strategy carries more risk than investing in an index fund that tracks either the S&P 500 or the Russell 2000. This is primarily because Kopion's (and Mr. Ledbetter's) strategy involves investing in a relatively small number of stocks and those stocks are primarily for small to medium sized companies. This approach results in greater volatility and greater risk of capital loss than index funds tracking either the S&P 500 or the Russell 2000.

Indices' performance figures have been obtained from sources believed to be reliable.