April 7, 2022

Quarterly Report - Kalo Capital Management, LP

Net Performance	Jan'22	Feb'22	Mar'22	YTD 2022	Trailing 2 Year (Apr'20-Mar'22)
Kalo Capital Management, LP	(3.7%)	1.9%	(5.8%)	(7.5%)	29.7%
Russell 2000 (IWM)	(9.5%)	1.0%	1.2%	(7.5%)	83.3%
S&P 500 (SPY)	(5.3%)	(3.0%)	3.8%	(4.6%)	80.4%
Small Cap Momentum ETF (DWAS)	(11.7%)	3.8%	2.7%	(5.9%)	108.8%
Gross Alpha Performance	(0.8%)	2.3%	(6.2%)	(4.9%)	15.4%
Gross Beta Performance	(2.7%)	(0.2%)	0.6%	(2.4%)	25.7%

Performance

In the first quarter, Kalo lost 7.5% net versus a 7.5% loss for the Russell 2000. The stock markets sold off broadly this quarter before bouncing back strongly in the last two weeks of the quarter. The Russell 2000 was down 14% for the year on March 14, before rebounding. Through most of the first quarter, our performance held up as the broader market sold off. However, in the most recent two weeks, investors urgently pushed into more liquid stocks, shunning microcap stocks. We believe this was instigated by Ukraine war fears which led to a quick rebound in the broader market, focused specifically on larger cap/liquid stocks.

We had over 1400 bps of performance from our shorts though mid-March, matching the losses in our long positions. But in the final two weeks of the quarter, our shorts rallied and gave back about ½ their gains, while our longs languished amidst the recent stock flight to liquidity. In addition, we had one stock-specific negative event with a company that had a surprisingly poor update as its business has materially slowed due to the extreme tightness in shipping and oil & gas industries.

Outlook

Concerns about the economy have reached new heights. Rampant inflation, sparked by the covid lockdowns and exacerbated by increased demand due to government stimulus, continued to intensify this quarter. Shipping/supply chain issues were worsened by the Ukraine war and Russian sanctions added fuel to the inflation fire. The Fed has made clear that their primary mandate is reigning in inflation. It has signaled several interest rate increases though 2022 and will soon be ending its bond purchases. This initially led to a broad sell-off across markets, until bouncing back strong in the last two weeks. We believe this bounce is likely more of a bear-market rally, and remain concerned that the market is due for further losses going forward.

Macro concerns continue to hinder momentum in microcap stocks. Investors seem to only be interested in a stock if it is liquid, so they can sell quickly if the market starts falling again. This has contributed to excessive sell-offs in smaller and less-followed stocks and has created exaggerated risk-reward opportunities. We continue to look to improve the quality of the long portfolio by shifting capital and adjusting position sizing into higher quality names as we continue to find new ideas. As a reminder, we focus on companies penetrating a market and cumulatively building the earnings power of its business. At some point when investors re-engage with microcap names, we expect these stocks to materially increase. As we discussed last quarter, I believe that interest in underfollowed/smaller companies will return in 2022.

Last quarter we discussed how large-cap stocks were due for a pullback and sported excessive valuations. This started to play out though most of Q1 before bouncing back strongly in the past two weeks. We still feel these stocks are excessively valued and will return to a downward trajectory. Benefitting from indiscriminate buying due to their stock liquidity, these stocks are inflated, especially considering the abundant macro risks that currently exist.

In tune with our market view, our exposure is currently 102% long / 59% short, for 43% net exposure.

Investment Spotlight: Fathom (FTHM)

Fathom Holdings is a fast-growing, low-cost residential real estate brokerage disrupting the industry through a differentiated commission model and attached mortgage, title, and insurance businesses. Fathom allows agents to keep 100% of the commission from a real estate sale and receives a flat $500 transaction fee per sale versus traditional brokerages which take a 20-30% cut of commissions. Agents are highly attracted to this model for a simple reason – they make more money. Assuming a 3% buyer-side commission on a $350,000 home, a Fathom agent will keep $10,000 in commissions versus only $7,350 for an agent with a traditional broker 70/30 commission split. This innovative model has allowed Fathom to grow agent count at a 44% CAGR since 2018, while enabling a low agent acquisition cost (they break even on the first sale) and benefiting from agent retention rates twice that of the industry.

In the last couple of years, Fathom has acquired a residential mortgage lender, a title insurance provider, and a home insurance agency in an effort to attach these services to home sales, boosting the profits generated with each transaction. We do not believe the market reflects the operating leverage that these ancillary services will generate. For perspective, the brokerage business generally does 2% operating margins while the above services operate with 17-70% operating margins assuming a 10% attach rate. Assuming 100,000 transactions per year and 10% attach rates for each service, management expects the company to generate $40M+ in EBITDA. Based on current trends and our research, we believe the $40M EBITDA target is an extremely conservative number from an equally conservative management team that historically underpromises and overdelivers. Fathom is already seeing 5-6% mortgage attach rates within six months of launching a local market, while attach rates for Title have steadily grown from 19% in 1Q21 to 39% in 4Q21. Meanwhile, more established competitors such as Compass are seeing > 40% title attach rates and believe they can get to 35% mortgage attach rates, so a 10% Fathom attach rate seems to be a low bar to hurdle. Using these modest assumptions, the shares trade at ~4x EBITDA.

We strongly believe its attractive economics and viral growth will spur significant agent growth for years to come (they have 8,000 agents growing at a 50% rate, out of 2 million in US), regardless of whether there is a housing downturn (in fact, a housing downturn could accelerate the agent growth as they become more frugal). Furthermore, since Fathom earns the same $500 transaction fee regardless of the sale price of the home, Fathom's economics are not hurt by decreasing housing prices. While they may have less transactions in a down housing market, the gain in agent market share and increased attach rates should more than offset any decrease in transactions, giving us confidence that the company will continue to recruit agents while improving ancillary service attach rates, and therefore profitability, in any housing market scenario. Lastly, unlike competitors that burn cash and spend heavily to recruit agents, Fathom has a very lean asset-light cost structure with limited overhead.

Despite this exciting penetration story with significant operating leverage, the stock is down ~70% in the last 12 months and trading at near its lows. Like many other microcap stocks, we believe

Fathom is getting pulled down due to the stock's low liquidity and small market cap. We see the stock at multiples of the current share price using reasonable multiples on earnings power in a couple of years. We are also encouraged by the highly incentivized management team which owns over half of the company, the recent stock buyback announcement, and conservative guidance setting the company to overdeliver on expectations.

Conclusion

The market has clearly shifted towards stock liquidity and away from smaller cap, less liquid names. While this shift has been painful over the last few quarters, we believe it has created the setup for significant alpha generation in the future. While the broad market has significantly bounced in the last couple weeks, we believe it is starting to stall. Combined with the setup in the microcap space being significantly out-of-favor with depressed valuations, we feel it is an excellent combination to generate strong alpha in 2022 for the Kalo strategy. We appreciate your confidence in us. Wishing you, your family, and your business health and happiness in 2022.

Sincerely,

Steven D. Friedman, CFA
Founder and Portfolio Manager

Please note that Kalo's expectations and strategy can change regularly and the views expressed here may change.

LEGAL DISCLAIMER

This document is intended for information purposes only. It is not an invitation or offer to purchase interests in any Fund. Any representation to the contrary is not permitted. This commentary does not constitute an offer to sell or a solicitation of an offer to buy securities and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.

Any views presented on individual stocks or other financial instruments are intended for informational purposes only. Kalo Capital Management ("Kalo") undertakes no obligation to correct, update, or revise the views presented or to otherwise provide any additional materials. Kalo may hold a position in any companies discussed and may change its views about or investment position at any time. Kalo disclaims any obligation to notify the market of any such changes. Views may include forward-looking statements, estimates, projections, and opinions, which may prove to be substantially inaccurate and are inherently subject to significant risks and uncertainties beyond Kalo's control. Although Kalo believes its views presented here are substantially accurate in all material respects, Kalo makes no representation or warranty, express or implied, as to the accuracy or completeness, and Kalo expressly disclaims any liability (or any inaccuracies or omissions therein). Potential investors and others should conduct their own independent investigation and analysis of any views and of the companies mentioned.

Performance and other quantified metrics shown here are estimates. Actual investor returns will differ. Past performance is not necessarily indicative of future results.

Any Fund or investment involves risk. Potential investors must familiarize themselves with the offering materials related to such investment and must meet certain investment sophistication levels in order to make such investments and must be able to fully absorb the risk associated with such investments. The Offering Memorandum for the Fund and related Subscription Agreement and Limited Partnership Agreement will be made available to those who demonstrate the capacity to evaluate the risks and merits of this investment.

The past performance of any Fund or investment discussed herein is no indication of future results that may be achieved by an investment in the Fund. The Benchmark indices presented in these materials may or may not hold substantially similar securities to those held by the funds referred to herein, and thus, little correlation may exist between the Funds' historic return and those such indices and there is no guarantee that any correlation which may have existed will continue to do so in the future.