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The Global Value strategy returned 3.51% gross (3.22% net) for Q2 2017. As always, our factsheet lists the major contributors and detractors for the quarter. In this letter, I will delve into the thesis behind our investment in the Fonar Corporation, an MRI manufacturer and service provider. Our investment in the company has returned 34.1% since initiating a position on 1/6/2017. To summarize our thesis in short, we believe that Fonar's declining device manufacturing business is hiding a healthy and growing medical diagnostic center business and overall the stock is trading at an attractive valuation.

History of the Fonar Corporation

Fonar was founded in 1978 by Dr. Raymond Damadian, the inventor of magnetic resonance scanning. MRI has been one of the most significant medical developments of the 20th century, creating vast new diagnostic and investigative abilities and almost single-handily eliminating exploratory surgeries.

A passage from a history of MRI's development, [The Pioneers of NMR and Magnetic Resonance in Medicine](#),¹:

NMR scanning resulted from two essential steps. They were taken by the two great MRI pioneers of this volume, Dr Raymond Damadian and Dr Paul Lauterbur. Dr Damadian provided the first step, the discovery of tissue NMR signal differences from which the image is made and the first concept of an NMR body scanner that would utilize these signal differences to detect disease in the human body. Dr Lauterbur provided the next step of visualizing these signal differences as an image and supplied the first method for acquiring these signals at practical speeds. It does not seem likely that MRI could have come to pass without the key steps contributed by both scientists. Without Damadian's discovery, it could not be known that serious diseases like cancer could be detected by an NMR scanner or that tissue NMR signals possessed sufficient contrast to create medically useful images.

Despite Raymond Damadian being the initial discoverer of nuclear magnetic resonance signal differences between different biological tissues, the 2003 Nobel Prize in Physiology or Medicine was solely awarded to Paul Lauterbur and Peter Mansfield. In my opinion, this was a snub by the Nobel committee who excluded Damadian from the prize for political reasons. MRI would never have been developed when it was without Damadian's contributions and observations.

¹ Mattson, J. and Simon, M., *The Pioneers of NMR and Magnetic Resonance in Medicine: The Story of MRI*, Bar-Ilan University Press, Jericho, New York, 1996. Passage from pg. 729

Fonar's patents on MRI technology have been successfully defended in several high profile infringement cases including a major one in 1997 against GE with a \$129.6 million judgement.

Fonar's Technology

While our investment thesis in Fonar is based on their physician management and diagnostic services segment rather than their equipment sales, it will be instructive to take a look at their product lines. Fonar's technology is differentiated from most of their competition in that Fonar's MRI devices are standup MRI scanners as opposed to the recumbent scanners which are standard for the industry.



Fonar Upright® Multi-Position™ MRI



Recumbent MRI, GE Signa HDxt 1.5T MRI

Spine imaging is one of the most common uses of MRI making up approximately 45% of all use cases (According to the company, Fonar is closer to 60% at their centers). For imaging the spine, a standup MRI like that produced by Fonar allows for the imaging of the spine in a natural weight-bearing modality. Attempts to image the weight-bearing spine phenomena using a recumbent MRI require the use of spring-compression onto the head to create an imperfect simulacrum of gravity, and this method never gained popularity. For imaging of spinal fluid flow in the head and neck, a standup MRI would also reveal information that may not be visible during a recumbent positioning. Fonar is very interested in further researching cerebral spinal fluid (CSF) flow as they believe that obstructions of CSF flow may be a major contributor to certain neurological disorders.

Fonar's scanners can be useful for people with spine curvature preventing them from lying down or for the severely obese. Standup MRI can also benefit the claustrophobic.

Downside to Fonar product vs high-field strength competition

The current greatest downside that Fonar's products have is that their current models use lower field strength than what is being used by other MRI manufacturers. Fonar scanners are at 0.6 Tesla, while competitors are at 1.5-3.0 Tesla. MRI field strength is important as it gives a higher resolution to the images, essentially allowing more image "slices" per tissue length. This weakness could be resolved if Fonar comes out with higher field strength models.

Esaote SpA: Competitor also manufacturing upright MRIs

Fonar also has new competition in the form of Italian competitor Esaote. Esaote is focused on making dedicated MRIs (MRI devices specialized in scanning a certain body part) and has a standup MRI model. While their field strength is even lower than Fonar's, Esaote's G-Scan upright MRI is manufactured and sold for a fraction of the cost of a Fonar device.

It is possible that Esaote will follow a classic disruption model trajectory and continue improving their products to achieve lower costs and superior image quality. Esaote currently has approximately 3500 MRIs in service in comparison to the 100-200 Fonar models currently in use, though most of Esaote's scanners are not upright MRIs.

Blue Tower has spoken with medical centers that have experienced using both Fonar and Esaote products and the preference for these centers was for Esaote's G-Scan.

Intellectual Property Situation

Fonar has unique scanning modalities in their probes. They have patent protection for some of their upright MRI technology. The patents that the management perceives as being most important to their competitive position will expire in 5-10 years.

Recent Developments of the Company

After the 2008 global financial crisis, Fonar made a pivot from being purely a medical device company towards being a diagnostic center operator. The events that precipitated this were that the capital equipment leasing companies that capitalized their customers stopped making loans during the liquidity crunch. Unlike their much larger competitors, Fonar lacked the financial assets to finance the purchases of their customers. Fonar would have customers interested in purchasing a machine from them who would then be unable to find the financing necessary. This made the company accelerate a strategy of operating their own diagnostic centers and selling the scans to patients directly (although the company had started managing their own MRI centers in the 1990s).

Growth Strategy & HMCA

Over the last few years, the company has pivoted towards operating their own diagnostic centers. They have grown from 9 centers in 2011 to 25 centers in 2016. In 2016, sales of MRI scanners made up only 1.1% of revenue while diagnostic centers provided 85.3% of revenues. The wholly-owned subsidiary by which Fonar operates its physician management and diagnostic services segment is the Health Management Corporations of America (HMCA) in Melville, NY. The centers collectively possess 24 Fonar scanners and 9 recumbent MRI scanners.

The ownership structure of the various diagnostic centers is fairly complicated, but the main subsidiary of HMCA is the Health Diagnostics Management, LLC (HDM) which is publicly doing business as HMCA. The reason for this structure was to help Fonar raise capital from investors for the acquisition of various independent diagnostic centers. Fonar has been using its free cash flow from operations to purchase additional ownership interests from some of these investors as well as make de novo diagnostic centers launches and new acquisitions. For example, on January 8, 2015, the Company purchased 20% of the outside ownership interest in HDM at a cost of \$4,971,094, bringing Fonar ownership of HDM to 60.4%. These purchases reduce the amount of net income attributable to the noncontrolling interests and give Fonar an effective avenue to deploy capital.

Historical Net Operating Losses

Fonar has had significant historical net operating losses (NOLs), especially during the 11-year period from 1997-2008. In this period, the company lost a total of over \$45/share. As a result of this significant tax asset, the company has had significant protection from income taxes. While the NOL tax credits will likely last several more years, it is important to keep in mind that these will eventually be exhausted and the current earning ability of the business is inflated. Since some of the NOLs are nearing their 20-year carryforward limit, it is unclear how much of it will be used. As of their most recent annual filing, net operating loss carryforwards of approximately \$110,029,000 were available to offset future taxable income through 2031. The net operating losses begin to expire in 2021 for federal tax purposes and in 2016 for state income tax purposes.

Dual share structure and corporate governance

At times during its history, Fonar has seemed to operate more like a family business than a public corporation. This is largely due to its multiple share class structure. Shares of Common Stock are entitled to one vote per share, shares of Class B Common Stock are entitled to ten votes per share and shares of Class C Common Stock are entitled to twenty-five votes per share (Raymond Damadian controls 382,447 Class C shares or 99.98% of the share class). At the close of business on April 12, 2017, there were issued and outstanding 6,202,242 shares of Common

Stock, 146 shares of Class B Common Stock and 382,513 shares of Class C.² This share class structure, therefore, gives Raymond Damadian complete control of the company.

There have been times when Fonar's management made decisions that may have gone differently were Fonar a company with a uniform share structure. An example of this is the rejection by the company of a buyout offer on October 3, 2008 for \$5.00 per share by the Diversified Lending Group (The shares had closed at \$1.26 that day). At 4X the market price, I imagine shareholders would have supported such an offer at the time. Another example was the succession of Raymond Damadian's son, Tim Damadian, to the position of President and CEO after his retirement from the role.

In fairness, the stock of Fonar has dramatically outperformed the overall market since the rejection of the buyout offer (For the period of 10/03/2008 to 06/30/2017, Fonar stock has had a 42.4% annualized return). The company behind the buyout offer was also revealed to be involved in fraud, so the deal may never have been completed anyway. Additionally, the strategy focus of Tim Damadian on service center management as opposed to equipment sales has been extremely successful for the company since his rejoining of the company in 2011. Therefore, both of these decisions were the correct ones from the benefit of hindsight. One thing to be sure is that investors in Fonar can't expect potential rerating catalysts in the form of activist investors.

Valuation

The strongest argument for investing in Fonar is valuation. The company is very profitable and generated \$2.19 of free cash flow over the last 4 quarters (with the closing price on June 30th of \$27.75, this gives a trailing FCF yield of 7.9%). Growth has been strong and the balance sheet is very healthy with almost no debt and a rapidly growing cash reserve. Some valuation figures for the company are in the chart below. Due to the unique nature of Fonar, there are no publicly traded companies that, in my opinion, are fair comparisons for valuation.

I believe one reason why the stock may be valued cheaply is that the market is looking at it as a declining medical device company as opposed to a growing medical diagnostic center business.

Selected Financial Figures for Fonar Corp

EV/EBIT³	Return on Assets	Trailing FCF Yield	5-Year Ann. Revenue Growth
9.60	23.18%	7.89%	15.90%

As of June 30th, 2017

² Def 14A proxy filing, filed April 26, 2017

³ EV/EBIT = Enterprise Value / Earnings Before Interest and Taxes = 174.52/18.175

I hope that this letter has been an informative demonstration of Blue Tower's investment philosophy.

Sincerely,

Andrew Oskoui, CFA
Portfolio Manager

Disclaimer: This commentary does not represent a recommendation to trade any particular security, but is intended to illustrate Blue Tower's investment approach. These opinions are current as of the date of this commentary but are subject to change. The information contained herein has been obtained from sources believed to be reliable but the accuracy of the information cannot be guaranteed. Past performance is no guarantee of future results.