

ALLUVIAL

CAPITAL MANAGEMENT, LLC

Second Quarter 2015 Letter to Clients

July 14, 2015

Dear Clients,

I am pleased to report that all Alluvial strategies recorded gains in the second quarter of 2015, outpacing their respective benchmarks. The **Global Focused Value** and **Global Value** strategies excelled on strong upward moves by a handful of holdings, while the conservative **Global Quality & Income** strategy managed an advance even as the bond market fell.

	Q2 2015
Global Focused Value	8.2%
Global Value	8.4%
Russell 2000 Index	0.4%
Russell Microcap Index	2.8%
MSCI ACWI Small Cap Index	1.3%
Global Quality & Income	1.9%
50% MSCI ACWI SC Index / 50% Barclays US Agg. Bond Index	-0.2%

	Performance Since Inception*	YTD 2015	2014*
Global Focused Value	29.2%	11.4%	15.9%
Global Value	27.5%	13.7%	12.2%
Russell 2000 Index	8.3%	4.8%	3.4%
Russell Microcap Index	6.7%	6.0%	0.6%
MSCI ACWI Small Cap Index	2.9%	5.3%	-2.3%
Global Quality & Income	8.4%	2.5%	5.7%
50% MSCI ACWI SC Index/50% Barclays US Agg. Bond Index	3.5%	2.6%	0.9%

* From March 31, 2014

Results are presented net of fees. Results for individual accounts will vary due to the timing of portfolio inflows and outflows and individual portfolio trading restrictions.

Strong as the quarter's performance was, as always I must caution against ascribing too much importance to the results of any particular quarter or even year. The prices of micro-cap and illiquid stocks will be volatile and will often bear little relation to business results in the short run.

Before I begin my usual discussion of new stock positions and developments at existing holdings, let me examine a few of the mistakes I made during the quarter. I believe an honest assessment of errors made in the investment process is beneficial toward the end of avoiding the same and related mistakes in the future.

The Bad

While value investing cannot be thought of as a “science,” there are parallels between seeking to identify attractive investment opportunities and the scientific method. When examining a security for its investment potential, an investor is performing a hypothesis test. In its simplest statement, this takes the form of a null hypothesis, as in “This security is not under-valued.” Having formulated the null hypothesis, the investor goes on to test it using a number of accepted methodologies for determining the intrinsic value of a security. In order for an investor to conclude the null hypothesis is disproven (in other words, that the security in question actually is under-valued) substantial testing must be done and substantial evidence produced. It is not enough to have an inkling or a hunch that a security’s price is well below its intrinsic value, this conclusion must be strongly supported by proper research and examination before a confident conclusion may be reached.

Now, there is always bias present in this process. Every investor has a “toolbox” full of techniques that are useful in the valuation process. And like a carpenter may have a favorite hammer or a mechanic a favorite wrench, every investor has a few favored valuation methods. They may be favorites for their ease of use, their compatibility with the investor’s education and disposition, or ideally, the investor’s history of success using these particular tools. Problems arise when the investor comes to rely too heavily on his favorite tools rather than employing more appropriate or effective methods. Wise investors are aware of this tendency and constantly seek to learn new techniques or better applications of existing ones.

Despite our best efforts, all investors still commit errors that results in investing mistakes. My major error this quarter was with **Real Industry, Inc.** I was far too slow to see the stock’s worth and subsequently left a great deal of value on the table. It was over a year ago that Real Industry (then called Signature Group) first blipped onto my radar, and multiple investors whose opinions I greatly respect recommended it to me for research over the months that followed. Each time, I performed a perfunctory investigation and concluded the stock looked somewhat cheap, but not cheap enough to interest me. I failed to recognize the enormous value of the company’s NOLs, and how much the realization of that value would be accelerated by a large acquisition. Thankfully, I eventually came around and began building a position in the stock in May. The stock has performed well since then, but I believe there is much more room to run.

In February, Real Industry closed on an acquisition of Global Recycling and Specification Alloys for \$525, financed mostly with debt. GRSA (now renamed Real Alloy) is an aluminum recycler. The market for aluminum recycling is strong and should get stronger, as automotive and aerospace manufacturers incorporate more and more lightweight aluminum components in an effort to save on fuel expenses. Real Alloy is profitable and produces healthy free cash flow. These profits will allow Real Industry to begin monetizing its NOLs, while the cash flows will allow for both deleveraging and further deal-making.

As I type, Real Industry has an enterprise value of \$673 million. Real Alloy’s results have been included in Real Industry’s financial statements for less than one full quarter, but Real Alloy should be capable of contributing over \$85 million in EBITDA and over \$45 million annually, before any growth or cost reductions. So Real Industry is trading at around 7.9x projected EBITDA and 15.0x projected EBIT. Not terribly cheap-looking. But, this ignores the value of Real Industry’s over \$900 million in NOLs. Valuing NOLs is a tricky business. My usual approach is to assume the NOLs are utilized equally over the next 10 years, and to discount the tax benefit to the present at 10% cost of equity. This yields a present value for Real Industry’s NOLs of \$200 million.

Reality may be very different. If Real Industry makes more successful acquisitions and manages to utilize a substantial portion of its NOLs over the next few years, the present value of the NOLs is much greater. If Real

Industry has trouble integrating acquisitions and profits are sluggish, the NOLs will take longer to use up and their present value is smaller.

Assuming my estimate of the present value of the NOLs is reasonable, Real Industry's adjusted enterprise value is only \$473 million and its projected EBIT multiple is only 10.5. That's too cheap for a company with attractive growth prospects and capable management. Should the company successfully execute additional acquisitions, the value of the NOL tax shield will increase and the company's value will rise even more. Another acquisition may be in the works for Real Industry, as the company canceled its at-the-market equity issuance and will make an announcement to shareholders on July 15. For a good overview of the company's strategy and its high regard for shareholders, I recommend reading CEO Craig T. Bouchard's letter to shareholders, available on the company website.

My other noteworthy mistake during the quarter was my poorly-timed acquisition of **Command Center** shares. I am extremely optimistic on the stock for the long-term, but I should have realized the company's exposure to the oil-producing Bakken region would result in diminished first quarter results and hurt the company's stock price. Theoretically, the slowdown should have already been discounted into the stock price. In reality, we know the market frequently ignores extremely relevant information, and the smallest companies' stocks are the slowest to adjust.

I have had multiple conversations with company management, and I am very satisfied with their plans for prudent expansion via acquisitions and new storefronts, and their plans to return capital through share repurchases. I fully expect the dip in the share price to be a distant memory before long.

The Good

Multiple portfolio holdings performed well this quarter on the strength of positive business developments and/or more attention from investors.

Meritage Hospitality Group participated in an online investor conference, emphasizing its plans to continue doing what they do best: acquire and upgrade Wendy's restaurants, as well as develop their own successful restaurant concepts. Just this morning, the company reported excellent earnings and investors sent the shares rocketing higher. Despite their rise to \$9, Meritage shares still trade at just 9.5 times the company's own 2015 earnings projections. The company has grown its restaurant base to the point where it is beginning to enjoy economies of scale, and I expect this process to continue.

MMAC Capital Management, LLC rose 24% as the company continued to repurchase shares, work off its legacy real estate holdings and invest in new cash flow streams. Significantly, the company restructured its remaining debt to a lower interest rate in return for quicker amortization. In late May the company recorded a gain of \$5 million on the sale of a multi-family low income property in Missouri. Between this gain and the ongoing buyback, I expect adjusted diluted book value per share to reach nearly \$14 as of June 30.

BFC Financial and **BBX Capital Corporation** progressed toward an eventual merger, finally settling litigation over the 2010 buyout of Bluegreen. BFC also announced the profitable sale of Florida real estate assets. The market value of these companies' real estate assets are well above their book values and I expect more profitable sales/development agreements in coming years. With BFC now owning over 80% of BBX, the companies may file a consolidated tax return, and BBX may dividend cash to BFC without triggering a tax liability for BFC. BBX recently made its final payment to BB&T and took ownership of Florida Asset Resolution Group, giving BBX the freedom to allocate the cash and real estate remaining within FAR as it sees fit.

Logistec rallied sharply despite a lackluster first quarter earnings report. The rally has erased the first quarter's stock decline and taken the company to all-time highs. At the current price, Logistec B shares go for 18.7x trailing earnings and have a trailing EV/EBIT ratio of 14.7. The trailing free cash flow yield is 7.3%. Logistec is a prime

example of what I would term an “exceptional” business, and thus it deserves a premium valuation. Just how much of a premium I am willing to pay is a question I have labored over this quarter, and I am not done examining the question. I do believe that Logistec will likely enjoy superior earnings growth for the next several years. The company recently completed a major capital expenditure program, the results of which will not be evident until the second and third quarter “warm season” earnings are released. At the current stock price and using my own conservative earnings growth projections, I believe Logistec is capable of returning in excess of 15% annually for the next several years, a return I am more than happy to accept for a business of this level of quality and stability. However, if shares reach a level at which the prospective returns are no longer attractive, I will not hesitate to reduce or eliminate Logistec’s weighting in Alluvial portfolios.

The New

During the quarter, I began positions in two new stocks, one a French company and the other in Hong Kong. Each is very different from the other, but each is extremely under-valued and provides exposure to attractive industries.

Umanis SA is a French data analysis company. Umanis provides data analytics to a number of large French companies, including 75% of the members of the blue chip CAC 40 Index. Umanis’ services are focused on risk management, customer relations management, anti-fraud administration, financial reporting and marketing. In short, they are services that are mission critical for large enterprises, and will only grow more data-intensive and complex.

Umanis has experienced rapid growth, with a five-year revenue growth rate in excess of 20%. Much of the growth has been organic, but Umanis is also not afraid to acquire smaller competitors. Despite these frequent acquisitions, I view the risk of empire-building by management as low. Founder Laurent Piepszownik owns 46% of shares outstanding. CEO Olivier Pouligny owns another 13%, giving the two control of the company and highly incentivizing them to pursue only profitable growth.

Umanis’ 2014 financial statement include numerous unusual charges and income, somewhat obscuring underlying results. Statutory operating income was 6.3 million Euros, while adjusted operating income was 8.0 million Euros. Regardless, it hardly matters; Umanis is dirt cheap using either figure. The company’s enterprise value is a tiny 50.3 million Euros, yielding an EV/EBIT ratio of 6.3-8.0x. That’s cheap for nearly any business, let alone one with such growth potential. Good luck finding a similar business in the US for less than 20x EBIT.

The Cross-Harbour Holdings is a Hong Kong holding company with two major assets: the Tate’s Cairn Tunnel and the Western Harbour Tunnel. Cross-Harbour owns and operates these tunnels under 30 year agreements with the Hong Kong government. Cross-Harbour’s concession on the Tate’s Cairn Tunnel expires in 2018 and the Western Harbour concession expires in 2023. Both of the tunnel concessions are owned with partners. Cross-Harbour ultimately owns 39.5% of the Tate’s Cairn Tunnel and 50% of the Western Harbour Tunnel.

Construction began on Tate’s Cairn in the late 80s and on Western Harbour in the early 90s. In retrospect, each project turned out to be a terrible investment for Cross-Harbour. The projected level of toll revenue never materialized, in part because of additional tunnel construction and also due to the effects of multiple global financial downturns. To date, Cross Harbour’s IRR on each project sits in the low single digits. Still, the last of the construction debt on each tunnel was recently paid off, and the company is now enjoying large dividends from each project. In the fiscal year ended July 2014, Cross-Harbour’s share of dividends from the two tunnel companies was 587 million Hong Kong Dollars. This is equal to 16.4% of the company’s current market capitalization.

Even assuming no growth in traffic and toll rates for from now through 2023 (an absurdly conservative projection) and thus no increase in dividends from the tunnel companies, Cross-Harbour will receive 118% of its current market capitalization in cash flow from its tunnel investments. Discounting the series of cash flows at 10% equals 2,869 million HKD.

That's just the beginning of the story. Cross-Harbour also owns two operating businesses: 70% of The Autopass Co. Ltd. And 70% of The Hong Kong School of Motoring Ltd. Autopass in turn owns 50% of Autotoll Ltd., which operates electronic tolling stations on eleven Hong Kong roads and tunnels. The Hong Kong School of Motoring is a driving school. In fiscal 2014, Cross-Harbour's proportional stake in the pre-tax profits of these businesses was 96.2 million HKD. At 8x pre-tax income, the value of these businesses would be 770 million HKD. To top it all off, Cross-Harbour has a large investment portfolio including significant cash. Even discounting the securities (many of which are unlisted) by 30% yields a value for the cash and securities as of July, 2014, of 1,620 million HKD.

When summed, the value of Cross-Harbour's tunnel cash flows, operating businesses and cash and securities is an estimated 5,259 million HKD. To this we can reasonably add another year's estimated dividends from tunnel operations, since the company's last financial report was as of July, 2014. This yields a total value of 5,846 million HKD. This value is a premium of over 60% to the current trading price. *Again, this is an extremely rough computation designed only to show the magnitude of Cross-Harbour's discount to any reasonable estimate of fair value.* Some discount may be deserved due to Cross-Harbour's small size and largely opaque securities portfolio, but I am reasonably confident in management's desire to increase the company's value. Billionaire Cheung Chung Kiu owns 42% of Cross-Harbour through his company Honway Holdings Limited, a subsidiary of the public company YT Realty Group Ltd.

The Departed

Lastly, I let a few investments go in the second quarter. I will miss Mexican auto part manufacturer **Rassini**, but the company's stock price rose to a level that no longer promised out-sized returns. **HC2 Holdings** was another excellent performer, but the company's growing complexity lead me to lose confidence in my ability to value its shares with confidence. Selling turned out to be prescient, as shares have declined nearly 30% since my sale. Finally, **Keck Seng Investments** was a victim of my desire to reduce Alluvial's strategies' out-sized exposure to real estate, and to avoid the deteriorating outlook of the Macau real estate market. In the end, Keck Seng provided a range of outcomes from respectable gains to moderate losses depending on my time of purchase.

Alluvial Updates

As of mid-July, Alluvial's AUM is approximately \$8.5 million. I am deeply, deeply grateful to all my clients for allowing me to steward their capital and build this business. Just two years ago I had little but a list of good stock ideas, a repeatable process for generating more of them, and some vague notions of how to start and run an RIA firm. Now I have a growing business and I am already planning what Alluvial's next steps will be.

At some point in 2016, Alluvial will launch a hedge fund product. This will not replace the existing separate account structure. I am well aware that many clients are unable to invest in hedge funds. Once established, the hedge fund will simply become another account managed by Alluvial Capital Management, LLC. My rationale for launching a hedge fund is simple: I have identified multiple markets and strategies that are difficult or impossible to access and implement via the separately managed account model. These markets and strategies have promising return potential, which I would like to capture for Alluvial clients.

Global Opportunities – At present, Alluvial is limited to investing in markets offered by Interactive Brokers. IB's global offerings are far better than most, but there are a number of global markets Alluvial cannot access without negotiating massive regulatory and logistical obstacles. These markets include the British and German OTC markets, the Swiss OTC-X, and the National Stock Exchange of Australia, not to mention dozens of others. An LP structure would allow Alluvial to open accounts at multiple brokers in the LP's name in order to access these markets, a logistical impossibility under the separately managed accounts model.

LLC and LP Secondary Markets – The secondary market for partnership-type assets is illiquid and highly inefficient—in other words, a perfect hunting ground for Alluvial. Liquidating equipment partnerships, agricultural co-ops, cash-flowing oil and gas properties and many other cash-flowing assets all offer opportunities for Alluvial to be a liquidity provider of last resort for motivated and often ill-informed sellers. These opportunities will be cyclical, as the ranks of distressed assets and sellers will ebb and flow with economic cycles.

Activism – As Alluvial's managed assets grow, activism will eventually become a viable strategy. I do not foresee activist investing ever becoming one of Alluvial's core investment approaches, but owning shares directly via an LP would facilitate efforts to protect or enhance the value of clients' investments when necessary. Appearing in the shareholder registry as a unified entry would enhance Alluvial's clout and would greatly simplify communication with management and/or board members of targeted companies.

I will keep you apprised of developments during the process of expanding Alluvial's offerings. I know little about setting up a hedge fund, so I would be grateful for any advice or referrals to good quality, cost effective service providers you may know of.

Thanks again for being an Alluvial client. Your success is my success and as always my personal assets are invested entirely in Alluvial strategies. Please feel free to reach out any time with questions or comments regarding any portfolio holding or investment topic. Also, if you know of anyone who could benefit from Alluvial's services, I greatly appreciate your referrals.

Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

Disclosures

All Alluvial Capital Management, LLC investment strategies are subject to market risk, including the risk of permanent loss. Alluvial's equity strategies may experience greater volatility and drawdowns than market indexes. These strategies are not intended to be a complete investment program, and are not intended for short-term investment. Before investing, clients should carefully evaluate their financial situation and their ability to tolerate volatility.

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