ALLUVIAL

CAPITAL MANAGEMENT, LLC

Third Quarter 2015 Letter to Clients

October 19, 2015

	Q3 2015
Global Focused Value	**-3.0%**
Global Value	**-3.1%**
Russell 2000 Index	-11.9%
Russell Microcap Index	-13.8%
MSCI ACWI Small Cap Index	-10.9%
Global Quality & Income	**-2.3%**
50% MSCI ACWI SC Index / 50% Barclays US Agg. Bond Index	-4.8%

	Performance Since Inception*	YTD 2015	2014*
Global Focused Value	**25.3%**	**8.1%**	**15.9%**
Global Value	**23.5%**	**10.1%**	**12.2%**
Russell 2000 Index	-4.6%	-7.7%	3.4%
Russell Microcap Index	-8.0%	-8.6%	0.6%
MSCI ACWI Small Cap Index	-8.3%	-6.1%	-2.3%
Global Quality & Income	**5.9%**	**0.1%**	**5.7%**
50% MSCI ACWI SC Index/50% Barclays US Agg. Bond Index	-1.4%	-2.3%	0.9%

* From March 31, 2014.

All figures are net of fees.

Dear Clients,

It had to happen eventually, and now it has: Alluvial's first quarter of negative returns. In the midst of an extremely challenging quarter for small and micro-cap stocks, all of Alluvial's strategies lost ground. While I will never be satisfied with a loss-making quarter, I hope clients will take solace in the fact that all Alluvial strategies avoided the lion's share of the market's losses and remain far ahead of benchmarks year-to-date and since inception. After all, the prospects of achieving long-term outperformance are greatly enhanced by avoiding large losses during market downturns. It's all about living to fight another day.

Despite the lackluster returns, I am generally pleased with the results reported by portfolio companies this quarter. Nearly without exception, each company made progress in increasing intrinsic value. Some did this by increasing normalized earnings power through wise investments and simple execution, and others took steps toward realizing a catalyst that will result in dramatic repricing. Whether or not the market chose to reward these efforts is, of course, a different story. Several portfolio holdings produced good results, yet their stock prices remained steady.

Meritage Hospitality continued to do what it does best: acquire Wendy's® restaurants from small operators, upgrade them, and create economies of scale. Meritage achieved its ten year goal of 150 Wendy's® restaurants in early 2015, and now operates 167. There will be some transitional costs associated with these purchases, but Meritage is well-positioned to achieve its 2015 earnings guidance of $5.5 million. Mid-way through fiscal 2015, net income is up 79%. Meritage shares continue to offer attractive value at a forward P/E of 9.4.

Our French data analytics provider **Umanis SA** reported earnings after quarter's end, and the company's rapid growth continued. Revenues for the first half of 2015 rose 9.6% and earnings were up 16.9%. The company is set to continue its growth, adding high profile clients like Damart and Credit du Nord in the quarter. Despite this success, Umanis shares trade at only 9.4 times trailing earnings.

Paul Mueller Company continued to post robust earning with both its European and domestic segments contributing. For its part, the market is just as content to ignore the company entirely, leaving Mueller to languish at 4.9 times trailing earnings. As is the case with many of Alluvial's holdings, GAAP figures tell just part of the story. Adjusted for an industrial accident the company suffered in September 2014, the company's trailing P/E is 3.9. The company also possesses a large LIFO reserve. The company does face a challenging European dairy market and a large pension deficit, but the market has fully discounted these risks, and then some.

Cross-Harbour Holdings raked in piles of cash from its valuable (and debt-free!) Hong Kong tunnel concessions. For the first half of 2015, the company earned 85 cents per share, up 33% from the same period in 2014. The company received 99 cents per share in dividends from its tunnel assets, and will continue to receive almost 20% of its capitalization in dividends annually between now and mid-2018. The company's trailing P/E ratio is now 7.0. With 77% of its market capitalization in cash and securities, Cross-Harbour represents a low-risk means of investing in essential infrastructure at a single-digit multiple of growing earnings.

Other positions suffered markedly in the quarter. **BFC Corporation** is a prime example. The company's shares fell 20% in the quarter despite posting great earnings. This is a story that has played out over and over again in BFC's share price: the market gets excited over the long-awaited merger and uplisting coming closer to fruition, then trashes the stock in frustration when yet another obstacle pops up. Fortunately, the long legal battle between the SEC and CEO Alan Levan may be close to an end. Having been found guilty, fined, and barred from leading a public company for two years, Levan has indicated he will resign if his appeal is unsuccessful or if he decides not to appeal at all. With the company's legal woes nearly settled, the merger with BBX Capital may finally be at hand. Regardless, the company's mountain of cash and real estate and its valuable Bluegreen subsidiary make the company worth multiples of the current share price, and the value will eventually be realized. This new quarter's upswing in the BFC's stock price may indicate the market is discounting an accelerated timeframe.

Real Industry and **Command Center** also suffered meaningful declines during the quarter, but I believe the future is bright for each. Despite weakness in oil-producing regions, Command Center continued to grow its top line and make investments for the future. Temporary staffing is a game of scale, and

Command Center will be an attractive buyout candidate once it reaches a certain size. Real Industry's price decline was due at least in part to the departure of momentum traders, plus concerns over worldwide demand for aluminum. While declining aluminum demand may impact Real Industry in the short term, declining world markets are actually a boon to Real Industry. Lower valuations will make it easier for the company to make attractive acquisitions and accelerate the monetization of its NOLs. Once it has agreed to terms with an acquisition target, Real Industry will likely turn to its shareholders to provide capital via a rights issue. Should this be the case, I will carefully evaluate the opportunity and participate if the terms are attractive.

There was one rocket ship of a stock this quarter, **Otelco**. I have been pounding the table for this little company for longer than I've been running Alluvial and for most of this time, I've looked pretty foolish. There is nothing like seeing a company's stock move steadily downward for months on end to make one question one's thesis, but each time I update my research, I come away more convinced of Otelco's value. The market has begun to wake up to the fact that the majority of Otelco's customers are now business clients, who are far less likely to go to wireless-only telecom service. The market is also beginning to take notice of the remarkable progress Otelco is making in reducing its leverage. In the past four quarters, Otelco has reduced its net debt by 12.5%, a full $14 million. The company now trades at just 4.1x trailing EBITDA, excluding the company's valuable patronage shares it owns in its lender, CoBank. The remaining piece of the puzzle for Otelco will be renewing its financing, which matures in April, 2016. I view the success of this process as all but certain, given the company's strong results and peer-level leverage. Once a refinancing is achieved, I expect Otelco will enjoy greater flexibility with respect to its cash flows, and may choose to invest in growth initiatives and/or initiate a dividend.

I'll spend the remainder of this letter discussing Alluvial's newest purchase. The security itself will go unnamed, because I remain in the market for shares of this illiquid stock. This company is actually in the midst of a liquidation process, but two different activists have intervened to attempt to halt the process. The reason is simple: in addition to its remaining tangible assets, this company possesses a massive *potential* asset that could be worth several times the company's market capitalization, if handled skillfully. That asset is net operating losses, or NOLs. I've mentioned investing in NOL-rich companies in past letters, but I've never taken the time to discuss why exactly these companies can be such attractive investments and how the value of NOLs can be realized. Essentially, net operating losses are the result of failure. When companies lose money on a pre-tax basis, they generate credits which can be used to offset future taxable income. When a company *really* messes up year after year, it can accumulate hundreds of millions in NOLs, both state and federal. These NOLs remain available for use for a period of 20 years. The right of a company to use these NOLs is not inviolate; the usage of NOLs can be sharply limited if a company experiences an "ownership change" as defined by law.

The process of successfully monetizing a company's NOLs often goes something like this.

1. One or more investors identifies an NOL-rich company and acquires a meaningful stake in it. As they buy, these investors are *extremely careful* not to trigger an ownership change which would restrict the use of the NOLs. Often an NOL-rich company will institute a poison pill in order to prevent any investor from triggering an ownership change.
2. Now that one or more savvy and often deep-pocketed investors is involved, the company sets about raising the necessary capital to complete a significant acquisition. Capital can be accessed via rights offerings (see **Real Industry**) or via creative financings like convertible preferred stock or debt (see **WMIH Corp.** and **Capmark/Bluestem Group Inc.**) Again, the key is to raise the necessary funds without risking an ownership change.

3. Capital in hand, the company begins to identify one or more acquisition candidates. A good acquisition candidate will be profitable and, ideally, free cash flow generating. Profitable, because the whole point is to generate positive earnings to utilize NOLs. Cash flowing in order to pay down acquisition debt or assist in funding successive acquisitions. Acquisitions are completed and their taxable income is offset via the parent company's NOLs, pushing the parent company's tax rate toward zero.
4. As it is able, the company will make more acquisitions to further speed the use of its NOLs, maximizing their present value. This may require more capital. This process is repeated until all of the company's NOLs have been utilized or expire, potentially saving millions or even hundreds of millions in taxes and greatly increasing shareholder wealth.

The process as described above is not overly complex, but a few things have to go right for the process to work as planned. The company must have access to capital on reasonable terms. For its part, management must balance its goals of monetizing NOLs as quickly as possible with the need to exercise patience in identifying the most attractive acquisition candidates.

One more thing, before I return to discussing Alluvial's most recent purchase. The process of monetizing NOLs often becomes *reflexive*. By that, I mean the market's perception of an NOL-rich company's success or failure in making good acquisitions can become a self-fulfilling cycle. If a company makes good acquisitions early on and begins monetizing its NOLs steadily, the market will often reward the company with a higher stock price. Pricier shares mean the company can more easily raise capital to pursue its next acquisition. A second successful acquisition can result in an even higher share price, and the process is reinforced. On the other hand, if the company has trouble integrating a company it has purchased or the promised profits don't materialize, the market may punish the company's shares severely. A declining stock increases the difficulty of achieving a redemptive follow-up acquisition, and the entire process may stall.

Back to the new position, which I'll call "NOLCo." NOLCo is a shell company with a market capitalization of less than $50 million. All that remains of the company's previous operating business is a small amount of cash and other physical assets, but NOLCo has close to $1 billion of accumulated net operating losses. Roughly 60% of NOLCo's market capitalization is backed by the company's remaining tangible assets. At current prices, the market is assigning a value to the company's NOLs of just 2% of the potential cash tax benefit of these NOLs. To see how low this valuation is, compare NOLCo with another NOL shell, like WMIH Corp. The market is currently valuing WMIH's NOLs at about 27% of their potential tax benefit. For NOLCo to be valued at the same ratio, its shares would have to appreciate by over 500%.

I am not saying that NOLCo's share are worth that much today. A number of milestones must be achieved in order to justify that sort of valuation. First, the company's liquidation must be halted. I view this as only a minor obstacle. The two activists I mentioned control over 20% of the company's stock, and it should not be hard to convince other shareholders that a liquidation is not in their best interest. Raising capital and making wise acquisitions will prove the greater challenge, but the activists have a history of deal-making. I believe they are up to the challenge.

NOLCo's return potential is extremely high, but risks are also present. If the company's liquidation is finalized, an ownership change is triggered, sufficient capital cannot be raised, or good acquisitions are not made, shareholders risk permanent loss of capital. For this reason, NOLCo will be a small position for now.

Let me wrap up with just a bit of housekeeping news. Across its three strategies, Alluvial now manages just under $10 million. I remain, as always, extremely grateful for the opportunity to manage a portion of your wealth. It is a responsibility that I take very seriously, and I will always endeavor to be a worthy steward of your capital. If you know of others who could benefit from Alluvial's services, I would be grateful for an introduction. I continue to explore the feasibility of launching a pooled vehicle in 2016, which would enable Alluvial to access an expanded set of potentially lucrative opportunities. I will provide updates when and if I begin this process in earnest. As always, please do not hesitate to reach out with questions or comments concerning portfolio holdings, or value investing ideas in general. I always enjoy corresponding with clients.

Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

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