

ALLUVIAL

CAPITAL MANAGEMENT, LLC

Fourth Quarter 2015 Letter to Clients

January 20, 2016

	Q4 2015
Global Focused Value	4.5%
Global Value	2.5%
Russell 2000 Index	3.6%
Russell Microcap Index	3.7%
MSCI ACWI Small Cap Index	3.8%
Global Quality & Income	2.6%
50% MSCI ACWI SC Index / 50% Barclays US Agg. Bond Index	1.6%

	Performance Since Inception*	2015	2014*
Global Focused Value	31.0%	13.0%	15.9%
Global Value	26.6%	12.8%	12.2%
Russell 2000 Index	-1.2%	-4.4%	3.4%
Russell Microcap Index	-4.6%	-5.2%	0.6%
MSCI ACWI Small Cap Index	-4.8%	-2.6%	-2.3%
Global Quality & Income	8.7%	2.8%	5.7%
50% MSCI ACWI SC Index/50% Barclays US Agg. Bond Index	0.1%	-0.8%	0.9%

* From March 31, 2014.

All figures are net of fees.

Dear Clients,

Happy New Year! I hope 2016 finds you in good health and good spirits. It is well that a new year is here because few investors will remember 2015 with much fondness. Volatility ruled (and continues to rule) the day, with small companies and so-called “value” stocks faring worst. For much of the year, owning these companies felt like paddling a canoe upstream, or walking up the down escalator. Even so, Alluvial was able to post strong performance with all strategies exceeding their benchmarks by healthy margins.

As always, I must caution that investing in obscure and illiquid securities carries the risk of loss. Indeed, these first few weeks of 2016 have shown just how quickly markets can turn south, taking even the soundest companies with them. While Alluvial's holdings have weathered the storm better than its benchmarks, investors' fears have driven the valuation of several of Alluvial's holdings to levels wholly at odds with economic reality. I do not know whether this downturn will prove short-lived or persistent, but I remain very confident that our portfolio companies will continue to generate cash, make prudent investments, and bring idle assets to productivity. I have been taking advantage of some very attractive entry points, knowing that the market will reward successful companies in the long run.

While Alluvial's positions performed well on the whole, 2015 was marked by a wide dispersion in returns amongst the various types of holdings. Winners tended to feature obvious and easily understandable trends such as accelerating revenue and earnings growth, or rapidly accreting book value. Companies like **Meritage Hospitality** and **MMA Capital Management** are prime examples of this phenomenon. On the other hand, companies with less obviously positive operational trends saw their share prices languish or fall. The market often acts as if the only developments that matter are the ones that appear in press releases and media headlines, and progress at less communicative companies often goes un-noticed.

It can be frustrating to see companies execute their business plans and create wealth for shareholders, but go unrewarded by the market. Often these companies are working toward a future event that will create or unlock immediate and significant value. In a truly efficient market, the share prices of these companies would steadily accrete toward that future value with the passage of time. After all, the present value of any future cash flow increases continually, assuming the likelihood and timeframe of its being realized remain unchanged. When the market fails to adequately price these future events, it creates ample opportunity for patient investors.

Regency Affiliates

Regency Affiliates is a prime example of this "someday" sort of company. Regency owns three major assets. Corporate cash, a 50% interest in a commercial property in the Baltimore suburbs, and a 50% interest in a steam plant in Mobile, Alabama. Both the property and the power assets are profitable, and Regency earned \$1.14 per share for the trailing twelve months. Net of the substantial corporate cash, Regency shares go for a scant 7.6x trailing earnings. But the real potential of Regency Affiliates shares does not lay in the current earnings, but in the potential for a substantial distribution, buyout, or profitable acquisition following a refinancing of its property's mortgage in the next few years. Regency's property investment is located at 1500 Woodlawn Drive in Woodlawn, Maryland and has been home to the Social Security Administration's Office of Disability and International Operations for the last 30 years. The 34 acre lot includes two buildings with a total of 717,000 square feet of leasable space. In 2003, the SSA agreed to extend its lease to October 2018. Following the lease extension, Regency and its partner in the investment arranged for a loan against the property of \$78 million, of which Regency received half. Ever since, nearly all the cash the property generates has been used to pay down the loan to its current balance of \$33.6 million. I believe that at some point in the next few years, the SSA will seek to extend its lease. (This is almost a certainty. After 30 years in the same building, just *imagine* the expense and disruption involved for a gigantic government agency to change locations.) With an extended lease in hand from an AAA-rated tenant, Regency will seek to re-leverage the property and will collect a handsome payout.

The value of 1500 Woodlawn has certainly appreciated since Regency bought its interest in 1994. The property's tax assessment is \$84.8 million, but this is well below market value. The property will produce about \$8.3 million in net operating income this year. Capitalizing this at even a conservative 8% yields a value for the property of \$104 million. At the current level of indebtedness, a new loan at 70% loan-to-

value would yield \$39.2 million, half of which Regency would receive. That's \$19.6 million, nearly half of Regency's market capitalization. At that point, Regency could pay a large dividend, or buy out minority investors, or even buy out its partner in 1500 Woodlawn. Regardless of what it chooses to do, the market will be forced to sit up and take notice.

I do not know if this will happen this quarter, or not until 2017 or even in 2019 once the SSA's current lease is up. But I am confident that shareholders will eventually benefit from the monetization of such a huge and valuable asset. In the meantime, Regency will continue paying down property debt and collecting cash flows from its power generation asset. In short, building value for investors.

"Building value" is the key. I don't mind investing in companies where value realization may be years off, *so long as* the company is vigorously seeking to increase intrinsic value today, and succeeding! That's often the difference between an acceptable investment result and a great one. Far too many investors are willing to buy shares in companies that promise a distant but significant payday, forgetting that what happens between now and then matters greatly. After all, a significant portion of any security's present value is the value to be delivered to shareholders over just the next few years, be it through direct cash payments or through profitably reinvested earnings. This is also the reason I don't often purchase cash flow negative companies, net-nets, or other melting ice cubes. While others may find success there, I find it easier to invest with the wind at my back rather than in my face.

The challenge to investing in these "some day" companies is exercising patience. It can be frustrating to watch stock indexes march higher and more communicative companies leap with each conference presentation or product launch, while shares of quieter companies plod along without meaningful movement. But the wise investor will remember that for as long as the market continues to act as a weighing machine in the long run, the value of a company's stock will eventually converge to the intrinsic value of the company. So long as that intrinsic value compounds at an acceptable rate in the mean time, the investor's reward will be received in due time.

Moleskine SpA

Alluvial's newest holding is an Italian company with a name that some may recognize, Moleskine. The company produces high-end notebooks and other similar products. The name of the firm is a callback to the small black notebooks that writers and artists like Hemingway, Van Gogh, and Oscar Wilde would use in pre-war Paris. The modern Moleskine is not a true descendent of these vintage products. Rather, the brand was very cannily resurrected in the 1990s by an Italian designer who recognized the huge potential of the name. The company clearly wishes its customers to associate themselves either with the romantic image of an impoverished Bohemian author scribbling away in a smoky café in the Left Bank, or with modern-day hip urban artists and designers. And the marketing works! Moleskine earns extraordinary operating margins and its global sales are soaring. Yet, the company is small and hasn't yet come close to reaching its potential. Moleskine's products offer an attractive "affordable luxury" niche. On a global scale, few people are able to shell out \$5,000 for a Prada handbag or \$700 for Louis Vuitton shoes. But many can spend \$12-\$15 on a sleek notebook as a gift or for personal use, and a handsome percentage of the selling price falls to Moleskine's bottom line. Moleskine is majority-owned by two reputable European private equity funds that keep a close watch on costs and guide the company's expansion efforts. The company has nearly zero net debt and generates more than adequate capital to fund its growth internally.

Moleskine's revenues have risen 54% since 2012 and are on pace to rise 34% in fiscal 2015, assisted by the strong US dollar. Operating income has grown less quickly, in part because the company has dedicated substantial resources to launching a new sales vector via its own stores, which now number 85. The company expects these stores to begin contributing in a major way in 2016. Sales within the Eurozone once made up the majority of Moleskine's revenues, but now account for less than half with sales in North America and Asia nearly doubling since 2012.

Despite a rosy growth outlook, incredible margins and pristine balance sheet, Moleskine shares trade at a distinct discount to both general market valuations and those of its luxury goods peers. For 2015 year, Moleskine should report normalized earnings of almost €25 million. As I write, that yields a trailing P/E of less than 13x, and trailing enterprise value/operating income of just over 9x. Try as I might, I cannot find another example of a company of this quality and with this growth potential trading so cheaply. Moleskine's small size, even smaller float, and challenging domicile probably contribute to its modest valuation. But I suspect the chief reason is that the market simply hasn't noticed Moleskine yet. I don't expect that to last.

Paul Mueller Company

Clients may notice that shares of Paul Mueller Company no longer appear on their holdings statements. In fact, I sold all shares of Mueller in the fourth quarter following the company's earnings report. This may seem strange, given my previous bullish stance on the company. On the surface all appears well at Mueller with the firm reporting steady profits and trading at a low single digit multiple of those earnings. But the company has failed to perform in important ways and hit the limits of my patience and tolerance for financial risk.

High quality earnings are those that convert into equivalent cash flow, and promptly. Low quality earnings produce assets, but not cash. There is nothing wrong with having receivables and inventories and other working capital, but they do not spend like cash. At the end of the day, cash pays dividends, buys back shares, funds productive capital expenditures and pays down debt. Other types of working capital can support the sales effort, but otherwise do nothing for shareholders.

By these standards, Mueller's earnings quality has degraded substantially. So far in fiscal 2015, Mueller has reported earnings of \$6.9 million. But excluding depreciation, that \$6.9 million in earnings created only \$1.4 million in operating cash flow. Where did the rest go? Working capital. Mueller has invested \$4.3 million in net working capital fiscal year-to-date, including \$8.8 million in inventory alone. Inventory now stands at 68 days of sales, a sharp increase from the end of fiscal 2014. Inventory build is not a problem if it is done in anticipation of a rise in sales, but no such rise is in sight for Mueller. The company's backlog has remained nearly unchanged the whole year long. Recently, elevated capex has compounded the cash flow issue. Since the end of 2013, Mueller has reported earnings of \$13.8 million, but free cash flow of *negative* \$1.9 million. That's an extraordinary divergence, representing a massive investment in working capital and fixed assets that has yet to bear fruit.

The last few years of heady reported profits should have enabled Mueller to pay down its substantial debt and defease its pension obligations. Instead, its earnings are sitting in warehouses and in accounting ledgers as inventory and receivables. For quite a while I was willing to overlook the lack of cash flow, rationalizing it as a timing issue and believing that the company's high capex would be money well spent. But I now must accept that with each passing quarter, the continued cash flow deficit increases the chances of a substantial inventory or fixed asset writedown. Most or all of the company's reported profits for the past several periods could vanish at a keystroke. That is an unacceptable risk, and it is why I sold.

Organizational Updates

I will be making some changes to Alluvial's strategies. To date, Alluvial has offered two different all-equity strategies, Global Focused Value and the more diversified Global Value. Following the end of the first quarter, Alluvial will no longer offer the Global Value strategy. The primary reason for this decision is that only 2.6% of Alluvial's assets under management are invested in the Global Value strategy. Maintaining this strategy is no longer an effective use of my time and resources compared to devoting additional effort to the Global Focused Value strategy.

There will also be some changes to the continuing Global Focused Value strategy. Rather than the current 10 to 15 holdings, the strategy will hold between 10 and 25 positions. This will provide Alluvial with the best of all worlds: the ability to concentrate in certain high conviction holdings when extraordinary opportunities present, and the ability to spread bets more broadly while awaiting these unusual opportunities. The strategy will also have the ability to consider "baskets" of small, themed positions as a single holding. For example, consider small bank stocks and thrift conversions. I am certain that the next decade will see a nearly unprecedented wave of consolidation among small banks. The regulatory burden that these institutions face makes their continued existence as independent entities untenable. Evidence of this trend is all around. In my own backyard, I have seen two different small bank companies bought by competitors in the last six months. And yet, it is very difficult to determine *ex ante* which banks and thrifts will be the target of merger activity in the short run. To address this issue, the Global Focused Value strategy may (for example) purchase eight or more different stocks in the category, weight them at 0.50% each and treat them as a single holding.

I have at various points mentioned the possibility of creating a limited partnership for the purpose of investing in various difficult-to-access stock markets, participating in the LP secondary market, and conducting activism. Further reflection has crystalized my thinking, and my research has lead me to believe that a small fund focused on purchasing interests in liquidating leasing partnerships, private REITS, agricultural and utility co-ops as well as participating in demutualizations could be highly rewarding to all participants. The goal would be to purchase these assets counter-cyclically. That is, to be a liquidity provider when liquidity is at a premium and buyers are few and to purchase quality assets at extremely large discounts to fair value. I believe a partnership with beginning capital of between \$2 and \$5 million would be ideally suited to exploit opportunities in these markets. If this idea is of interest to you, please contact me and we can discuss the very preliminary details of such a venture.

A Personal Note

Once again, I would like to thank all Alluvial clients for being a part of the success of this young firm. I am proud of the performance Alluvial has achieved to date. No matter what the market does in the short run, I am certain that a disciplined application of value investing principles in overlooked markets will continue to yield very attractive long-term results. Also, I am thrilled to announce that my wife and I will welcome a son, our first child, in May. So if you had been thinking about increasing your investment with Alluvial, now is a very good time. I joke, but I honestly do believe the market is offering some very good opportunities at the moment. I will do my best to take advantage of these opportunities and to grow your wealth and mine in 2016.

Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

Disclosures

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