

ALLUVIAL

CAPITAL MANAGEMENT, LLC

First Quarter 2016 Letter to Clients

April 21, 2016

	Q1 2016
Global Focused Value	-4.9%
Global Value	-2.6%
Russell 2000 Index	-1.5%
Russell Microcap Index	-5.4%
MSCI ACWI Small Cap Index	0.3%

Global Quality & Income **1.8%**

50% MSCI ACWI SC Index / 50% Barclays US Agg. Bond Index 1.7%

	Performance Since Inception*	2016	2015	2014*
Global Focused Value	24.6%	-4.9%	13.0%	15.9%
Global Value	23.3%	-2.6%	12.8%	12.2%
Russell 2000 Index	-2.7%	-1.5%	-4.4%	3.4%
Russell Microcap Index	-9.8%	-5.4%	-5.2%	0.6%
MSCI ACWI Small Cap Index	-4.4%	0.3%	-2.6%	-2.3%
Global Quality & Income	10.6%	1.8%	2.8%	5.7%
50% MSCI ACWI SC Index/50% Barclays US Agg. Bond Index	1.8%	1.7%	-0.8%	0.9%

* From March 31, 2014.

All figures are net of fees. Please see additional disclosures.

Dear Alluvial Clients,

The first quarter saw mixed results for Alluvial's strategies. The Global Focused Value strategy lost ground, lagging small-cap stocks while marginally outpacing micro-caps. The Global Value strategy produced a better but still negative return in its final quarter as an offered strategy. In its two years of existence, the strategy performed admirably, exceeding the Russell Microcap Index® by 33.1% net of fees and expenses. Finally, the more conservative Global Quality & Income strategy rose, outpacing its benchmark by a hair.

The returns produced by each strategy belie the actual volatility that the market brought in the quarter. At one point in mid-February, small-cap and micro-cap stock indexes had fallen 15-18% and seemed to be pricing in an imminent and severe global economic downturn. Then as suddenly as they arrived, these fears dissipated and stock indexes roared back to breakeven or even positive territory. Well, large-cap indexes did. Micro-cap stocks remain in the red for the year, and

have in fact fallen nearly 20% from their highs in June, 2015. In retrospect, I launched Alluvial Capital Management at a fairly poor time for investing in micro-cap companies. In the two years since, micro-cap stocks have provided a total return of a pitiful negative 9.8%. Regardless of the direction of the market as a whole, I believe there will always be opportunities to invest in under-valued companies poised to appreciate. I will continue to dedicate all my efforts to identifying these on clients' behalf. When searching for these opportunities, it helps to identify factors that increase the likelihood of inefficient pricing and to concentrate efforts on companies exhibiting these characteristics.

- **Obscurity.** The company may operate in a very unpopular, unfamiliar, or niche industry, may be listed outside of its core business market, or may have reclusive management/ownership that does not communicate with Wall Street or the Press. The reduced number of market actors that are even aware of the company's existence, much less familiar with its operations, increases the chances of a mispricing.
- **Small size and/or limited trading activity.** A company with a market capitalization of \$25 million or one that trades fewer than \$25,000 worth of shares per day is simply uninvestable for market actors of significant size. For that matter, so is a company with a market capitalization of \$250 million and daily trading dollar volume of \$250,000. Not to say there aren't many sophisticated investors tracking these tiny and illiquid companies, but the number of potential investors is reduced, which decreases market efficiency.
- **Financial statement complexity.** This is my favorite, because a startling number of market actors perform only very shallow analysis of a company's filings and news releases. The more complex these documents are, the fewer investors will put forth the effort to make sense of them. This creates opportunities for investors willing to put in the time and effort required to understand the many moving parts. All the same, it is critical not to confuse business complexity with financial statement complexity. I have a strong preference for companies with simple business models over businesses whose profits are derived from arcane processes.

Barriers to discovery, barriers to investment, barriers to understanding. These are Alluvial's primary engines of idea generation. A prime example of all three is MMA Capital Management.

MMA Capital Management

Alluvial's highest conviction holding and largest position in client portfolios is **MMA Capital Management**. Though I have mentioned the company more than once in previous letters, I have never laid out my investment thesis in any depth. Clients certainly deserve such an explanation as MMACM's performance will have a large impact on client portfolios going forward. The intrinsic value of MMACM's shares is not readily apparent due to accounting conventions and the firm's history. GAAP rules require the firm to consolidate many assets and liabilities to which it has only de minimus exposure, largely consisting of investment funds managed by past and present subsidiaries. Adjusting for these "phantom" statement entries and giving credit for significant hidden economic value, it becomes apparent that MMACM trades for half or less of its worth.

MMACM is a small specialty finance company with a market capitalization of \$104 million. The company, once nicknamed "MuniMae," was a major player in the low income housing tax credit ("LIHTC") market but fared extremely poorly in the financial crisis when all liquidity left its markets. MMACM spent years in survival mode, selling off assets and deleveraging. The company ultimately survived as a scaled down version of its former self, a hodgepodge collection of legacy assets with no central business model and significant remaining debt. MMACM has spent the last few years selling off legacy assets, developing new cash flow streams, and restructuring its debt to ensure long-term viability. Oh, and repurchasing lots and lots of stock. Recognizing the persistent discount between its stock price and the economic value of the company's assets, MMACM's management has repurchased 24% of the company's shares since the end of 2012. At present, MMACM's assets and business lines include the following:

- **Bonds** - The company continues to hold a legacy portfolio of 39 tax-exempt bonds backed mainly by multifamily affordable housing complexes. These bonds are held at fair value of \$309 million against principal value of \$310 million. About 16% of these bonds by principal value are non-performing. These non-performing bonds are valued at a weighted average of 72% of principal. Historically, MMACM has had success in resolving non-performing bonds profitably by foreclosing on the underlying properties and selling them.
- **Real Estate** – MMACM continues to hold interests in real estate partnerships and joint ventures. The value of many of these interests was written down substantially during the financial crisis, and the market value of these

assets substantially exceeds their balance sheet carrying value. On a GAAP basis, this real estate is carried at \$38.3 million. The fair value is \$46.8 million, or \$1.30 per share above their balance sheet value. In February, a real estate holding in which the company held a 50% interest was sold for a gain of \$2.7 million.

- Solar Financing – In 2015, the company invested \$50 million in a solar construction financing joint venture. The venture has been profitable to date.
- Loan Receivable, Repurchase Option - In 2014, MMACM sold off its interest in a South African LIHTC manager for \$15.9 million and an option to repurchase the business in five years. The company provided seller financing for the entire amount. GAAP rules prevent the company from recognizing the gain at the present time, which will provide another source of future income. The current loan balance of \$13 million does not appear on MMACM's balance sheet.
- LIHTC Management – MMACM has reentered the LIHTC management market, inking a deal to manage a portfolio of low income housing for Bank of America. MMACM received an upfront payment of 2% of the portfolio's \$211 million equity value, and will receive 2% ongoing annual management fees for its services, plus certain residuals as the portfolio is liquidated. The company also invested in several LIHTC properties outside the Bank of America JV.
- Net Operating Loss Carryforwards – MMACM has \$400 million in NOLs, which do not expire for many years. The company has protections in place to preserve these NOLs.

MMACM also holds some corporate cash. Against these assets, the company has \$232 million in debt. As of December 31, 2015, the company reported diluted book value per share of \$17.43. There are many reasons to believe this figure is substantially understated, and I do mean substantially. The excess real estate value not recorded on the balance sheet adds \$8.5 million to equity, and the deferred gain on the sale of the South African LIHTC manager adds \$15.9 million. Since year-end, the company has repurchased 105,000 shares for \$1.5 million.

The net effect is to raise pro forma book value per share to north of \$21 per share. This does not include the value of intangibles like the significant NOLs. There are still more potential sources of value, like the repurchase option the company holds on the subsidiary it sold and possible gains from resolutions on non-performing bonds.

The value creation path ahead for MMACM is extremely clear. The company will continue to manage the runoff of its legacy assets, recording occasional gains on sale and restructuring. In the first quarter alone, the company will record a 42 cents per share gain on the sale of some legacy real estate. The capital generated from the runoff process will be invested in a mix of cash-producing businesses like solar construction lending and LIHTC management and ownership, and aggressive share repurchases. The net effect of these actions will be continued increases in book value per share, and a growing stream of sustainable cash flows from the company's operations.

Wilh. Wilhelmsen ASA

Another example of obscured value is one of Alluvial's new holdings, Wilh. Wilhelmsen ASA. Wilhelmsen is a blue chip Norwegian specialty shipping company controlled by a venerable shipping family. With a market capitalization of 1 billion USD, Wilhelmsen appears at first to be much larger than Alluvial's usual investments. However, only around \$120 million worth of Wilhelmsen shares are freely-floating, greatly limiting the ability of large funds to invest. Wilhelmsen conducts its business mainly through a series of joint ventures, only some of which are consolidated on the company's financial statements. The company carries out extensive hedging of currency, interest rate, and bunker exposure, which creates quite a lot of noise in reported results. Together, these factors effectively mask the underlying earnings power of the company's operations.

On the whole, the shipping industry is rather unattractive. The industry is deeply cyclical, requires huge capital expenditures, and ship owners have little pricing power. Wilhelmsen has mitigated these factors by concentrating on differentiated shipping sub-sectors, chiefly automobile and heavy equipment transport, as well as land-based logistics. Focusing on these sectors has allowed the company to produce healthy margins and returns on capital without employing excessive leverage. For the last ten years, Wilhelmsen has compounded its book value per share at 8% annually after paying out the majority of its net income in dividends.

Despite this solid track record and a healthy level of current profitability, Wilhelmsen shares trade at deeply depressed levels. Class A shares are changing hands at 60% of book value and around 6 times trailing normalized income despite double-digit returns on equity, reasonable debt levels and a generous dividend. This situation is not terribly unusual. Family-controlled holding companies often trade at deep discounts for years on end. However, Wilhelmsen is taking a steps to reduce this discount and to highlight the value of their high quality assets.

Wilhelmsen's most significant asset is a 12% stake in a Korean shipping company, Hyundai Glovis. Glovis transports automobiles for Hyundai and Kia, and has a market of almost USD 6 billion. Wilhelmsen's stake is worth just over \$700 million, or 70% of the Wilh. Wilhelmsen ASA's market capitalization. Despite this, Glovis contributes only around 25% of Wilhelmsen's annual net income. This summer, Wilhelmsen will be spinning off its ownership of Glovis to shareholders via an intermediary vehicle to be named Treasure ASA. Assuming this vehicle trades at a reasonable discount to the market value of its Glovis shares (say, 15-20%) then investors who purchase Wilhelmsen shares today are creating the remaining core shipping company at 3 times normalized earnings and 35% of book value. There is one wrinkle in some pending anti-trust penalties for certain Wilhelmsen subsidiaries. The company's balance sheet already reflects an accrual of \$200 million for these potential penalties. Given the company's traditionally conservative approach, I believe this estimate is excessive and actual penalties will come in far lower. Final penalties below the company's estimates could act as an additional catalyst. Barring unforeseen delays, the spin-off will take place on June 7 and Treasure ASA will begin trading on June 8.

Portfolio Updates

Over all, I was very happy with fourth quarter results reported by our portfolio companies. Nearly without exception these companies reported healthy profits and cash flow and made progress on their long-term business plans. Needless to say, I disagree with the market's decision to devalue certain stocks or ignore their successes entirely. The biggest detriment to this quarter's performance was Otelco, which fell 26%. As I predicted in the fourth quarter's letter, Otelco was successful in achieving new financing, extending its debt maturity to 2020. However, the new debt package did not offer any increased flexibility with respect to cash flows and the company's cost of debt rose significantly. A much more difficult lending environment resulted in the company's previous lenders taking a pass on rolling over the debt despite greatly improved leverage ratios and demonstrated business stability. The new debt package includes both senior and mezzanine debt, with the mezzanine portion commanding a punitive interest rate.

Due to the higher rates, the company's progress in reducing its leverage will slow. By my estimates, Otelco will still be able to amortize its debt by around \$8 million annually, not an insubstantial amount for a company with an enterprise value of around \$112 million. Still, equity value has been reduced. Directly, by the fact that more of the company's cash flow will accrue to lenders, and indirectly due to increased risk and a slower path to achieving sustainable leverage ratios.

I am disappointed that Otelco's management and board of directors did not seek an outright sale of the company rather than accept this unattractive debt package. Otelco is by far the cheapest of all traditional telecom providers, and there is big potential for earnings improvement via cost cutting measures. Between NASDAQ listing fees, audit expenses, board of director's fees and management compensation, I estimate an acquirer could cut \$3 million or more from Otelco's annual operating costs on day one, increasing EBITDA by 10%. Using this assumption, an acquirer paying \$130 million for the whole enterprise and employing leverage of two times EBITDA at 7% would generate a return on equity of around 20%. Otelco shareholders would receive more than \$9 per share. Even if this scenario or one like it does not come to pass, the stage is set for further value creation via deleveraging. Holding valuation ratios steady, every \$2 million in debt reduction increases equity value by 59 cents per share. Otelco should be capable of that level of debt reduction on a quarterly basis. The other side of the equation is the evolution of the company's revenues and cash flow. Thus far, the company has done an admirable job of preserving earnings in the face of a slow decline in revenues. However, I will continue to monitor the development of Otelco's revenues with care. The company's success depends on growing its business services segment while managing the long-term erosion of its consumer services segment.

Alluvial accounts no longer hold any shares of Command Center. Though I remain optimistic about the company's long-term prospects, the downturn in the oil market means the company's revenues and profits may not reach previous levels for an extended period of time. In my view, the company has not done an adequate job of controlling corporate costs during this downturn, leading to large profit declines. The company's performance is a helpful (if costly) reminder that operating leverage cuts both ways. In light of this, I thought it prudent to reallocate capital to more attractive and timely ideas.

I have begun building positions in a variety of attractive small banks. Nearly without exception, these banks share the following characteristics.

- Over-capitalization. Each bank is in a position to return substantial capital to shareholders via dividends and buybacks without jeopardizing its financial footing.
- Insufficient size. Most of these banks are too small to achieve an acceptable level of profitability in the face of rising costs and increasing regulatory burdens. This makes them more likely to agree to a merger or acquisition, or to seek a sale.
- Deeply discounted valuation. Each bank trades at a discount to tangible book value. Tangible book value is a rough proxy for bank liquidation value (especially for small banks without complex derivative exposure or credit issues.) Bank acquisitions tend to be completed at well above tangible book value.

Many of these banks are recently converted thrifts, which are often acquired once the three year ban on transactions after conversions expires. Additionally, many are actively repurchasing stock and/or have activists involved. Over the next three to five years, I expect the majority of these banks to be acquired at large premiums to current value, yielding an attractive rate of return for the group.

I am very happy with how Alluvial's strategies are positioned and I am optimistic for the remainder of 2016.

Organizational Updates

With this letter, Alluvial has now reported two full years of performance and portfolio commentary. Though a two year period is not sufficient to assess the true measure of an investment manager, I am proud of what Alluvial has achieved so far. My mission and practice are simple. Every day I wake up and set to work with the goal of finding a great idea for Alluvial's clients. Doing so is my great responsibility and privilege.

As I mentioned in previous letters, I am exploring creating an LP dedicated to transacting in liquidating partnerships, co-op units, demutualizations, and other attractive illiquid assets. This quarter was unexpectedly busy for the organization and a number of obligations prevented me from making progress toward this goal. However, I still fully intend to make this venture a reality and I will provide more details when they are firmly established.

Thank you once again for the opportunity to manage funds for you. I will do my utmost to grow our wealth together as this year continues, and I look forward to reporting to you once again in July.

Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

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Client accounts are included in strategy composites in the first full calendar quarter following initial account funding. Client accounts are removed from strategy composites following the calendar quarter in which they are defunded or are removed from Alluvial's discretion.

For the three month period ended March 31, 2016, the Global Focused Value strategy composite included 64 accounts.

For the three month period ended March 31, 2016, the Global Value strategy composite included 4 accounts. This will be the final reported performance period for this strategy.

For the three month period ended March 31, 2016, the Global Quality & Income strategy composite included 4 accounts.

For further disclosures concerning performance calculations, please contact Alluvial.

Contact

Alluvial welcomes inquiries from clients and potential clients. Please visit our website at alluvialcapital.com, or contact Dave Waters at info@alluvialcapital.com or (412) 368-2321.