ALLUVIAL

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Second Quarter 2017 Letter to Alluvial Fund, LP Limited Partners - July 21, 2017

Monthly Performance Figures

2017	Jan	Feb	Mar	Apr	May	Jun	Inception, Jan. 2017
Alluvial Fund, LP	2.2%	1.9%	1.0%	2.9%	3.5%	0.6%	**12.6%**
S&P 500 TR	1.9%	4.0%	0.1%	1.0%	1.4%	0.6%	**9.3%**
Russell 2000 TR	0.4%	1.9%	0.1%	1.1%	-1.2%	2.6%	**5.0%**

Top Holdings	**%**	**World Allocation**	**%**
Contura Energy	8.6%	United States	69.8%
Ferronordic Machines - Pref	8.6%	Sweden	14.3%
Meritage Hospitality Group	6.9%	Germany	4.2%
Advanced Emissions Solutions	4.8%	Italy	3.7%
Calloway's Nursery	4.7%	France	3.1%
Top 5 Positions, % of Total	**33.7%**	**Top 5 Countries, % of Total**	**95.1%**

Dear Partners,

It is my pleasure to report results for Alluvial Fund, LP's first six months of existence. While such a period of time is insignificant in the grander scheme, I am nonetheless happy to see the value of our investment grow at a healthy clip out of the gate. For the three months ended June 30, 2017, the value of an investment in Alluvial Fund, LP rose 7.1%, net of full fees. This compares favorably to the S&P 500 Index total return of 3.1% and the Russell 2000 Index total return of 2.5%. Year-to-date, Alluvial Fund, LP has produced a net return of 12.6% compared to 9.3% for the S&P 500 and 5.0% for the Russell 2000. The partnership finished the quarter with $9.3 million in assets.

In launching the partnership, Alluvial has welcomed several new limited partners. I am grateful for the opportunity to manage capital for you, and I will work to the fullest of my abilities to maximize the value of our investment. I am equally grateful to those partners who took a risk on a young, wholly unproven manager back in 2014, when Alluvial was born from a blog I would update in the wee hours in my rowhouse apartment on Pittsburgh's North Side. It's been incredibly rewarding to see both our portfolios and the scope of Alluvial's activities grow.

These quarterly letters are a medium for me to discuss meaningful events at portfolio companies and lay out the investment case for various holdings. From time to time, I may share some general investment-related thoughts. However, I tend to leave the pontificating on value investing to others. I enjoy talking about the opportunities I have found much more.

With that said, let's get to it. Alluvial focuses on small companies, illiquid securities, and special situations. Though we maintain this focus, we will purchase larger and more liquid securities when they are especially misprice. We invest globally and are willing to wait years for value to be realized, provided value is accruing at a reasonable rate in the interim. When thinking about Alluvial Fund's various holdings, I divide them into four informal categories. Many Alluvial holdings do not fit neatly into any of these categories, but the categories do provide me with an analytical framework I use in evaluating possible investments.

1. **"True Growth" Companies**

Any company that has access to additional capital can grow its revenues and earnings. Whether or not this actually increases intrinsic value depends on the rate of return achieved on the additional capital deployed. While many firms waste investor capital on dubious acquisitions and initiatives, there are companies that have the ability to deploy significant additional capital at attractive rates of return. Through reinvesting internally generate cash flows and tapping capital markets judiciously, these firms can grow their earnings and free cash flow at double-digit rates for years on end, creating incredible shareholder wealth in the process. There is a word for these types of companies that some like to use, "compounders." That word makes me mildly queasy because in present usage, a "compounder" seems to be any company with a reasonable return on invested capital and a share price that just keeps going up. History shows what eventually happens to the share prices of companies like these when commensurate economic value is not being produced. So, I prefer my own terminology. In practice, these "true growth" companies are rare in public markets. The best never go public at all, having little need for external capital. Or, when the market catches wind of the superior economics on offer, a larger firm quickly swoops in with an acquisition offer. Large firms are ever hungry for growth.

Examples of these companies in Alluvial Fund's portfolio include **Meritage Hospitality** and **Scandic Hotels**. Meritage, which I have written about several times in past letters, is extraordinarily adept at purchasing run-down Wendy's units from motivated sellers. Once renovated, unit sales soar and thanks to Meritage's centralized purchasing and scheduling systems, so do operating margins. Meritage has added units at a rapid pace over the last decade and now has 249 units, with a goal of owning 400 within four years. The company has the managerial talent, access to capital, and the support of Wendy's corporate to accomplish this goal. Insiders control the large majority of Meritage's common and convertible preferred shares, and Alluvial is one of the largest outside shareholders.

Scandic Hotels is a rather new holding, but has an intriguing business model. In the US, a typical hotelier purchases a property by borrowing 60-70% of the purchase price. This model's fixed costs are high because of interest and principal paydown requirements, but so are the rewards if hotel occupancy and room rates remain strong. In Scandinavia, the industry works a little differently. Rather than purchase properties using mortgage financing, hotel operators sign long-term leases with hotel owners. These leases include both a fixed annual rent component and a royalty on the gross revenue the hotel generates. This model limits the hotel operator's upside somewhat, but also reduces risk in difficult operating environments as lease expenses decrease along with hotel revenue. In addition, property owners are incentivized to work with hotel operators to keep properties in top condition and maximize their lease earnings.

Scandic takes full advantage of this operating model. The company can add rooms to its network at a rapid pace because nearly no upfront capital is required. At year-end, the company offered over 40,000 rooms and had nearly 5,000 in its pipeline to add in 2017 and 2018. As long as the company is successful in filling these rooms, profits will follow. But Scandic's business model possesses one more very attractive feature. It generates float! The majority of Scandic's hotels are basic but comfortable, and Scandic has an extensive presence in mid-sized and smaller cities. This makes them perfect for corporate travel, and indeed Scandic operates a loyalty program for business travelers and others. This results in a lot of prepaid revenue. And I do mean a lot. In 2016, Scandic Hotels earned SEK 879 million, but negative working capital investment added another SEK 150 million to operating cash flow. The amount of float that Scandic adds varies from year to year, but will remain positive as long as the company continues to expand its hotel network.

When investing in a company like Meritage Hospitality or Scandic Hotels, Alluvial's intent is to be a very long-term owner and enjoy the exponential increase in value that such companies often produces. However, I am not oblivious to the fact that in a market economy, economic moats are constantly under attack and can vanish. Should these companies lose their ability to earn excess profits or their values reach truly unjustifiable heights, I will not hesitate to sell them.

2. Traditional Value

Alluvial Fund also owns companies that may not have truly exceptional economics or business models, but nonetheless trade at large discounts to a conservative estimate of intrinsic value. Alluvial is especially interested in situations where downside is limited by the presence of valuable tangible assets or a highly secure stream of cash flows. Typically, these companies are cheap because some aspect of their operations or outlook is misunderstood by the market. Other times there is some barrier to efficient pricing, such as a tiny investable float, an unusual listing status or reporting format, or the limits of GAAP accounting conventions.

Contura Energy is a prime example. The reorganized metallurgical and thermal coal provider's shares are illiquid and unlisted, controlled by a group of former debtholders. The company is not an SEC reporter and operates in a thoroughly despised industry haunted by the memory of recent bankruptcies. What the company *does* have is a newly robust balance sheet and cash flow, so much cash flow. The recovery of coal prices since mid-2016, especially for metallurgical coal, will allow Contura to produce free cash flow of at least $15 per share in 2017, and possibly more. Results will likely ease in future years as the metallurgical coal supply and demand environment normalizes, but I expect the company to remain a healthy cash generator. Right now, the company is not on most investors' radar and shares are difficult to accumulate, but I expect this to change once the company does an IPO later this summer and resumes regular SEC reporting.

Calloway's Nursery is another deeply discounted stock, one that is backed by quite a bit of real estate value. The Texas nursery and greenhouse company has seen its results improve dramatically since Peter Kamin bought a controlling stake, but shares still trade hands at less than 7x trailing operating income. There is good reason to believe this ratio will decline as new management continues to improve margins and open new centers. The fact that the company owns several attractive real estate parcels underlying its stores in growing areas provides both downside protection and potential gains if the company elects to sell them outright or perform a sale-and-leaseback transaction.

Then there is **Retail Holdings NV**, which I have owned for several years. "ReHo" is truly an odd duck. This is a company headquartered in the Caribbean backwater of Curaçao, traded over-the-counter in the US, and with all its operating assets in Southeast Asia. ReHo is a slow-moving liquidation story. For years, the company has been selling down its holdings in consumer goods companies in India, Bangladesh, Sri Lanka and formerly, Thailand and Pakistan. Retail Holdings has used the proceeds to pay large dividends and buy back stock, all the while promising a full liquidation in the "medium term." That liquidation is finally within view as the company is now guiding for a 2-4 year period for completing the liquidation process. Evaluating the likely proceeds is a simple matter as the company's operating assets are publicly traded. As I write, the value of ReHo's Asian shareholdings is just over $27 per ReHo share. The company also possesses some corporate cash and over $20 million in defaulted debt that may still have some value. In my view, shareholders will receive at least $30 in distributions in the course of the liquidation. The current trading price represents a 33% discount to this value, and the value of the underlying assets may grow if the earnings of the Asian subsidiaries continue to improve.

3. "Someday" Stocks

Possibly my favorite category, "someday" stocks are the impetus behind launching Alluvial Fund, LP. The partnership structure, with the backing of very patient capital, provides Alluvial with the ability to invest in some absurdly undervalued and extraordinarily illiquid securities that may take several years, even a decade or longer, for value to be realized. Many of these holdings I am reluctant to name because I am constantly in the market trying to acquire scarce shares. These securities are often very high-priced, may have a controlling shareholder, and rarely if ever does the issuer communicate with the market. I can provide one example, **Tower Properties**. (I have written about this company before, so the cat's already out of the bag to some extent.) Shares of Tower Properties are some of the highest-priced that trade over-the-counter in the US. The most recent trade took place at $16,800, and the current bid is higher. On a heavy volume month, a mere handful of shares change hands. And yet, I have been able to build up a position and I intend to buy more shares as the market allows. Why? Because Tower Properties owns real estate, cash, and securities worth over $38,000 per share, net of debt. The company is well-run and management has succeeded in building equity value steadily over time. The company also rewards its shareholders with occasional share buybacks and special dividends when it does not have attractive investment opportunities. This is an important distinction, because there are many other companies that trade at huge discounts to asset value, but management is either actively siphoning off that value for themselves or else failing to increase asset value at an acceptable rate. If I buy shares in a company at 50% of asset value and I receive that same asset value in one decade, the annual rate of return is ~7%. Nothing to write home about. On the other hand, if I buy shares at a 50% discount to asset value and that value compounds at 10% annually before value realization occurs one decade hence, that's 18% annualized and what I would consider a very successful outcome.

That's my hope with these "someday" stocks, that I manage to buy them at a steep discount and benefit both from increasing intrinsic value and eventual convergence to that value. I never really know when the discount will disappear. It could happen tomorrow, next year, or next decade. But if I purchase shares in firms that are actively increasing their equity value, not these that are melting ice cubes or metaphorically encased in amber, I am confident the outcome will be satisfactory.

4. Cash, Liquidations, and Arbitrage

Like most value investors, I don't spend much time worrying about macro-economic factors. My time is better spent in monitoring existing investments and looking for new ideas. That, and chasing my very active baby son around the house. Because I am no expert at forecasting market corrections, I don't hold a large cash balance. But I do like to keep some cash around, mostly because I never know when the next opportunity comes along. There's only one problem with that: the return potential of cash is terrible. So whenever possible, I like to invest spare cash in liquidations and arbitrage opportunities. The best of these opportunities offer mid-teens return potential with little correlation to the movement of the broader market. They also serve as a source of liquidity if a more traditional opportunity comes along.

It’s been difficult to find attractive liquidations and merger arbitrage opportunities in recent years. Merger arb spreads have compressed to the low single digits for large company deals, and improved economic conditions have reduced the number of firms entering liquidation. Nonetheless, I’ve identified some excellent opportunities. Like my “someday” stocks, I won’t mention most of these as I am still buying shares and I don’t want the spreads to collapse prematurely. But I will talk about **Precision Auto Care**. This company is being acquired by Icahn Automotive for a gross price of $37 million. The deal is expected to be completed by the end of July. Shareholder approval is a foregone conclusion based on management’s level of ownership. The estimated per share merger consideration is $1.84, 8% greater than the last trade of $1.70. However, the merger compensation will be received over a period of time. The company estimates shareholders will receive $1.57 per share in connection with the closing, and approximately $0.27 per share over the next two years as excess working capital and escrow proceeds are released. The prospective IRR on this transaction is wonderful as over 90% of the current share price will be returned in a matter of weeks, freeing up capital for other opportunities. I expect Alluvial Fund to receive cash inflows from other merger transactions and liquidations later this summer and into autumn. As I write, 13% of Alluvial Fund’s value consists of cash, liquidations, and merger arbitrage positions.

Value and Where to Find It

One of the most common questions I get from Alluvial partners and others is “Where are you finding value right now?” While I am certainly very bullish on the domestic companies that Alluvial Fund owns, I have been finding the majority of *new* ideas in overseas markets, especially Western Europe and Scandinavia. Despite a strong upward move in European equities, many small companies (in particular, those outside of indexes) have not seen the same appreciation and offer outstanding value. I am continually amazed at the valuation differential that exists between companies with very similar business models, capital structures, growth outlook, and profitability, just because one happens to operate and trade in Europe. A good example is the continental IT consulting industry, which has been very good to me. There are probably twenty small listed IT consultants in France, Germany, and Sweden alone. Nearly every one of them enjoys organic revenue growth of 6-8% annually, an operating margin of 8-10% and rising, and has net cash on its balance sheet. And yet, these businesses trade at under 10x EBIT and with a P/E of under 15, net of excess cash. The demand outlook could not be brighter as the need for technical expertise at Europe’s large corporations will only increase. Were these companies American, they would be investor darlings and trade at P/E ratios of 25x or higher. I am happy to invest in these high quality firms at very reasonable valuations and enjoy their growth. Right now I am spending a lot of time looking for new opportunities in Central Europe and in Australia.

On Banks

About one year ago I identified community banks as a very attractive segment for those with the ability to invest in these often tiny firms. Not long after that, the sector got hot as hopes rose for some regulatory relief and the advent of a rising interest rate environment. That optimism has abated somewhat, but I am still finding many good opportunities in the small bank space. I have invested Alluvial Fund capital in a handful of banking stocks. Some are simply well-run, growing banks trading far too cheaply and others are special situations where balance sheet restructuring could unlock value. One Alluvial holding is **Alerus Financial**, a highly successful “non-bank bank” that has expanded into benefits administration and mortgage banking. Heavy amortization charges and one-time items mask the bank’s underlying profitability, and I believe normalized earnings will exceed $2.50 per share in short order. Alerus has been a steady acquirer and will likely continue to expand in retirement plan administration and other fee-based services.

Operational Updates

I have been highly encouraged by the level of interest in Alluvial Fund. I truly believe we are building a vehicle that can take advantage of some really unusual and lucrative opportunities in the forgotten corners of world markets, as well as value that is hiding in plain sight. I am currently evaluating providers who can offer access to many more world stock markets, many of which are sure to offer exceptional bargains. In addition, I continue to evaluate the market environment in niches like agricultural co-ops and liquidating leasing companies. At present the market does not offer many opportunities in these areas, but it one day may.

I hope to welcome many additional limited partners to Alluvial Fund through the rest of the year. Alluvial Fund accepts new limited partners and new investments from existing limited partners on a monthly basis, so please reach out if you are interested. As Alluvial Fund grows, our ability to access new markets and opportunities will also grow. As always, do not hesitate to contact me with questions about the partnership's holdings or general strategy. I hope you enjoy the rest of your summer and I look forward to reporting to you again in October.

Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

Disclosures

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Performance data provided in this publications is not audited. Alluvial Fund, LP has a fiscal year end of December 31, 2017 and is subject to an annual audit.

Performance figures for Alluvial Fund, LP are reported net of all partnership expenses, management fees, and performance incentive fees. Reported performance figures assume Alluvial Fund's standard management and performance incentive fees apply.

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