Alluvial

CAPITAL MANAGEMENT, LLC

http://alluvial.capital 1833 Kleber Street, Pittsburgh, PA 15212 info@alluvialcapital.com (412) 368-2321

First Quarter 2018 Letter to Alluvial Fund, LP Limited Partners – April 23, 2018

	Alluvial Fund, LP (Gross)	Alluvial Fund, LP (Net)	S&P 500 TR	Russell 2000 TR	Alluvial Fund, LP (Net) vs. S&P 500	Alluvial Fund, LP (Net) vs. Russell 2000
YTD 2018	**3.4%**	**2.7%**	**-0.8%**	**0.0%**	**+3.5%**	**+2.8%**
2017	38.5%	29.6%	21.8%	14.7%	+7.8%	+15.0%
Cumulative	43.2%	33.1%	20.9%	14.6%	+12.2%	+18.5%
Annualized	33.3%	25.7%	16.4%	11.5%	+9.3%	+14.2%

Partnership began operations 1/1/2017

Top Holdings	**%**
Otelco	8.1%
New Ulm Telecom	7.2%
Syncora Holding	7.0%
Bluelinx	5.7%
Meritage Hospitality	5.6%
Bredband2 I Skandinavien	5.6%
Retail Holdings	5.3%
MMA Capital Mgmt.	5.0%
Calloway's Nursery	4.9%
Polaris Infrastructure	4.9%
Total, Top 10:	**59.2%**

World Allocation	**%**
United States	82.1%
Sweden	8.6%
Canada	5.0%
Mexico	1.9%
Poland	1.7%
Other	0.7%
Total	100.0%

Dear Partners,

Alluvial Fund, LP was up modestly in the first quarter, returning 2.7%. The S&P 500 was down slightly, while the Russell 2000 treaded water. The small change in each market index's ending value belies the volatility that markets experienced this quarter. I am pleased to say that even during the worst of the correction, Alluvial Fund's holdings held up very well. At the lowest point, Alluvial Fund had declined roughly 2.5% from its year-end value, compared to nearly 10% for large cap and small cap indexes. This may not always be the case, but recently our focus on obscure and ignored securities and special situations has served us well.

With a new season of quarterly earnings updates upon us, I am very excited to see what each of our portfolio companies has to report. I trust the companies we own to run their businesses well and to increase their intrinsic values at an acceptable rate. When and to what degree the market will reward this progress, I can never say. My mission is to identify securities trading at large discounts to intrinsic value, to purchase these securities with care, and then to wait. Sooner or later, the market recognizes this intrinsic value and prices adjust accordingly.

Special Situations

Special situations like liquidations and merger arbitrage continue to be an important aspect of Alluvial Fund's strategy. These scenarios can offer very attractive return potential with little exposure to the gyrations of the stock market or changes in general economic conditions. I regularly encounter liquidation and merger arbitrage opportunities in small companies offering mid-teens or higher internal rates of return. The small size of these opportunities makes them inaccessible for very large pools of capital, but ideal for a smaller partnership like Alluvial. The specifics of active special situations will go undescribed in this letter, as I am still increasing our holdings in some. However, I would like to describe a special situation that Alluvial Fund participated in in 2017 that should be fully realized in the next few months.

Essex Rental was, simply put, a disaster of a company. Formed from a SPAC, the company was an owner and lessor of various types of construction cranes. From the beginning, the company struggled mightily with low utilization rates and excess debt. As the company's share price sunk far below tangible book value, multiple investor friends of mine pitched the stock, noting that reasonable estimates of value in an orderly liquidation far exceeded its enterprise value. The idea was never compelling to me, and I never bought shares. Distressed companies rarely receive "orderly liquidation" prices for their capital assets, especially when demand for these assets is at a cyclical ebb. Business never did improve much. The company entered a series of forbearance agreements with its lenders and deregistered its stock. Most investors moved on as the company went radio silent.

One day in May of last year, Essex Rental sprang to mind as I was looking through old investing notes. I decided to give the company another glance. Information was not easy to find, as the company was no longer making SEC filings or doing press releases. But a little poking around the company's website turned up an extremely interesting news item. Turns out the company had reached an agreement to sell off all its remaining assets to a private equity firm. A little more searching turned up a proxy statement with a plan for liquidation for Essex following the closing of the sale. The estimated liquidation proceeds to shareholders? 28-35 cents per share. Management's estimate of liquidation expenses appeared appropriately conservative, leading me to believe that shareholders would ultimately receive at least 25 cents per share.

Imagine my excitement to see that shares were changing hands for just 19 cents! Reviewing the deal agreement and the company's ownership structure gave me a high degree of confidence that the deal would be completed, and the plan of liquidation approved by shareholders. Over the next months, I bought up 2.5 million shares of Essex Rental, nearly 15% of the company. Essentially, I purchased every share that became available for 21.5 cents or less. 21.5 cents was my self-imposed ceiling. It's always best to build in a good margin of safety in liquidation scenarios, where unexpected costs can eat away at shareholder recoveries.

It didn't take long to receive 95% percent of our investment back. The deal closed in June and in August, Essex Rental declared a 20 cent distribution. The company also announced that shareholders could expect to receive up to 8 cents per share in additional distributions over the next two years. The majority of these payments should be received this summer, when $2.5 million in held in escrow following the asset sale will be released. Assuming Alluvial Fund receives 6 cents per share this summer and ignoring any additional distributions, the partnership will have achieved a 28% return on this investment in fifteen months. This figure actually understates how good the opportunity was, because we received 95% of our capital back in just three months, allowing us to invest in other opportunities. The internal rate of return on Essex Rental should be higher than 60% when all is said and done.

Opportunities as good as Essex Rental are rare, but they do exist. Most require serious digging to discover. Good thing digging into these obscure and unusual opportunities is my favorite thing to do!

Syncora Holdings Ltd.

At first glance Syncora is a distressed monoline insurance company in run-off. The company appears highly leveraged, with an earnings stream that is volatile and difficult to predict. In reality, Syncora has nearly completed its process of rehabilitation, and is now a collection of valuable assets that should be monetized over the next six to eighteen months.

In January, Syncora announced two major transactions. The first was the merger of the company's two active insurance subsidiaries into a single entity. This transaction had no major economic impact on the company but did simplify Syncora's complex corporate structure. The second transaction was a settlement of long-running litigation with Greenpoint Mortgage Funding for at least $335 million. Syncora has long been engaged in litigation with various counterparties it accuses of making misrepresentations during the underwriting process for various debt that Syncora insures. The Greenpoint suit was the largest of these suits in terms of damages sought, but litigation continues with other parties and additional settlements are possible.

Investors sent Syncora shares up 25% following the announcement of these transactions, but I believe there is much more to come. Syncora is now engaged in another set of proposed transactions that will again reveal hidden value and see the company dispose of 90% of its remaining insurance obligations.

The first is the sale of American Roads. American Roads is a collection of high-quality toll road concessions Syncora received from a default on debt it insured. Now, Syncora is seeking to sell these assets. Bidding for American Roads has entered the second and final round. The range of possible selling prices is wide, but the successful conclusion of the sale process will provide Syncora with a lot of cash and further simplify operations.

The second significant transaction is the proposed reinsurance transaction with Assured Guaranty. Syncora is seeking to lay off 91% of its remaining insurance exposure. Syncora would be left with $1.3 billion net par value of bond insurance exposure with a weighted average maturity of 12.5 years. This remaining book includes $220 million net par value of Puerto Rico bonds, but these are very well reserved against. This transaction is subject to approval by the usual regulatory bodies, but I do not view this as a meaningful obstacle.

Following these transactions, Syncora will be "barely" an insurance company, and should be free to use its unrestricted cash to redeem its holding company obligations and explore other transactions. The company has billions in NOLs and while I am hesitant to value these too generously given the dismal track record of other NOL acquisition platforms, the NOLs do carry potential value. Adjusted book value per share should be above $7, more than twice the current trading price for Syncora shares. I will have to reassess my estimate of the company's worth following the completion of these transactions, but I don't expect to sell Syncora shares anywhere close to the current price.

MMA Capital Management

MMA is a long-time Alluvial holding, and we are one of the larger holders of MMA stock. It's been enjoyable to see our proportional interest in MMA increase as the number of shares outstanding has steadily declined. This years-long process of selling off various assets and applying the proceeds to share buybacks at well below economic value was one engine of returns for MMA shareholders. The other was the company's successful efforts to build operating businesses. The company has established a profitable and growing solar complex construction lending business and re-entered its specialty low income housing tax credit management business.

In January, the company announced a sweeping transaction with the Hunt Companies. In this transaction, MMA sold its asset management businesses to Hunt and externalized management. MMA's former leadership is now employed by the Hunt Companies, a move which is expected to save on administrative costs. The Hunt Companies also agreed to purchase 250,000 MMA shares at an average price of $33.50. Hunt will use "new MMA" as a public vehicle with which to continue MMA's leveraged fixed income investing and solar construction lending activities.

As a result of this transaction, MMA's book value per share will rise to at least $32. The current trading price of $27.5 represents a 15% discount to GAAP book value. Book value should see further increases in 2018 from operating earnings and continued share buybacks. MMA will not repurchase its shares at the same breakneck pace as before, but they do have approval to buy 125,000 shares at or below $30 per share. The current trading price represents a discount of roughly 20% to my estimate of year-end 2018 book value. I find this price very attractive, and so do company insiders. Since announcing the deal in January, insiders (including one James Hunt) have purchased nearly $300,000 in company stock on the open market.

On Selling

Now for a little discussion on two holdings that have left the portfolio, ALJ Regional Holdings and Fusion Telecommunications. Like many investment managers, I find the decision to sell a holding much more difficult to parse than the decision to buy. I find it useful to remind myself that all investing is an exercise in evaluating opportunity cost. Whenever I buy a security, I am also choosing *not* to buy any other security in existence instead. That's sobering, considering the length of the roster of potential investments. How can I be sure I am making the best choice? All I can do is keep looking for a superior alternative. And that's the first reason for a potential sale: I found something better. Whenever I come up with a new investment idea, I compare it to all the existing portfolio holdings, as well as our idle cash. In order for the new idea to earn a place in the portfolio, it not only has to meet my potential return requirements, but it must be better than all existing holdings on a risk-adjusted basis. (It also has to be a better idea on a *tax-effected* basis. I will not sell an appreciated position and trigger a current tax liability in order to buy something that has only marginally superior return potential.)

That is why I sold Fusion Telecommunications. I still like the company and think they'll succeed in proving the viability of their business model. Success in the enterprise connectivity market is a game of scale and Fusion's proposed merger with Birch is an excellent transaction. However, the resulting company will be highly leveraged and faces an uphill march as it competes against much larger and more established competitors. The "superior alternative" to Fusion I have found is Bluelinx. Shares of Bluelinx have the same or better return potential, but with less leverage and transaction and integration risk. More on Bluelinx in a few paragraphs.

Another reason for selling is that a company fails to meet my standards for integrity and credibility. My responsibility as an investment manager includes avoiding investing in companies and management teams that are untrustworthy, self-serving, or predatory. I believe that any short-term advantage a company can achieve by acting abusively toward its customers, employees, suppliers, or investors is outweighed by the long-term costs of such behavior. Mistreating stakeholders eventually shows up in higher employee turnover, lower customer satisfaction, a lower quality product, and a higher cost of capital in the marketplace. More importantly, it's simply wrong.

ALJ Regional Holdings let me down on multiple fronts this year, and so I sold. In January, Reuters reported a massive sexual harassment lawsuit against ALJ's chairman. The allegations do not involve an ALJ employee, but the company still owes shareholders a response. In light of the allegations, independent board members have a duty to examine the chairman's conduct at ALJ to ensure he has complied with all company policies. The company has not released any statement, perhaps hoping that investors will choose to ignore the issue. This is not sufficient.

The company also failed investors by quoting highly optimistic guidance in January, then following that guidance with an abysmal first quarter earnings release just six weeks later. Note that the lousy quarter was already complete when management provided its rosy outlook on January's investor conference call. I very much question management's candor in providing this guidance, knowing as they did that first quarter was so weak. It's possible that management anticipates a strong uptick in business conditions as the year goes on, but they did not see fit to mention this fact to investors in conjunction with the first quarter report. In order to meet the low end of its EBITDA guidance for 2018, the company will have to grow its EBITDA by 28% year over year in the remaining three quarters of fiscal 2018. Free cash flow will have to exceed $20 million, far more than the company has ever produced in any nine-month period. A tall order.

Questions about the chairman's conduct and management's forthrightness with shareholders caused me to lose confidence in the company. ALJ Regional Holdings no longer meets my standards for integrity and credibility, so I can no longer own shares.

Rural Telecommunications

Alluvial Fund's largest industry concentration is rural telecommunications. Our two largest holdings, New Ulm Telecom and Otelco, make up 15% of the partnership's value. We also hold shares of LICT Corporation and small positions in LICT's associated entities. I remain extremely optimistic on the future of these companies as they transition from traditional telecom services to fiber and data services, supported by the FCC's new subsidy mechanism, ACAM.

Otelco reported solid fourth quarter results. Revenue declined 0.2% year-over-year and EBITDA declined 3.0%. For the full year, revenue declined 0.6% while EBITDA was down 1.6%. To be clear, I expect Otelco to continue to report EBITDA declines for some time. However, I expect the company's debt load to decline much more quickly, reducing risk and creating equity value. Thanks to its new, lower interest CoBank borrowings and tax incentives, I expect the company to generate at least $12 million in free cash flow this year, nearly all of which will be used to pay down debt. The company is also free to invest in growth opportunities following several years of creditor-enforced austerity. Otelco could install an additional 100 miles of fiber this year, creating revenue opportunities from rural customers able to access the internet at true broadband speeds for the first time.

If anything, I am even more excited about New Ulm! The company has announced an enormously savvy acquisition of a local competitor. New Ulm is buying Scott-Rice Telecom from fiber company Zayo Group as Zayo seeks to exit low-growth legacy businesses. New Ulm did not provide much information on Scott-Rice in its press release, but thankfully Zayo provided a little more. We know that Scott-Rice has annual revenue of $15 million and EBITDA of $10 million. An older presentation from Zayo indicates Scott-Rice has annual capital expenditure needs of about $3.5 million. For this $6.5 million in pre-tax, unlevered cash flow, New Ulm is paying just $42 million. Better yet, New Ulm will borrow nearly the entire amount from CoBank at under 5%. With this transaction, New Ulm will increase its annual pre-tax earnings and cash flow by more than $4.5 million. This is extremely significant for a company with a market capitalization of $83 million! The deal is set to close this quarter, but the market remains disinclined to credit the company in any way for its excellent acquisition. I do not think this state of affairs will last.

BlueLinx

BlueLinx is a new, but relatively large holding for Alluvial Fund. BlueLinx is a building products distributor. The company supplies homebuilders, contractors, and dealers and retailers like Home Depot and 84 Lumber with all manner of materials, mainly for use in home exteriors. As a distributor, BlueLinx compensates for its structurally low margins by attempting to minimize its working capital investment and economizing wherever possible on delivery and service costs. BlueLinx has just acquired a competitor, Cedar Creek. With the purchase, Bluelinx has nearly doubled in size and will enjoy greater purchasing power and a more efficient distribution network. The company believes the transaction will create at least $50 million in annual savings. The company took on debt to complete the acquisition of Cedar Creek but will pay down this debt rapidly by selling or performing sale-and-leasebacks on the company's substantial real estate holdings. BlueLinx owns many of its distribution centers outright, and estimates these sites are worth $150-160 million. The company will not owe tax on the proceeds from the sale of these parcels due to accumulated net operating losses.

I believe BlueLinx is capable of earning at least $8 per share in 2019, and perhaps far more if housing starts rise to average historical levels. Even after the purchase of Cedar Creek, BlueLinx remains a small company with a low profile. Shares soared following the announcement of the Cedar Creek acquisition, but I expect them to rise further as market awareness grows and the company achieves its projected cost savings.

Partnership and Personal Updates

As I write, Alluvial Fund, LP has assets of $18.5 million. We welcomed several new partners into the partnership this quarter. We are looking for more! The world is wide, and I continue to see promising investment opportunities in the United States and abroad. If you know of any qualified investors who may be interested in Alluvial Fund, I would welcome your referral.

I will be attending the Berkshire Hathaway shareholders' meeting in Omaha the first weekend of May. Immediately following the end of the Berkshire question and answer session, I will be participating in an investor day hosted by Willow Oak Asset Management. The investor day will begin at 4pm and will be held at the Hilton Hotel in the Murray Conference Room on the second floor. The hotel is located at 1001 Cass St. next to the CenturyLink Center. The investor day will be a great chance to ask questions of me and a few other fund managers, so I hope I see you there! If you cannot attend the investor day but do plan to be in Omaha that weekend and would like to meet up, please let me know.

Finally, I am incredibly excited to announce that my wife, Kayleigh, and I are expecting another child to be born in late September. Please wish us good health and boundless energy as our family grows!

Please feel free to reach out with any questions about Alluvial Fund's portfolio or strategy, or just to catch up. Have a great spring, and I look forward to reporting to you again in July.

Best Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

Disclosures

Investment in Alluvial Fund are subject to risk, including the risk of permanent loss. Alluvial Fund's strategy may experience greater volatility and drawdowns than market indexes. An investment in Alluvial Fund is not intended to be a complete investment program and is not intended for short-term investment. Before investing, potential limited partners should carefully evaluate their financial situation and their ability to tolerate volatility.

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Performance Notes

Net performance figures are for a typical limited partner under the standard fee arrangement. Returns for partners' capital accounts may vary depending on individual fee arrangements.

Alluvial Fund, LP has a fiscal year end of December 31, 2017 and is subject to an annual audit by Cohen & Company. Performance figures for year-to-date periods are calculated by NAV Consulting, Inc. Year-to-date figures are unaudited and are subject to change.

Gross performance figures are reported net of all partnership expenses. Net performance figures for Alluvial Fund, LP are reported net of all partnership expenses, management fees, and performance incentive fees.

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.