Alluvial

CAPITAL MANAGEMENT, LLC

Dear Partners,

For the quarter ended September 30, Alluvial Fund, LP declined 2.0%, modestly better than the Russell 2000 Index. Year-to-date, the fund remains slightly behind the index. Since inception, the fund has roundly out-paced small-cap and micro-cap indexes but remains behind large-cap stocks.

Alluvial Fund remains focused on identifying opportunities in the overlooked corners of the market where larger funds cannot or will not invest. Our holdings are drawn from the ranks of the illiquid and the little-known and offer exceptional value versus large, liquid stocks. I am equally happy to buy into a liquidation or reorganization scenario as I am an undiscovered growth story. Value takes many forms. No matter the scenario, I continue to express a strong preference for companies with strong balance sheets, healthy margins, durable demand for their products and services, and sensible, well-incentivized management.

TABLE I: Alluvial Fund LP Returns (%) as of September 30, 2019

	YTD 2019	2018	2017	Cumulative	Annualized
Alluvial Fund LP NET	12.0	-9.0	29.6	32.1	10.7
S&P 500 TR	20.6	-4.4	21.8	40.4	13.1
Russell 2000 TR	14.2	-11.2	14.7	16.3	5.6
Russell MicroCap TR	7.9	-13.1	13.2	6.2	2.2

Partnership began operations 01/01/2017

With the majority of 2019 in the books, I would call this a moderately frustrating year. The fund's successes have outnumbered the disappointments, but the market's attitude toward our average holding has been one of disinterest. To be clear, I expect the market to ignore many developments at our tiny, thinly-traded securities in the short run. Instances where market perception lags economic reality routinely create opportunities for the fund. However, the present market seems particularly uninterested in value creation occurring anywhere besides a short list of high-profile, on-trend companies. There is an expression we use in Pittsburgh and which I imagine is common in many other places: "If you don't like the weather, just wait a minute." The same applies to markets. Sooner or later, the market will discover the merits of the assets, cash flows, and growth opportunities our holdings possess.

Syncora Holdings

It finally happened. After spending years undergoing a complex restructuring and rehabilitation, **Syncora Holdings** announced the sale of its insurance subsidiary. This long-anticipated outcome was central to my thesis for holding shares. Unfortunately, the price Syncora achieved was disappointing. I suspect the company accepted a less lucrative offer over alternatives that could have resulted in a higher price, but over a longer time period or with less regulatory certainty. Even after the acquirer, Goldentree Asset Management, raised its bid in September, the resulting deal value was still a bitter pill for many long-term shareholders. Unfortunately, the structure of the deal does not require a shareholder vote.

Despite the stumble at the finish line, the fund's investment in Syncora Holdings was an extremely successful one. In a little over two years, Syncora returned greater than 50% with minimal exposure to market risk. My only regret is not buying more, sooner. Syncora is an excellent example of the type of special situation that can arise in complicated, stigmatized securities. Having sold nearly all our Syncora shares, I am working on redeploying that capital into other compelling ideas.

Rural Telecoms

As has become *de rigeur* in these quarterly updates, I'll provide an update on the market's most boring stocks: the rural telecom complex. Our holdings, the largest of which are **Nuvera Communications** and **LICT Corporation**, continue to generate huge cash flows and invest these cash flows in next-generation fiber optic networks. They reward shareholders directly with dividends and share repurchases, and indirectly via deleveraging. Both companies participated in the recent FCC spectrum auction, purchasing high frequency bandwidth for future 5G applications.

Shares of Nuvera are hovering around $20. The company's 2019 cash earnings will be $2.80 or so, measured as GAAP profit plus non-cash intangibles amortization. Net of excess cash, the company's normalized price-to-cash-earnings ratio is under 7x. I believe a fair value for this defensive, well-capitalized, fiber-rich telecom is at least 12x normalized cash earnings, which would value shares at more than $32. I never know when exactly a company's shares will converge with fair value, but I am thrilled to hold this high-quality company at a double-digit earnings and free cash flow yield.

TABLE II: Top Ten Holdings (%)

Nuvera Communications	10.3
LICT Corporation	6.8
Crawford United Corp.	6.7
Rand Worldwide Inc.	6.3
MMA Capital Management	5.9
P10 Holdings Inc.	5.5
Intred S.p.A.	5.0
Bredband2 i Skandinavien AB	4.6
Sirio S.p.A.	4.6
Polaris Infrastructure	4.6
Total, Top Ten	***60.3%***

Shares of LICT Corporation had a great summer, rising to nearly $20,000 before retreating slightly. LICT continues to enjoy the fruits of its aggressive investment in fiber over the last several years with non-regulated broadband revenue growing nicely. The company is also a major beneficiary of the FCC's A-CAM program. After years of debt reduction, LICT now has net cash on its balance sheet—highly unusual for a telecom! The tremendous strength of LICT's balance sheet provides the company with optionality. LICT can accelerate its share buyback program, consider a large special dividend, or perform a sizable acquisition. My preference would be for an acquisition, but we will have to wait and see what Mario Gabelli and Co. have in store for us. LICT's normalized annual free cash flow per share is approaching $1,500. With net cash on the balance sheet and a premier network, LICT shares are an excellent buy anywhere below $25,000. This valuation will increase as time goes on and LICT's fiber investments mature, or if the company performs an accretive acquisition.

Alluvial Fund also holds smaller positions in **Alaska Power & Telephone** and **North State Telecommunications**. Alaska Power & Telephone jumped recently after a mention in Barron's, but remains far, far undervalued. North State Telecom is a fiber-optic provider in North Carolina's Research Triangle. After a few lean years, the company's investment in its network is paying off and cash flows are inflecting higher.

Alluvial Fund's rural telecom investments make up 18% of our portfolio. These are not the type of holding that will double overnight. It can be frustrating to hold companies like these when the market soars, watching them plod along as Keynes' "animal spirits" excite the flashier companies and sectors. However, I am highly confident our investments in these steady companies will yield annualized returns of 15-20% for years to come.

P10 Holdings

P10 Holdings is a relative newcomer to the Alluvial Fund portfolio and one of the most interesting and potentially lucrative opportunities I have come across in some time. P10 Holdings is a textbook example of GAAP accounting conventions obscuring underlying profitability. Combine that with illiquidity and non-SEC reporting status and you have a deeply discounted stock.

P10's history is convoluted. The enterprise was formed from the bankruptcy of Active Power, Inc. In 2017, the company was recapitalized by a team of investors in Texas, and the company's substantial net operating losses were preserved. P10 industries then bought an interest in a Chicago-based private equity group, RCP Advisors. RCP was founded in 2001 and has attracted nearly $8 billion in capital commitments over its history. P10 purchased the rights to the management fees generated by RCP's managed funds, with the rights to performance-based fees generated by the funds being retained by the sellers. P10 financed the transaction by issuing 49% of P10 stock to RCP's owners (again carefully avoiding an "ownership change" for the purpose of preserving NOLs) and issuing zero-interest seller's notes for the remainder. As cash flows allow, P10 has been replacing the seller's notes with term loans.

Today, P10 owns a highly predictable revenue stream that will only grow as RCP launches new funds and grows its assets under management. The asset management business requires practically zero reinvestment, allowing P10 to invest the cash it receives in co-investments with RCP or other opportunities. Because of the way the deal was structured, P10 recorded a large intangible assets balance related to its purchase of RCP: $53 million for management fund contracts, $17 million for tradenames, and $6 million for technology. These $76 million in intangible assets will be fully amortized over the next several years, but the economic value of RCP will not diminish as long as the firm is successful in attracting additional capital for new funds. P10's free cash flow production will far exceed its reported profits for the years to come.

In 2018, P10 took in $16 million in operating cash flow following its purchase of RCP. Through June of this year the company has collected another $9 million. Capital expenditure needs are minimal. The company is allowing cash to build on its balance sheet to fund future acquisitions or co-investments. Fundraising efforts have been productive. Revenues associated with legacy funds will naturally decline as these vehicles liquidate, but RCP has already closed on $280 million in new capital commitments year-to-date.

P10 is capable of producing 18 cents per share in free cash flow this year, and more in future years as RCP's assets under management grow. The company will not be a cash taxpayer for many years, with over $260 million in federal net operating loss carryforwards and $59 million in intangible assets still to be amortized. At around $1.25, P10 trades at just 7x free cash flow. Shares of P10 have been volatile and may continue to be. After peaking around $1.50 this summer, a few small sellers managed to knock shares down to as low as $1.06 earlier this month. I am happy to say Alluvial Fund was able to take advantage of the sale!

Meritage Hospitality

Of all Alluvial's holdings, the one that seems to attract the most questioning and brow-furrowing is **Meritage Hospitality**. *"Why do you like it? What's the attraction? Can this really be a decent business?"* Critics of the company fixate on its financial leverage and its perceived exposure to consumer spending and confidence. I do understand the skepticism. Meritage shares have not traded well over the last two years. But I believe critics are missing the larger picture. Meritage's business model is simple, profitable, repeatable, and scalable. The recipe that allowed shares to rise tenfold from 2011 to 2018 remains intact.

Ex. — "Classic" Wendy's

In order to assess Meritage's business model, we have to look at its most fundamental equation. Meritage acquires tired old Wendy's restaurants in second and third tier markets (pictured at right as "Classic" Wendy's) and spruces them up ("Modern" Wendy's).

Ex. — "Modern" Wendy's

Or, it simply builds a new restaurant. The economics are compelling! Per the company, a newly built Wendy's at current brand standards costs a shade over $2.4 million. That includes the land, building, and fixtures. Once this restaurant is up and running, it will produce cash flow of around $300,000, a 12.5% cash yield on cost. The returns improve once leverage is considered. Meritage will do a sale-and-leaseback of the underlying real estate, take out a mortgage, or draw on its credit lines to reduce the equity component of each deal. A Wendy's franchise is an investment-grade asset, and Meritage easily borrows a significant portion of the total investment at a cost of 5-6%. Even factoring in taxes, the return on equity is attractive. In other words, it behooves the company to invest as much capital as possible in order to expand its restaurant count. So long as the return generated by new units exceeds Meritage's cost of capital, shareholders benefit.

The equation works for one unit, and it works for hundreds. Meritage spent the last decade bootstrapping its way from fewer than 50 Wendy's units to more than 300, with plans to reach 420 units by the end of 2021. All indications say they will. The company recently acquired another 5 restaurants in Texas and struck an agreement with Wendy's to build another 40 units on preferential terms. I believe Meritage's earnings will be substantially higher 2, 5, and 10 years hence.

But what about now? It's wonderful if we can identify a company that has a tremendous runway for profitable growth, but it's even better if that company trades at a low multiple of its current profits and cash flows. Meritage fits the bill. I believe shares of Meritage Hospitality are trading at 8-9x times 2019 normalized free cash flow, or free cash flow assuming zero new restaurant additions. Of course, Meritage does not actually produce free cash flow, nor would I want it to. Given the returns on restaurant acquisitions or builds it can achieve, I want the company to continue adding to its invested capital base by however it can, including by accessing debt on reasonable terms.

"But Meritage is highly leveraged!" Yes, Meritage employs a healthy amount of debt financing. But the debt is very low cost, averaging 5.25%. Furthermore, the level of debt is not unreasonable given the company's high-quality assets. At June 30, the company had $166 million in net debt. That works out to $530,000 per Wendy's unit. Valuing the company's Wendy's units at only 6x restaurant-level EBITDA (well below replacement value) yields a value of $1.2 million per unit. $530,000 of debt against a $1.2 million asset is a loan-to-value ratio of 44%, not concerning to me. The company's healthy operating cash flow underpins the value of its assets and its ability to service its debt. For the twelve months ended June 30, the company produced $42.5 million in operating cash flow before interest expense. How can I be sure that the value of the collateral will not suffer a material decline? There are no guarantees, but the value of a Wendy's unit is not very sensitive to economic fluctuations.

"But what happens if we enter a deep recession?" Believe it or not, very little! Wendy's restaurants, especially in smaller metros, are remarkably resilient assets. In tough times, customers downgrade from sit-down and the pricier fast casual options to plain old Wendy's, McDonald's, etc. Back in 2008, Meritage's restaurant network was located entirely in Michigan. In the midst of the near-collapse of the local industrial economy, Meritage's same-store sales declined just 2.8%! Plenty of people enjoy the comfort of a burger, fries, and a Frosty® when times are lean. Meritage has grown considerably since and expanded to several other states, but the principle holds. Wendy's probably has more to fear from the ebbs and flows of consumer tastes and habits than it does from recessions.

So why, if everything is so great at Meritage, why are shares down 20% over the last two years?

The biggest reason is margin pressure. The tight labor market is causing wages to rise. Meritage's restaurant-level EBITDA margin peaked in mid-2017 and has trended slightly lower since. Another reason is the company's heavy investment program. Large depreciation charges associated with acquisition and building activity depress GAAP profits. Depreciation as a percentage of sales has risen to nearly 3.0% in 2019 from 2.2% in 2015. That may not seem significant, but it actually works out to a reduction in annual earnings per share of 28 cents at the current revenue run rate. The aggressive investment program also generates restaurant opening and closing expenses that are charged to the income statement. Shareholders are too focused on reported net income and are missing the value being created as the company grows. If Meritage were to simply stop acquiring, building, or renovating new restaurants tomorrow, it would instantly become a free cash flow monster.

TABLE III: World Allocation (%)

United States	69.3
Eurozone	15.1
Canada	6.6
Sweden	4.6
Australia	2.7
United Kingdom	1.5
Other	0.2
Total	***100%***

Wage pressures will come and go. GAAP net income will eventually catch up with underlying profitability. The market will eventually come to see Meritage in a different light. Meritage insiders are huge shareholders and are highly incentivized to grow the company profitability. I am happy to be along for the ride, no matter where shares head in the short term.

Looking Abroad

I continue to find value in Europe, specifically within small companies listed on the Italian AIM. Shares of **Intred SpA** moved little this quarter, but the company reported first half revenue growth of 20% year-over-year. I expect this rate of growth to continue as Intred rolls out new services and grows its owned and leased fiber network. The company remains cheap by any metric. **EdiliziAcrobatica SpA** has been a solid performer since the fund first acquired shares a few months ago. This innovative building services provider is experiencing incredible growth, both in Italy and now in France. Yet its shares trade at a tiny multiple of the company's earnings power just a few years out. Finally, I recently began buying shares of **Sirio SpA**. Sirio is a restaurant concessionaire operating mainly in hospitals and airports all over Italy. The company enjoys long concessions with high renewal rates, good margins, and strong returns on capital. The company's recent IPO provides funds to win additional concessions and expand into new markets. Company shares trade at less than 5 times my estimate of 2020 cash flow.

I believe each of these companies will provide exceptional returns over a medium time frame, but each may be affected by the whims of the larger Italian stock market in the short run.

Alluvial Fund Updates

As I write, fund assets total just under $23 million. There is ample capacity to purchase far more of the small, exceptional companies that make up our fund, and I continue to seek likeminded partners to join our venture.

Thank you to those who were able to turn out for the Willow Oak Asset Management-sponsored investor event last month! I presented on the fund's strategy, results, and several of our holdings. Anybody interested in viewing my talk can do so here.

Thank you for reading. Please feel free to reach out with questions or comments on our holdings or strategy. With the holidays approaching, I want to wish all partners a peaceful and joyful season. I look forward to providing another quarterly update in January.

Warm 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. Alluvial Capital Management, LLC believes the figures, calculations and statistics included in this letter to be correct but provides no warranty against errors in calculation or transcription. Alluvial Capital Management, LLC is a Registered Investment Advisor. This communication does not constitute a recommendation to buy, sell, or hold any investment securities.

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, 2018 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.

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