Alluvial

CAPITAL MANAGEMENT, LLC

Dear Partners,

In the first quarter, Alluvial Fund declined 17.7%. This compares favorably with small-cap and micro-cap indexes, which fell more than 30%. Like I've said before following difficult periods, losing always hurts. But avoiding the worst of the pain during market downturns goes a long way toward achieving long-term success, and I am happy to have succeeded on that front. Since inception, Alluvial Fund has produced a total return of 15.0% net of all fees and expenses, while the Russell 2000 Index has fallen 11.3% and the Russell MicroCap Index is down 18.1%.

### *TABLE I: Alluvial Fund LP Returns (%) as of March 31, 2020*

| | YTD | 2019 | 2018 | 2017 | Cumulative | Annualized |
|---|---|---|---|---|---|---|
| Alluvial Fund LP NET | -17.7 | 18.4 | -9.0 | 29.6 | 15.0 | 4.4 |
| Russell MicroCap TR | -32.0 | 22.4 | -13.1 | 13.2 | -18.1 | -6.0 |
| Russell 2000 TR | -30.6 | 25.7 | -11.2 | 14.7 | -11.3 | -3.6 |
| S&P 500 TR | -19.6 | 31.5 | -4.4 | 21.8 | 23.1 | 6.6 |

*Partnership began operations 01/01/2017*

I hope you and your families and friends are healthy and have managed to maintain some semblance of normalcy in these unprecedented times. While the economic damage that coronavirus has wrought is immense, the cost in terms of human lives and relationships is immeasurable. Like everyone else, I am grateful for the many brave and compassionate healthcare workers caring for the afflicted, and for the medical researchers, virologists, and others racing to develop treatments and ultimately, a vaccine. I also respect the extremely difficult task that government officials and public health experts have in determining what restrictions should be in place and for how long. Not being a member of any of these groups, I will refrain from conjecturing on the nature and trajectory of the pandemic, the most promising treatments for COVID-19, or the appropriate timeline for reopening the economy and allowing millions of people to return to their ordinary routines as best they can. There is a very human tendency for those with a degree of knowledge in a specific realm to act as if this knowledge qualifies them to comment with equal confidence on subjects occupying very different spheres. This trait seems especially common among professional investors, which is why I find it so important to avoid the temptation. I will confine my comments on coronavirus to the impact on our portfolio companies.

In the aftermath of one of the most brutal months in modern stock market history, many investors are asking themselves "What did I do wrong?" The answer, no matter how unsatisfactory, may be "Nothing!" Catastrophes happen. For as long as humans have existed, there have been wars, famines, natural disasters, plagues, and all manner of other nastiness. Bad things have always happened, and short of us all achieving total mastery over ourselves and our environment, they always will. The astute investor understands that the value of any business may become impaired in an instant by external, completely unpredictable events. In fact, the astute investor recognizes that over a typical company's lifespan, it almost certainly *will* be affected by one or more of these events. That is why investing with a *margin of safety* is so important. If an investor succeeds in paying only $60 for a security conservatively worth $100, the investment will not be permanently impaired by some unforeseen event that wipes away even 20%, 30%, or even 40% of the security's intrinsic value. The trading price of the security will likely diminish, but the decline will ultimately be temporary.

Investors who purchased securities with an appropriate margin of safety may experience discomfort at their present-day losses but can rest assured their capital is not permanently impaired by this downturn. On the other hand, those who were not rational or rigorous in their assessment of intrinsic value may experience the pain of permanent loss. There are, of course, exceptions. Some events may prove so cataclysmic that no degree of margin of safety proves adequate—giant meteor, supervolcano, alien invasion, etc.—but the principal holds. My task as manager of Alluvial Fund is to be a member in good standing of the first camp of investors as often as possible. Being human, I will occasionally find myself in the second. I pledge to undertake every effort to ensure this is an increasingly rare event!

***TABLE II: Top Ten Holdings (%)***

| | |
|---|---|
| P10 Holdings Inc. | 11.6 |
| Intred S.p.A. | 7.3 |
| Nuvera Communications | 7.2 |
| Crawford United Corp. | 7.0 |
| Rand Worldwide Inc. | 6.7 |
| Bredband2 i Skandinavien AB | 6.3 |
| MMA Capital Management | 6.2 |
| LICT Corporation | 6.1 |
| Butler National Corp. | 4.2 |
| Polaris Infrastructure Inc. | 4.2 |
| ***Total, Top Ten*** | ***66.9%*** |

In a previous letter, I wrote about my attempt to build an "all-terrain" portfolio that could perform well under a variety of economic conditions, not only in a goldilocks economy of low unemployment, minimal inflation, and steady GDP growth. I think this effort is paying off in the relatively muted losses we experienced in the first quarter compared to small-cap and micro-cap benchmarks. Despite soaring unemployment and a looming recession, I expect the majority of our holdings to experience only mild-to-moderate disruption in their business activities and ultimately, their near-term profits and cash flows. Our portfolio has no material exposure to the most severely affected industries. We do not own a meaningful position in any hotel operator, airline, casino, or retailer. With limited, strategic exceptions, our portfolio companies have strong balance sheets with minimal debt or net cash. Our companies that do carry higher levels of debt support that debt with extremely stable, predictable cash flows. This lower economic exposure to the impact of coronavirus and the accompanying shutdowns is borne out in the fund's outperformance, year-to-date.

That said, every one of our portfolio companies, no matter how large or small, international or domestic, will feel the effects of coronavirus. The sudden, severe shock to virtually all revenue streams and the difficulty of conducting normal operations amidst lockdown conditions will cause earnings to decline in the short term. This is an unavoidable outcome, and I try not to spend much time worrying about the inevitable. Rather, I am spending my time assessing the impact of an extended period of reduced revenue will have on our holdings, and how quickly each will recover its previous level of profitability. I am also spending considerable time searching for value in situations where a disconnect has developed between the action in a company's shares and the company's actual economic exposure to the pandemic-related slowdown.

## Bear Market Opportunities

If you've ever wondered what your manager does all day, the answer is rather dull. I sit, think, and read. I also make phone calls and write emails, chat with other investors online, and yes, gaze out the window. The actual buying and selling of stocks for the portfolio rarely occupies more than a few minutes of my day. That was true for most of March. However, late March provided a number of opportunities to increase our holdings in some of our most illiquid stocks. True to my previous experiences in nervous markets, extremely illiquid securities held up very well at first. But as the fear and trembling grew, panic sellers eventually showed up and began selling indiscriminately for whatever price they could get. That is when I delightedly relieved them of these "unownable" stocks.

This time around, I was able to buy shares in **Tower Properties Corp.** for sensational prices. Tower shares usually trade in the low $20,000 range (and are *easily* worth $35,000 or more.) The company owns a collection of good quality office and multi-family real estate in the Kansas City (Missouri) and St. Louis metro areas, plus cash and securities. The company is well-run. They invest in their properties and periodically sell mature properties to purchase others that they can improve. Real estate is a cash flow game, and Tower Properties produces normalized funds from operations of $3,400 per share, fully taxed. Over the last decade, Tower grew its net operating income at an annual pace of 7% *while* reducing shares outstanding by 14% and paying a large special dividend along the way. Suffice to say, this is a company I want to own for decade to come and then some. On some of the worst market days in March, the fund was able to acquire shares of Tower at prices ranging from $12,500 to $13,500.

The fund was also able to acquire shares in a fast-growing food technology/food manufacturing company. I won't name the company as its shares are highly illiquid and I am very interested in owning more, but the firm's highly innovative products are purchased by Starbucks and Costco, among other blue-chip customers. The financials impress me, but what impressed me more was meeting and talking with management at their shareholder meeting in Virginia this February. The company is long-term oriented and dedicates a huge portion of revenue to research and development. The company's founder remains CEO and owns the majority of shares outstanding but treats minority shareholders as partners. Alluvial Fund was able to increase our position in this company substantially at prices nearly 40% below the last trade as fearful sellers raced for the exits.

The share prices of Tower Properties and this un-named company have rebounded this month, but both remain well below any reasonable estimate of intrinsic value. I hope to acquire more at distressed prices and will use any market weakness to do so.

### A Bright Spot: Telecoms and Communications Services

Since inception, Alluvial Fund has held a large position in various telecommunications companies, typically domestic rural telecoms working to build out their fiber-optic networks with generous government support. I am attracted to these companies for their predictable earnings and cash flows and for their improving economic profiles as they transition from copper to fiber networks in order to offer next-generation broadband services. Fortunately for Alluvial Fund, broadband providers are among the best-situated businesses for a world where more commerce, education, and entertainment than ever before is conducted in front of a screen. I expect only a modest impact on these companies' profits and cash flows. At quarter-end, these holdings represented just over 26% of the fund's value.

First, our domestic rural telcos. Despite their healthy balance sheets and robust outlooks, both **Nuvera Communications** and **LICT Corporation** have seen their share prices fall meaningfully this year. Nuvera declined nearly 30% before recovering to the mid-$15 range. In 2019, Nuvera achieved normalized earnings per share of $2.39 (adjusted for CEO transition costs and non-economic amortization.) In 2020, interest expense will decline due to lower average debt balances and leverage ratios. Capital expenditures will remain elevated for some time, but every foot of fiber laid in the Minnesota ground improves Nuvera's network and its ability to be the internet provider of choice for decades to come. I continue to believe Nuvera is a steal at less than 7 times normalized earnings and with a healthy free cash flow yield.

***TABLE III: World Allocation (%)***

| | |
|---|---|
| United States | 71.3 |
| Eurozone | 14.5 |
| Sweden | 6.3 |
| Canada | 4.2 |
| United Kingdom | 1.8 |
| Australia | 1.6 |
| Other | 0.2 |
| ***Total*** | ***100%*** |

LICT shares also took a drubbing to begin the year, plunging from $18,750 in early March to a low of $12,800 just weeks later. Shares have recovered to $16,000 or so, but the company remains cheap by any measure. LICT recently pocketed several million from the sale of an interest in a Northern California wireless partnership, bolstering its already substantial net cash position. My hope remains that LICT will make a substantial acquisition and bring its considerable expertise to bear in new markets, but I will be satisfied if the company merely continues its voracious shares buyback activities. I like to joke that if the share count continues to shrink at this rate, someday LICT's only shareholders will be Alluvial, a handful of other holders I know, and Mario Gabelli. At that point, he'll have to make us one incredible offer!

Our foreign communications services companies have also been bright spots for Alluvial Fund in 2020. The home territory of **Intred S.p.A.** in Northern Italy has had one of the world's highest incidences of coronavirus, yet Intred has announced it expects to continue to grow revenues despite the near complete economic lockdown. Shares have rallied close to new highs as the Italian economy restarts. **Bredband2 i Skandinavien** continues adding customers and those customers continue paying well in advance of the services they receive, perpetuating the negative working capital virtuous cycle. Shares are close to all-time highs.

### Other Stalwarts

Other portfolio companies that I believe will suffer only minimal disruption include **MMA Capital Holdings** and **Polaris Infrastructure**.

MMA Capital Holdings is one of Alluvial's longest-held companies, and presently one of the most frustrating. Despite intelligent, aligned management, continued excellent operating results, and a simplified balance sheet, shares continue to trade at enormous discounts to book value, with or without the company's substantial tax assets. Excluding these tax assets, shares now trade at discount to book value of around 40%. Including tax assets, shares trade at less than half of book value. Discounts to book value are often justified for firms that are not expected to earn their cost of capital through the full economic cycle. But MMA Capital Holdings is well on its way to achieving a consistent double-digit return on equity (tax assets excluded.) The only logical explanation for the shares' doldrums is concern over the combined effects of recession and free-falling oil prices on the company's solar development loan book. There will be an effect. The most pristine of loan books in any industry will feel some stress this year. But the move toward solar will continue. The economic case for renewables is not driven by short-term fossil fuels prices. There is no reason to believe MMA Capital Holdings will experience a worrying degree of impairment of its loan book resulting in a meaningfully decreased book value. If this degree of weakness in its trading price persists, I expect MMA to resume its share repurchase program. The financial logic is too compelling not to do so. I consider MMA Capital Holdings one of the best-managed companies I know, and I have no doubt its shares will be several times the current price by the end of the decade. While shares have been flat over the last three years, book value per share (excluding tax assets) has grown 85% over the same period. This dynamic cannot hold forever.

Polaris Infrastructure also remains mystifyingly cheap and largely insulated from the effects of coronavirus on the world economy. Having successfully diversified beyond Nicaragua, the company is set to generate serious free cash flow this year as its Peruvian assets contribute. While its share price moves in a fashion that defies logic, the company itself continues to generate cash, reduce debt, and search for its next accretive acquisition. Progress on refinancing its debt to a lower cost, longer-amortization facility is likely on hold for now but remains a future catalyst as the company deleverages.

### The Pain Points

Sadly, all of our businesses will not be so unaffected. I've often sung the praises of **Meritage Hospitality**, one of the largest Wendy's franchisees. I hold their management team in high regard, and I like their operating model and the economics of restaurant newbuilds. The company has been good to us over time. But there is no denying the fact that Meritage's rapid expansion has been financed by a hefty amount of debt. The company also has a fair amount of operating leverage, due in part to the sale-and-leaseback strategy it uses to grow its unit count. In ordinary times, this is not a major issue. Even during recessions, Meritage tends to experience only small revenue declines. But the restaurant industry operating model is not built to withstand anything like coronavirus. Meritage's revenues are down 20-25% since lockdowns began. Management has been proactive: negotiating rent concessions, halting all non-essential capital expenditures, and securing a large SBA loan through the PPP initiative. But all of these efforts cannot make up for the sheer loss of customers the company will experience for the foreseeable future and the difficulties the company will have in returning to a growth footing. I am carefully considering Meritage's continued role in our portfolio.

**Crawford United** will also see a marked slowdown. This Ohio industrial mini-conglomerate's largest segment is manufacturing sophisticated HVAC systems for large buildings like hospitals, educational facilities, and factories. A recession will see many customers delaying or canceling orders, figuring they can live with that 1970s-era system just a little longer. Despite the short-term downturn, I am not concerned about Crawford's long-term prospects. The model simply makes sense: acquire small niche industrial businesses at mid-single digit multiples of operating income, run them well, and use the cash they generate to buy additional businesses. With the application of a judicious amount of debt financing, the returns on equity can be impressive and value compounds quickly. There are thousands of these acquisition candidates, many of them run by founders approaching retirement age and looking for an exit. For that reason, it does not especially bother me if Crawford has to spend the next year or two just biding its time and preparing for its next round of acquisitions. Crawford's balance sheet is strong enough to withstand the economic contraction, and careful cost control will limit the short-term pain.

### The Top of the Portfolio: P10 Holdings

This letter would not be complete without an update on Alluvial Fund's largest holding, **P10 Holdings**. Shares dipped in March but have since recovered strongly. Fortunately for P10, the private equity fund management fee stream that P10 owns is largely unaffected by coronavirus despite the impact on the underlying investments. The fees are contractual and highly visible for several years. P10's near-term earnings are all but assured. What will become more difficult is growing P10's annual fee revenue by increasing assets under management. I think the company is up to the challenge. At the beginning of April, P10 closed on the acquisition of Five Points, a North Carolina-based alternative investment manager. Following the acquisition, P10 will produce roughly 30 cents per share in annualized free cash flow. I expect the company to perform more and larger acquisitions as it attempts to build a major alternative investment shop. Interestingly, the company revealed it spent the end of 2019 pursuing a deal worth nearly $250 million that ultimately did not close. I like the ambition. At around $2 per share, P10 remains an incredible value. It also remains a value that large pools of capital cannot access as the company has ownership limitations in place in order to protect its tax assets. At the current price, any new investor is limited to buying less than $10 million worth of P10 shares (and that's if the fund is comfortable owning 20% of the free-floating shares!) P10 is an ideal holding for a small fund like Alluvial.

### Concluding Thoughts

Thank you for your patience during this tumultuous season. This letter is not as timely as usual, a fact I owe to the challenges of working from home and attempting to keep two small children entertained, exercised, and educated while parks and playgrounds are not a viable option. Despite the disruption to the usual routine, I am very happy with the quantity and quality of the investment research we've generated for the fund this quarter. Sometimes a change of scenery and routine can invigorate the mind. I am extremely grateful to the partners who chose to provide new capital for the fund to invest this quarter. Despite the highly uncertain environment, there is incredible value to be found in our existing holdings and in new ideas we are identifying. Whether or not we have seen the market's lows, I have no doubt that conservatively underwritten investments made now will pay off in time.

Stay well, and please do not hesitate to reach out with your questions or comments. I look forward to reporting to you again in July, and I will be putting out several additional communications between now and then.

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, 2019 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***
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