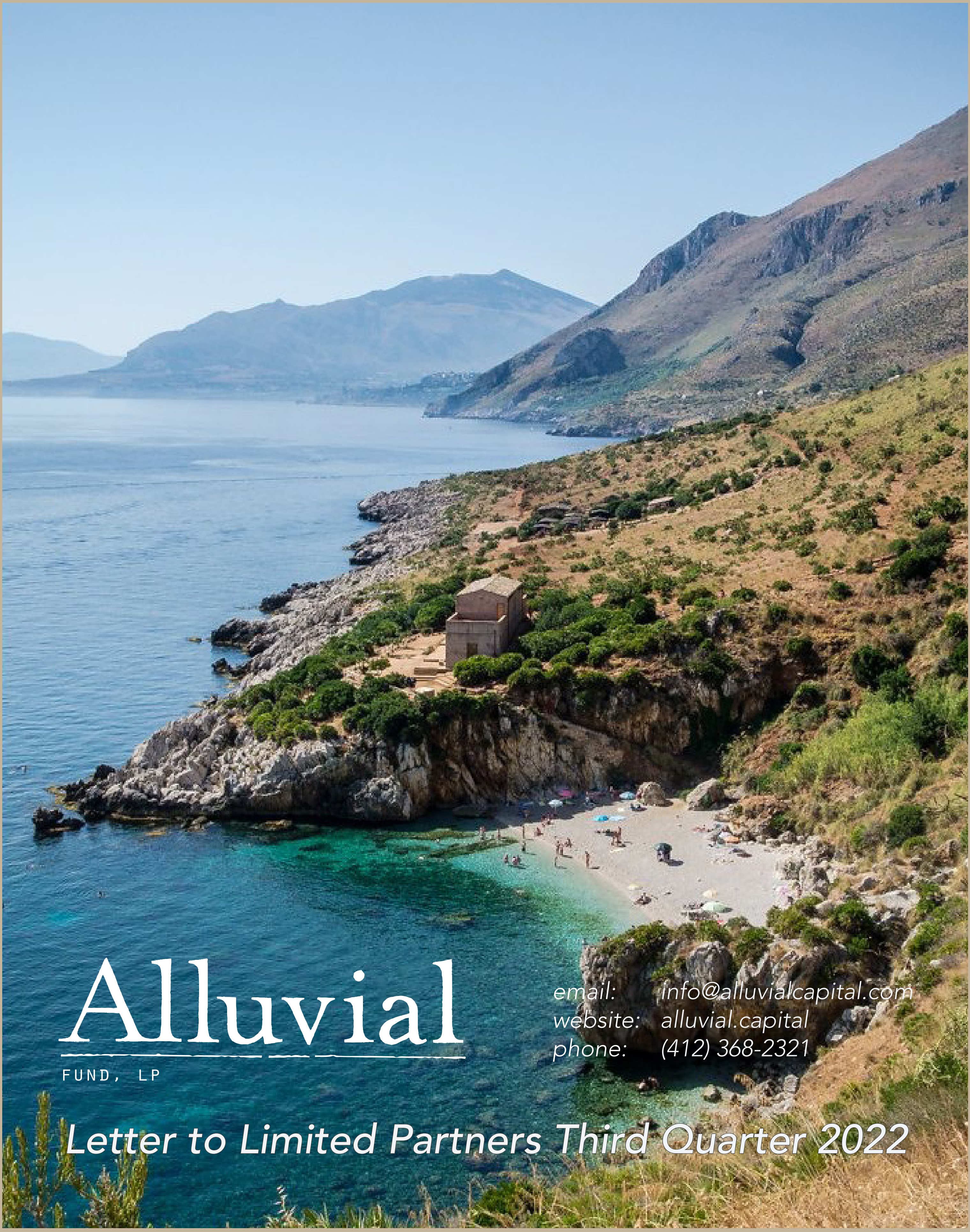

# Alluvial

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## Letter to Limited Partners Third Quarter 2022

*The Western coast of Sicily has long been an important base for marine activities, ranging from fisheries, ports, and shipbuilding, all the way to leisurely, beachside enjoyment of the crystalline Mediterranean.*

*All these inhabitants will soon enjoy better data connectivity thanks to a subsea cable being built by portfolio company Unidata S.p.A connecting Mazara del Vallo to Genoa on the mainland. As the cable runs north through the Tyrrhenian Sea towards Liguria, it will also branch east towards Rome and the new green data center being built by Unidata in the capital city.*

*More information about the developments at Unidata can be found in this quarter's letter.*

Alluvial

CAPITAL MANAGEMENT, LLC

Dear Partners,

Alluvial Fund declined 2.2% in the third quarter, in line with comparable indexes. The fund remains well ahead of its benchmarks this year and has outpaced these benchmarks by 7% annually net of fees since inception in 2017. The economic performance of our portfolio remains robust with nearly every holding continuing to report strong profits and cash flows. However, mounting fears over recession, inflation, an energy crisis, and even the possibility of nuclear war have investors in the doldrums. The market mood is simply miserable and in a miserable market, nobody cares about any of the good news your companies may report. The best you can hope for is to tread water. (And pity any of your holdings that reports bad news in a time like this. Look out below!) This isn't my first time investing in a miserable market. I don't know when sentiment will change—maybe later this year, maybe next year, maybe 2025—but it will change. Since nobody will do us the courtesy of shouting "All clear!" when the market has bottomed, the best approach is, as always, to go on accumulating good quality securities at large discounts to intrinsic value.

***TABLE I: Alluvial Fund LP Returns (%) as of September 30, 2022***

| | 2022 | 2021 | 2020 | 2019 | 2018 | Cumul. | Annual. |
|---|---|---|---|---|---|---|---|
| Alluvial Fund LP NET | -18.3 | 31.0 | 28.4 | 18.4 | -9.0 | 91.8 | 12.0 |
| Russell MicroCap TR | -25.5 | 19.3 | 21.0 | 22.4 | -13.1 | 29.6 | 4.6 |
| Russell 2000 TR | -25.1 | 14.8 | 20.0 | 25.7 | -11.2 | 31.9 | 4.9 |
| MSCI World Sm+MicroCap NR | -26.9 | 15.8 | 16.5 | 25.7 | -14.3 | 31.0 | 4.8 |

*Partnership began operations 01/01/2017*

## ECIP Banks

Alluvial Fund has an important new investment in a group of community banks. Thanks to a new Treasury Department program, numerous small financial institutions have received a generous infusion of low-cost permanent capital. This program will result in an incredible increase in profits for several of the recipients, but the market has not yet adequately priced in this game-changing development.

Imagine you are the CEO of a bank. Your bank, let's call it "First Citizens Fidelity Savings Bank," is a small institution with total assets of $900 million and shareholder capital of $100 million. FCFSB operates in an area where many of the residents are lower-income and have long struggled to join the middle class, and you are proud of the ways in which you have helped them achieve stronger financial standing. You are also proud of the healthy returns you have provided your shareholders through careful lending, measured growth, and keeping operating costs in check.

One afternoon you get a call from a nice staffer at the Department of the Treasury.

> *"Hello Mr./Ms. CEO! I wanted to tell you about a new program the Department is rolling out to support banks like yours and invite you to apply. We've noticed how active your bank is in lending to the local community. This program will support your efforts with low-cost permanent capital."*
>
> "You have my attention. Go on, what are the details?"
>
> *"We would like to purchase preferred stock from you. The terms are very fair. The preferred stock will be perpetual and non-cumulative. There will be no dividend due for the first two years. After that, you pay a maximum of 2%. Maybe lower, depending on your ability to increase lending to disadvantaged communities. "*
>
> "Sounds too good to be true. What's the catch?"
>
> *"No catch! There are some reasonable restrictions on executive compensation, return of capital to shareholders, and mergers and acquisitions, but nothing punitive. An institution like yours is unlikely to have any issues complying."*
>
> "I'll have to run it past the board, but everything I've heard so far is wonderful. How much preferred stock can we issue the Treasury? $1 million? Maybe $2 million?"
>
> *"How does $110 million sound?"*

After picking your jaw up from the floor and asking the Treasury representative to repeat the figure a few times, your mind might begin to race. The Treasury would really *double* your bank's equity capital, and all this new equity would cost the bank a maximum of 2% per year, forever? Imagine the possibilities! You could double the size of FCFSB's balance sheet. Profits would skyrocket! Why, even just parking $110 million in short-term treasuries would net you millions.

This conversation is purely imagined, but the scenario is real. Thanks to the Emergency Capital Investment Program, many banks, thrifts, and mutuals have received extremely low-cost permanent capital. Anyone interested in delving into the details of the program can check out the Treasury's extensive publications here. Suffice to say, the banks that have received this dirt-cheap funding have it made. With just moderate balance sheet expansion, their profits should increase 100-200% over the next few years. Several ECIP recipients are trading at low single digit multiples of 2024-ish earnings.

Of course, most of these banks will not achieve this kind of profit growth. Only some of the ECIP recipients are high quality institutions. Many have issues with loan quality or are too sub-scale to earn a competitive return on equity even post-ECIP. There's an argument to be made for holding one's nose and investing in the banks that received the largest capital infusion relative to their prior market capitalization or shareholder capital, but I believe we can generate more certain and lower-risk returns by focusing on the stronger institutions. I don't believe these ECIP funds will change the character of the banks receiving them. Banks making good loans and looking out for shareholders now have much greater ability to do so. However, banks with sloppy operations making bad loans can now make twice as many or more. That's rarely a good thing.

Alluvial Fund is invested in three ECIP program banks. **BankFirst Capital Corporation** is a $2 billion Mississippi bank holding company that received $175 million from the ECIP. Already, BankFirst has acquired one bank and is working to acquire another, fellow ECIP recipient Mechanics Bank, which received $44 million. I fully expect BankFirst to acquire additional banks. **United Bancorporation of Alabama** received $123 million. Just before the ECIP investment, United Bancorporation of Alabama repurchased 5% of shares outstanding. I expect the company to continue returning capital in proportion with its ECIP-driven earnings growth. Finally, **Bay Community Bancorp**'s Community Bank of the Bay received $119 million, equal to nearly 180% of the bancorp's June 30 shareholder equity—a stunning multiple. The California bank also got in the act of returning capital, repurchasing 3.2% of shares outstanding in August.

***TABLE II: Top Ten Holdings, 9/30/22 (%)***

| | |
|---|---|
| P10 Inc. | 11.5 |
| Unidata S.p.A. | 8.8 |
| ECIP Bank Basket | 6.7 |
| Rand Worldwide Inc. | 6.0 |
| GEE Group Inc. | 5.5 |
| Garrett Motion Inc. | 4.3 |
| LICT Corporation | 4.2 |
| Harbor Diversified Inc. | 4.1 |
| Butler National Corp. | 3.9 |
| Undisclosed Packaged Foods Co. | 3.7 |
| ***Total, Top Ten*** | ***58.7%*** |

### P10 Builds

Alluvial's largest holding remains **P10 Inc.**, owner of a diversified set of alternative assets managers. Second quarter earnings were strong and saw continued organic growth in assets under management. Shortly following the earnings report, P10 announced an acquisition that will grow assets under management and be accretive to free cash flow per share, in a deal that closed just days ago in mid-October.

P10 has purchased Western Technology Investment, a manager of venture debt funds. Founded in 1980, WTI has provided nearly $8 billion in debt commitments to venture companies largely in the technology and life sciences sectors. Building on this track record, WTI is expected to launch a new fund in 2024. P10 purchased Western Technology Investment for $97 million in cash plus the equivalent of $40 million in P10 stock, representing a multiple of 11x WTI's pre-tax cash flow. The deal also includes an earn-out provision if WTI's earnings achieve certain thresholds.

This transaction will benefit P10 by growing fee-paying assets under management to at least $19.9 billion, as well as increasing both the average fee rate on and average duration of assets under management, resulting in annualized revenues climbing to $200 million. Given these improvements, adjusted for the additional debt and higher interest rates, I now estimate P10's annualized free cash flow at 84 cents per share. If WTI hits the high end of its earn-out range, that free cash flow would increase to 91 cents per share. Currently priced around $10.30, P10 shares change hands for just 12.3x forward-looking free cash flow, less if the WTI investment works out well. Increases in AUM from P10's existing strategies will further depress that multiple.

Meanwhile, P10 shares are just plain depressed.

It's not hard to see why. The economic picture is rocky. There are concerns about the ability of alternatives managers to raise capital amidst jittery equity and debt markets. It may seem like an inopportune environment in which to own a small, little-known alternatives manager. But nothing about the P10 story has changed. The company still enjoys supremely predictable, high-margin revenues looking out several years. Management is still as sharp as they come and well-incentivized to grow the value of the company, not least because they own most of it. Free cash flow per share will continue to grow and the market will come around in the end.

### Unidata and the Value of Ambition

Despite the flow of negative headlines out of Europe, Alluvial's second-largest holding, **Unidata SpA**, is thriving. First-half results saw Unidata's customer count rise 29% year-over-year and its fiber network expand by 35% to 4,920 kilometers. EBITDA rose 53%. The company issued a €10 million bond to help finance the construction of a green data center in Rome. Most excitingly, the company announced two large new initiatives: the doubling of the scope of its "Unifiber" project installing fiber in unreached areas of Lazio, plus "Unitirreno," a proposal to build an 890 kilometer submarine cable in the Tyrrhenian Sea connecting Sicily and Genoa. In order to finance this major expansion of Unidata's footprint, the company will seek to raise up to €50 million in equity capital and simultaneously uplist to the STAR segment of the Borsa Italiana in 2023. I expect the improved trading liquidity and higher profile will help Unidata shares achieve a more reasonable valuation.

***TABLE III: World Allocation, 9/30/22 (%)***

| | |
|---|---|
| United States | 75.7 |
| Eurozone | 13.1 |
| Poland | 5.7 |
| Sweden | 3.9 |
| Other | 1.6 |
| ***Total*** | ***100%*** |

I love the ambition. I wish I could find more small companies willing to undertake measured risks in pursuit of transformational and extremely profitable growth. I'm not talking about pie-in-the-sky, risk the company moonshots, but simply large investments representing meaningful capital commitments with ample financial rationale. I see far too many small companies that are more or less cast in amber. They look the same and act the same year in, year out. Some are at least honest that they have no ideas and simply return profits to shareholders. Others hoard cash flow or piddle it away on immaterial initiatives, hoping to juice profits 2-3% over the next 18 months or achieve some other inconsequential goal. The dishonest ones, of course, find ways to divert shareholder wealth to insiders and related parties. Not good enough! Now, some large companies have genuinely reached the limits of their markets and further expansion offers either insufficient reward or could invite antitrust attention. But for a small company, there is *always something to do*. Customers want additional products and services. Competitors and sometimes suppliers and distributors can be acquired. New markets are always developing. It's not that any of these options is always a good idea to pursue, but often enough, at least one of them is. A company that refuses to engage with the full slate of possibilities is failing its shareholders.

At the heart of the problem is incentives. Most small company management teams draw a nice salary but own shares in amounts not meaningful to their overall wealth. In that case, why rock the boat? Far better to hunker down, draw a comfortable salary and benefits and at all costs, protect that easy money. Unidata could not be more different. Management owns 70% of the company. They have built a profitable and dynamic operation and have enjoyed the rewards, becoming very wealthy in the process. But they see an opportunity in front of them to double or triple the value of Unidata shares, and they're going after it.

### Other Holdings and Updates

Other Alluvial Fund holdings have reported meaningful developments and updates. The most significant is **Harbor Diversified**, whose Air Wisconsin subsidiary reported a new contract to operate the majority of its fleet for American Airlines. Details of the new contract are not yet available, but the market continues to value Harbor Diversified as if the new contract has negative economic value. Despite the good news, shares continue to trade at a sharp discount to Harbor's existing assets and remaining earnings from its contract with United. I expect this discount to narrow as we receive more clarity around the company's new contract with American and plans for its substantial cash and securities holdings.

**Garrett Motion** has elected to begin paying cash dividends on its convertible preferred shares. Doing so prevents dividends in arrears from further accruing and is a wise use of the company's free cash flow. I believe the choice to initiate a cash dividend is a tacit admission by the company that the necessary conditions for converting the preferred shares will not be met soon. This is a mild short-term negative, as the complex capital structure will remain in place for now. On the other hand, I am thrilled for us to earn a 9% yield as the company uses its free cash flow to buy back cheap stock and wait for the automotive cycle to turn.

**GEE Group** reported outstanding quarterly earnings, but shares remain exceptionally cheap. At a market capitalization of $75 million, the company trades at just 5x normalized cash earnings and has 22% of its market capitalization in cash. While GEE Group shares have been winners for the fund, they continue to trade at stubbornly low valuations. Perhaps investors are anticipating a cooling labor market, but it would take a deep retrenchment in hiring trends for GEE Group shares to be anything except an incredible bargain at today's prices.

Unless we experience a dramatic rally to close out the year, 2022 is shaping up to be one that investors will not remember with much fondness. I am pleased that our collection of cash-flowing, well-financed companies has held up better than markets in general, but I look forward to a time when the market looks on our portfolio with a more favorable eye. Until then, I will continue scouring markets for opportunities to complement our existing set. I find it best to think of bear markets the way I think of inclement weather (a phenomenon I am all too familiar with as a life-long Western Pennsylvanian). Dreary clouds full of cold rain may linger for a good while, but they always move on. Alluvial will go on purchasing good securities at deep discounts to intrinsic value and the weather will take care of itself.

Before I sign off, I want to recognize my associate, Tom Kapfer, for passing the Level III CFA exam! Congratulations! Tom has been with Alluvial for more than four years now and he contributes more and more to our efforts with each year.

Thank you, as always, for the privilege of managing capital on your behalf. I look forward to reporting to you again in the new year.

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. 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, 2021 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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