Alluvial

FUND, LP

email: info@alluvialcapital.com
website: alluvial.capital
phone: (412) 368-2321

Letter to Limited Partners Third Quarter 2024

The cover image offers a view of the Montserrat mountain range in Catalonia, Spain. These "serrated mountains", as the name translates, are home to a Benedictine Abbey as well as several paths for hiking and climbing. On a clear day, anyone reaching the summit at Sant Jeroni can see as far as the Pyrenees to the north and the Mediterranean Sea to the east.

In much closer proximity to Sant Jeroni, an antenna sited on the neighboring Mirador del Moro peak stands out among the rugged terrain. Built atop what was once the upper station for the steepest cable car in Europe, this telecommunications station is currently in use by one of Alluvial Fund's newest holdings: Zegona Communications. Continue reading the letter to learn more about Zegona Communications.

Dear Partners,

Alluvial Fund had a quiet third quarter, rising 4.8%. Comparable indexes fared better with the Russell 2000 returning 9.8% and the Russell MicroCap Index returning 9.9%. Year-to-date, Alluvial Fund remains ahead of benchmarks with a net return of 15.7%. Alluvial's portfolio is full of mostly boring companies making, doing, and owning mostly boring things. Profitable, cash-generating things, but undeniably dull. Offices, envelopes, agricultural loans, laundry detergents, cement, industrial hoses, and canned vegetables do not quicken the pulse for most. When the market has one of its periodic fits of excitement, is it not usually our companies that benefit. The opposite is also true, of course. The plodding approach has worked well for us over time, and I see no reason to deviate from it, even if it occasionally feels like looking forlornly through a window at a convivial dinner party to which we were not invited.

TABLE I: Alluvial Fund LP Returns (%) as of September 30, 2024

	YTD	2023	2022	2021	2020	Cumul.	Annual.
Alluvial Fund LP NET	15.7	15.1	-14.9	31.0	28.4	166.2	13.5
Russell MicroCap TR	7.4	9.3	-22.0	19.3	21.0	59.3	6.2
Russell 2000 TR	11.2	16.9	-20.4	14.8	20.0	82.1	8.0
MSCI World Sm+MicroCap NR	10.8	15.1	-19.1	15.8	16.5	84.8	8.2

Partnership began operations 01/01/2017

I have been looking forward to writing this letter because there's so much to discuss. I want to introduce two new holdings and provide some updates on others. First, the new.

New Holdings

Our most significant new holding is **Zegona Communications**. Zegona is a special situation that I believe will return multiples of our purchase price over the next 2-3 years. The Zegona story is complicated but is essentially a turnaround play in which experienced telecom executives are tackling an underperforming European telecom operator. Let's back up a few years. Two former Virgin Media executives, Eamonn O'Hare and Robert Samuelson, established Zegona back in 2015 with the goal of buying a struggling telecom company, fixing the issues, then selling it. Zegona proceeded to buy Telecable, a lackluster Spanish cable provider. Two years later, Zegona sold Telecable for a 15% stake in Euskaltel. The team then increased Zegona's investment in Euskaltel and took charge, hiring top people, cutting costs, and improving product offerings. In 2021, MasMovil purchased Euskaltel at a nice premium. Zegona returned capital to shareholders through a tender offer and began searching for its next "buy-fix-sell" opportunity.

This opportunity arrived in the form of Vodafone Spain. Vodafone Spain was an undermanaged and non-core segment of Vodafone Group. Vodafone Group was over-indebted and facing a downgrade to "junk" status if it did not sell assets, so it struck a deal to sell Vodafone Spain to Zegona for €5.0 billion, a great price for the buyer. Zegona Communications funded the deal through a share offering, seller financing from Vodafone, and bridge financing from a consortium of European banks. Zegona put up only 6% of the deal's value in cash. Echoes of the glory days of leveraged buyouts, if you ask me. The deal closed in May 2024.

Deal accomplished, Zegona set out to right the ship at Vodafone Spain. First order of business: replacing the bridge financing. In July, the company announced a new loan package with a 5-year maturity. Following the announcement, Zegona announced that new Vodafone Spain CEO, Jose Miguel García, had purchased €1.5 million worth of Zegona shares in the open market. Quite a show of confidence. Next, Zegona's cost structure had to be addressed. Vodafone Spain had long struggled with inefficient operations and weak margins. A lack of management focus didn't help. Vodafone Spain's CEO didn't even live in the country! Zegona announced it would reduce headcount by one-third, with more efficiency initiatives to follow. Finally, Zegona needed to realize the value of its extensive network infrastructure. To that end, Zegona announced agreements with both MasMovil and Telefonica to contribute network assets and form fibercos. When the transactions are completed, Zegona will receive billions from the sale of its stake in the fibercos to financial investors.

Currently, Zegona is the moderately-levered owner of a stagnant Spanish telecom player with weak margins and no growth. But 2-3 years from now, I expect Zegona to be a lightly-levered owner of a vibrant Spanish telecom with margins approaching industry averages and increasing customer counts. The progress may not be linear and may at times be frustratingly slow. After all, a large European telecom like Vodafone Spain does not turn on a dime. But improvements will happen all the same and the value creation for shareholders will be extraordinary.

Another important new holding is **Bahnhof AB**. Bahnhof is a Swedish internet service provider. The Alluvial Fund portfolio includes a few holdings I consider semi-permanent, with such incredible economics that it is difficult to imagine finding better. Rand Worldwide is one. Boston Sand & Gravel is another. Bahnhof AB could well join the pantheon.

Bahnhof has provided Swedes with internet since 1994. The firm is constantly winning awards for speed, service, and privacy protections, all reasons that revenues have grown at an incredible 20% annual pace over the last 15 years. Operating income has kept pace, growing at 27% annually over the same timeframe. Even better, Bahnhof is startlingly efficient with its capital. A decade ago, Bahnhof produced operating income of SEK 62 million on invested capital of 35 million. Impressive enough! But in 2023, Bahnhof earned operating income of SEK 270 million while employing less invested capital. The secret to Bahnhof's financial success is two-fold. The company is light on physical assets, needing only SEK 1 million in servers, offices, switches, etc. for every SEK 5 million in revenue. But the company is wildly efficient with working capital, enjoying a deeply negative working capital cycle that results in collecting payments from customers well before services are rendered and suppliers are paid. I have written about the wonders of negative working capital before, and Bahnhof is an excellent example. At year-end, Bahnhof's net non-cash working capital stood at negative 87 days, meaning that on average, the company receives customer payments nearly 3 months before it pays suppliers and renders services to customers. Put another way, when Bahnof signs up new customers that add say, SEK 10 million in incremental annual recurring revenue, it also generates SEK 2.4 million in balance sheet cash before any actual profit associated with serving these customers is earned.

I did the math and since 2013, Bahnhof's growing revenues have resulted in incremental negative working capital of SEK 365 million, enough to fund 75% of Bahnhof's capital expenditures over the period. It's not every day that you find a company where customers and suppliers fund most of its investment needs.

TABLE II: Top Ten Holdings, 9/30/24 (%)

Net Lease Office Properties	10.6
McBride plc.	7.3
Zegona Communications plc.	6.8
Fitlife Brands Inc.	6.6
ECIP Bank Basket	4.1
Talen Energy Inc.	3.9
MRC Global Inc.	3.9
Crawford United Corp.	3.6
Rand Worldwide Inc.	3.1
Unidata S.p.A.	3.1
Total, Top Ten	***53.0%***

Today, Bahnhof trades at 23x earnings, net of cash, 18x operating income and at a 5% trailing free cash flow yield. I'll be the first to admit this is more than I like to pay for a business. (Although, this view seems exceedingly quaint when I look at the valuations of many members of the NASDAQ 100 or similar.) But there are times when paying a mid-20s earnings multiple truly is a bargain, and this is one of them. Bahnhof's revenue growth will likely slow in coming years, though the firm is busy making inroads in the surrounding Nordic countries and Germany. Still, I have no doubt that Bahnhof's profits will continue growing at a mid-teens pace for quite a few years to come and that shareholders will be richly rewarded.

Holdings Updates

Net Lease Office Properties remains Alluvial Fund's largest holding. In August, Net Lease sold one of its best properties for $71.5 million, allowing it to reduce its term loan balance to $74 million and its mezzanine loan to $81 million. Less than a year into its corporate existence, Net Lease Office Properties has reduced these loans by $300 million. The sale of just a few more choice properties will allow Net Lease to extinguish its corporate-level debt in full and begin the process of distributing cash to shareholders. I expect to receive the majority of our investment back in 2025. Net Lease shares remain very cheap. I calculate the REIT's enterprise value at $615 million against net operating income of $94 million, a cap rate of 15.3%. On a price per square foot basis, the portfolio trades at $96. I continue to believe the remaining portfolio properties are worth $130 per square foot, or $45 per share net of debt.

McBride Plc shares have drifted down after hitting a high of £1.43 in July. At £1.15, shares change hands for just 4.8x trailing adjusted operating income and 6x reported net income. McBride had a great fiscal year, with both revenues and earnings at all-time highs. There's no indication the good times are about to end, either. In September's annual results announcement, the company indicated that trading has remained strong in the first months of fiscal 2025 and projected another year of revenue growth with operating margins well above historical averages. The company expects to reduce net debt by another £20 million. McBride continues to see tailwinds from European customers opting for private label laundry soaps and detergents over name brands. I expect the fruits of McBride's years-long efficiency efforts to offset any significant margin pressures in coming years. Bottom line, a steadily profitable producer of consumer staples should not trade at a mid-single digit price-to-earnings ratio. Yes, this is the United Kingdom, where small-caps go to die. But even so, someone will eventually notice McBride's success. There are a few upcoming catalysts that may hasten the process. I expect McBride will soon announce a refinancing of its revolving credit facilities that will allow it to resume dividend payments in 2025. Even if McBride chooses to distribute only 30% of its earnings, a nearly 8% dividend yield would be hard to ignore.

FitLife Brands recorded another strong quarter, with revenues up 15% year over year and earnings per share up 33%. The company's decision to concentrate on online sales continues to pay off in the form of higher gross margins, which reached nearly 45% in the second quarter. Musclepharm, acquired by FitLife nearly a year ago, is performing well, though it will take time to rebuild relationships with former wholesalers. FitLife is rapidly reducing acquisition debt and should soon be in position to perform another meaningful acquisition. I trust CEO Dayton Judd to find a great one.

TABLE III: World Allocation, 9/30/24 (%)

United States	60.6
United Kingdom	14.8
Eurozone	10.7
Poland	4.6
Sweden	3.6
Canada	2.3
Mexico	2.0
Other	1.4
Total	***100%***

Talen Energy has been an incredible performer for the fund this year. Despite pulling back from all-time highs, shares are still up more than 150% year-to-date. Talen was a classic situation in which an over-leveraged company becomes insolvent thanks to a tough industry backdrop and a string of bad luck, then exits bankruptcy into a much-improved operating environment and with a clean balance sheet. And since exiting, Talen management has put on a master class: selling non-core assets, executing a transformative agreement to supply power to Amazon data centers, and repurchasing huge quantities of deeply under-valued shares. Despite the run-up in the shares, Talen still looks reasonably valued given the rosy outlook for producers of carbon-free baseload power like nuclear. In September, Talen introduced 2026 free cash flow guidance of $10.50-$17.50 per share, putting shares at 13.6x mid-point 2026 free cash flow as I write. I suspect Talen will easily exceed the midpoint of the projection, in part because the figures are based on the current share count of 51 million. Talen recently increased its share repurchase authorization to $1.25 billion by the end of 2026, good for 13% of shares outstanding. Given the need to produce more reliable baseload energy without contributing to harmful emissions, investors and governments around the world are looking to nuclear energy again. But nuclear plants aren't built in a day, and incumbents will benefit from scarcity value for years to come.

The fund exited two positions in the third quarter, and another this month. I had been gradually selling off our shares of Butler National since last year. Shares moved up substantially this year on good earnings reports, so I elected to sell our remaining holdings as the discount to fair value narrowed. I visited the company last year and liked what I heard about growth initiatives and strategy, but I was bothered by what I saw as a weak board of directors with lavish board remuneration. My fears were confirmed when not a week later, Butler National made a filing disclosing that a board committee voted to grant another board member a whopping 300,000 shares (worth $250,000 at the time) as compensation for vague "investor relations services" during the CEO transition. $250,000 for maybe twenty e-mails and phone calls, at most? Good work if you can get it! This casual disregard for shareholders killed my confidence in the board's ability to properly oversee the company, so selling was an easy decision.

Selling Hammond Manufacturing was a tougher decision. I continue to like this small Canadian manufacturer, but it has become more and more clear with time that management likes being small and has no real intention of taking steps to maximize the company's value or failing that, sharing more than a small portion of earnings with shareholders. There are simply too many good opportunities out there to place our capital with companies uninterested in seeing their shareholders prosper.

Last, this month we exited Scandic Hotels. At the time of purchase, I made the case that Scandic's share price was depressed by an overhang of shares issuable when its large convertible bond issued during the pandemic matured. Scandic repurchased a large portion of the bond issue, and the rest converted on schedule. Shares rose 40% and were approaching fair value, so it was time to sell and move on. I look forward to investing in Scandic Hotels for the third time in the history of Alluvial Fund the next time a transient issue causes its shares to plunge.

Portfolio Themes

Alluvial Fund does not take a "thematic" approach. We don't try to identify market trends and then find ways to take advantage, rather we try to find cheap securities and if they happen to have thematic tailwinds, all the better. We incorporate any positive or negative trends affecting a business into our estimate of intrinsic value. Still, I think it is worthwhile to look at our holdings now and then and ask "For this portfolio to perform well, what needs to be true? What exposure do we have to various themes and trends, both current and developing?"

"Commercial real estate isn't dead." is a major theme for Alluvial Fund. Looking back, "______ industry isn't dead" has been a frequent investment thesis for the fund, and one that has paid off handsomely. I find the market is often directionally correct about the long-term trajectory of an industry or asset class, but way off concerning the pace of the coming change and the short-term impact on industry participants. Yes, it is likely true that the future demand for office space will be permanently lower due to technological and demographic changes. But no, office vacancy rates are not heading to the stratosphere. Marginal buildings will be demolished or repurposed, lease rates will decline, the market will stabilize, and buildings will become financeable on reasonable commercial terms once again. And that's how investors make money.

"Non-US markets are investable!" is another big theme expressed through the Alluvial Fund portfolio, though recent history is doing its utmost to disprove the assertion. Alluvial has always had a large allocation to non-US markets. We continue to find excellent value in small companies that get even less attention than US counterparts and many have performed very well for us. But the backdrop has been nothing short of grim. No tailwinds to be found. In 2014, when I launched Alluvial Capital Management, the US stock market capitalization to GDP ratio was around 115%. Today it's >200%. By contrast, the European Union's 2014 ratio was around 55%. Is it not substantially different in 2024. Not only has the European economy grown less quickly than the USA's, its companies remain modestly valued as a percentage of GDP while American companies are more highly valued than ever before. Now, much of the gap is deserved. The American economy is more vibrant, its workers more productive, and its companies more incentivized to innovate and invest. Still, I am not convinced these real advantages justify a valuation gap of this magnitude. At some point, unless one believes there is no ceiling on American market valuations, the tide will turn and our European holdings will finally enjoy a favorable market environment. While it seems almost unimaginable now, European markets used to outperform American markets at regular intervals. From 2002 through 2007, the MSCI EAFE Index returned 123% versus the S&P 500's 42%.

TABLE IV: Sector Breakdown, 9/30/24 (%)

Consumer Staples	20.5
Communications	15.5
Real Estate	14.6
Financials	12.7
Information Technology	9.9
Consumer Discretionary	9.1
Industrials	6.3
Materials	5.9
Utilities	4.0
Energy	1.3
Health Care	0.3
Total	***100%***

One last theme our portfolio expresses is "Business are run by people, so invest in good, well-incentivized people." I say "theme," but this is really more of a core belief that gets stronger with time. It's hardly a revolutionary idea, but I appreciate its value more and more with each passing year. Fully 40% of our portfolio is invested in companies where management are the largest shareholders or a major shareholder is directly involved in the business. In my experience, the more of their net worth that members of management have riding on the success of a company, the more likely management is to do intelligent things that help that company prosper.

Other Updates

Thank you for reading this update, and for the trust you have placed in Alluvial. I wanted to remind partners that I do write occasionally at alluvial.substack.com, so feel free to sign up for updates.

We will host an update for partners in the coming weeks. These updates have become something of a bi-annual event that I always look forward to. We will reach out with additional details and to invite you to submit questions in advance of the date.

Work continues in preparing for the January launch of our new offering, Tactile Fund. Tactile will make long-term investments in companies with extraordinary physical assets. I don't intend to inundate you with sales pitches for the new fund, but please do reach out if you have interest or are simply curious.

As we look toward the end of 2024, I wish you and yours a joyous holiday season. I look forward to speaking with you soon and to writing to you once 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, 2023 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.