July 21, 2020

Dear Investor:

I hope this letter finds you making the best of these continued trying times. Following the worst quarter in nearly forty years, markets responded with one of their best quarters in the same period. I'm pleased to report we were able to capitalize on the volatility as we had three positions double which enabled us to ourselves more than double the market's performance in the quarter. For the quarter, the S&P finished up +20.5%, while small caps and the Russell 2000 enjoyed a rare bit of brief outperformance finishing +25.4%. Our portfolio was +51.0% for the quarter, producing gains of +6.1% for the year thus far versus losses of -13.0% and -3.1% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we discuss the major drivers of our performance, highlighting Celsius Holdings, Inc. (CELH) and Digital Turbine, Inc. (APPS) as the biggest contributors in the quarter. We then discuss several new portfolio additions which we group into two baskets: Digital Advertising Beneficiaries including new positions in APPS and Pinterest (PINS) and Small Cap Value Stocks including new positions in Citi Trends, Inc. (CTRN) and Carrols Restaurants (TAST). Finally, we provide a few thoughts on the outlook, and provide a brief update on our view of a K shaped recovery.

QUARTERLY COMMENTARY

Markets bounced back from deeply oversold conditions in the second quarter. Though COVID-19 remains a nuisance and continues to suppress activity, an increased collective understanding of the virus has enabled our country and its citizens to make incremental progress in learning to cope with its impacts on our daily lives. Equally importantly, quick and massive government fiscal and monetary responses have allayed many of the worst-case potential economic outcomes associated with the crisis, and markets responded accordingly. Against this volatile market backdrop, we were quite active and are pleased to report this upward move in markets rewarded our purchases made during the precipitous market decline. Three positions doubled while most other positions were positive contributors.

Shares in Channel Advisor (ECOM) doubled this quarter, as its unique role in helping brands manage inventory and optimize sales through multiple online channels has become an immediate and obvious need for many brands and retailers. The move to ecommerce has clearly been underway many years, though the recent environment has only accelerated this channel shift further. The company continues to generate outsized growth from its largest customers and is similarly enjoying the benefits of strong operating leverage on incremental sales attendant with its SAAS busines model.

Recently initiated positions in Digital Turbine and Celsius Holdings, Inc. enjoyed similarly strong share price performance. CELH was the largest single contributor to performance in the quarter with APPS the second largest driver. As CELH and APPS are new positions, we offer some commentary on these positions further below.

Lastly, we were again active in the restaurant space. Our repurchase of Chipotle again proved timely. As the preeminent fast casual chain in the US, the company is thriving in this environment and growing share on the back of the digital capabilities the company has been building over prior years. More recently, with shares back in the $1,000s and again reflecting a full valuation, we have taken profits here and reallocated funds to a new position in Carrols Restaurant's, Inc. (TAST), also discussed further below.

POSITION COMMENTARY

CELH – Celsius Holdings, Inc. is an energy drink company. With a sales CAGR of ~45% over the last three years, it is one of the fastest growing beverage companies in the fastest growing category of beverages. The company has carved out a niche for itself for its offering of healthy carbonated and sparkling beverages that provide an energy boost with no crash. The beverages are made from healthy ingredients and contain no sugar, high fructose corn syrup or preservatives. A typical 10-ounce single serving can has only 10 calories and numerous studies show the drinks accelerate the body's metabolism and aid in burning both calories and fat. And they actually taste good.

Sugar water can be a great business. Coke and Pepsi are two of the greatest success stories in our country's proud capitalistic history. And Monster, a fast follower behind Red Bull in the still relatively nascent energy drink category, produced one of the greatest 10-year total shareholder return records ever, with shares increasing 100 fold in less than ten years, as profiled in Chris Mayer's excellent book 100 Baggers: Stocks That Return 100-to-1 and How to Find Them. So sometimes, when these businesses work, they can really work. Of course, these success stories are well known and have attracted a great deal of attention – and competition. Accordingly, getting to scale in a crowded and competitive field can be difficult and is rife with countless "can't miss" stories that missed.

So with these elements at play, when I met with the management team of Celsius at a conference last spring, I was intrigued with the company as a possible investment, but I also wanted to watch it season for a little while. Though the team was impressive and said and did all the right things, the microcap company was still subscale. While sales were expanding rapidly on successful initiatives to target a healthy and fit crowd through gym partnerships and clever influencer marketing campaigns, they still only had about $70M in sales and were unrepresented or underpenetrated in important channels. The company also had a minor issue with a Swedish distributor that had some balance sheet problems of their own doing.

But late in 2019, the company bought Func Foods and brought their Swedish distribution partner in house, so entering 2020, the stage appeared set for Celsius to have a breakout year. Then COVID-19 wreaked havoc on the world. Though many gyms shut, company sales continued to prosper as many loyal Celsius fans took to Amazon to fulfill their Celsius needs, soon making it the one of the top selling drink brands on Amazon. With the continued strong growth, 2020 has become the year the company will surpass the $100M sales threshold, an important one in the industry for a number of reasons. For starters, achieving the $100M sales level in a crowded industry is no mean feat. Incumbents do not exactly welcome the competition, and the field is crowded with upstarts. So reaching this level of success – independently and without the marketing or distribution help of any the established players – suggests two important things: 1) the product is valued by a non-trivial segment of potential customers, and 2) management has a good plan in place for reaching their growing customer base and the ability to execute on it. So, at these sales levels, though fad risk cannot be eliminated, it can be minimized. This a fact incumbents, many of whom are facing stagnating sales in their core product lines, seem to be well aware of, as many suggest this is about the level that young brands become viable acquisition targets.

Other recent developments have been positive as well. This March, peer energy drink manufacturer Rockstar was acquired by Pepsi for $3.5B. Though the Pepsi acquisition may highlight increasing competition, it was followed one month later by another deal from Pepsi, this time with Bang Energy for distribution of their energy drink portfolio. This new arrangement potentially clears the way for Celsius to further penetrate the convenience store channel as relationships with certain direct store distributors that were previously contractually blocked have now become available.

The 8x sales multiple for Rockstar, for a business that had actually seen stagnating sales growth, is quite interesting, as it approximates Monster's trading multiple during its hypergrowth phase. Though Monster was a pioneer in developing the category for sugary and syrupy tasting energy drinks, Celsius appears to be blazing a path as a healthy and refreshing alternative in this channel. And it is worth noting, at similar levels in their growth trajectories, Celsius appears to be doing so with a stronger growth profile and higher gross margins. While it is clearly too early to say Celsius is on the path to becoming a Monster, at this stage it appears quite well suited for success in an attractive market that is $10B in size and still growing.

DIGITAL ADVERTISING BENEFICIARIES

Digital Turbine, like recent addition Pinterest, and existing holding Magnite (MGNI, formerly The Rubicon Project) are beneficiaries of increasing digital advertising spend. Many advertising related stocks were sold off quite hard in March, as advertising is generally considered quite cyclical. But within this massive end market, the digital channel is a clear secular share gainer and one that has also shown relative strength throughout the pandemic. All three of these names stand to benefit from this growing trend.

APPS – Digital Turbine is a middleman of sorts with an interesting value proposition as the company has managed to build an increasingly entrenched position in a growing market niche as the app installer of choice for non-iPhone smartphones. Their On Device Media Platform, which comes embedded in the Android operating systems upon installation and recently crossed the 400 million device installation threshold, enables app developers like Uber, Netflix and Spotify to have their apps pre-installed on new phones. Carriers like Verizon and AT&T like this arrangement as it simplifies app and content discovery while higher app usage rates drive higher overall subscriber engagement and phone usage rates. Functions like SingleTap, which allows a user to download a new app with a single click of a button, have been shown to improve download rates by as much as 10x, thereby driving further usage and engagement. Additionally, their software enables the capture of user data, which can in turn be shared with marketers and enables higher ROIs on advertising spend within the app.

Accordingly, as the company is able to grow the revenue pie for both carriers and app providers, their platform benefits from expanding network effects and creates a bit of a virtuous cycle in a segment that is growing strongly as smartphone usage grows across the globe. Earlier this year, the company acquired Mobile Posse who has an important relationship with T-Mobile and a heavier mix of recurring revenue business. The cross-selling opportunity here is promising with management recently commenting it could one day drive over $100M in incremental sales. Partly with the aid of the accretive Mobile Posse acquisition, the company looks set to double EBITDA for the second year in a row. Now trading with a ~25x NTM PE, growth prospects look attractive with device installations, revenue per device and advertising rates all improving. With strong operating leverage inherent in the busines model and steady tailwinds from increased smartphone growth and a growing focus from app providers on monetization efforts, the company appears well-positioned to expand on its strong market position.

PINS – Pinterest is a little more well-known, but as a one-year old public company, it has quite a big opportunity in front of it. Established in 2010, the platform has become home for 330 million global users who are searching for inspiration. Typically, these "Pinners" are looking for that something they can't quite describe, and the images the company's algorithms recommend often act as a brainstorming session of sorts to stimulate new and inspirational ideas for things like home projects, new recipes or ideal vacations. Pinners save these images as "pins" and store them by boards grouping them by subject. Entering the year, Pinners had saved 240 billion pins across five billion boards, creating a large network that the company can continue to build upon with increased user growth and interaction. The typical user is an attractive one, as Pinners are known for spending more time on Pinterest per visit than is typical of most other social media platforms. The primarily female customer is also typically affluent and has shown a high propensity to spend after engaging with the platform.

Accordingly, though the company is in the early stages of monetizing its growing user base, a path to high user monetization rates is quite visible. Like many growth stocks that show softening growth rates, shares were punished when revenues were softer than expected in Q1. But the softness had more to do with a momentary standstill in advertising spending than any negative implications around the company's user base, where growth reaccelerated during the period. The growth in its user base is something that can be a lasting positive for the company as ad rates improve and further monetization efforts begin to take hold. Though it is not clear today the company will become the next multibillion-dollar social media platform behemoth, the potential is there as evidenced by a scalable platform that has impressive gross margins and a unique and valued platform offering.

SMALL CAP VALUE STOCKS

After small cap value stocks sold off 40% last quarter – we added some names to our small cap value bucket. Like our two trucker stocks Schneider Logistics, Inc. (SNDR) and US Xpress (USX) (which are exhibiting all of the hallmark signs of embarking on a new freight upcycle exhibited by high but decreasing unemployment, declining Class 8 truck sales and improving spot rates), historically names in this bucket have performed well when similar market and economic conditions are present. Hooker Furniture (HOFT), Carrols Restaurant and Citi Trends, Inc. are recent additions.

CTRN – Citi Trends is a store-based retailer of discount merchandise. While most store-based retailers have been challenged in recent years, discount retailers like TJX and ROST have thrived reselling marked-down merchandise in a physical store only manner. Citi Trends fits this mold but has a narrow focus on the primarily female African American target customer.

Entering the year, Citi Trends was executing well. It had just reported a solid comp, a well-positioned inventory assortment and unveiled a plan targeting mid-teens EBIT growth, driven by 3-4% same-store-sales growth, moderately expanding gross and operating margins and supplemental cash return to shareholders to drive a 20-25% EPS CAGR over the coming years. Then COVID-19 hit, and Citi Trends and other store-based retailers all shut their stores. Unlike other store retailers, the company has continued to distinguish itself during the reopening. Nearly 90% of its stores were reopened by the end of May, partly as a result of a geographic mix that was less impacted by state government mandated closures. The stores that have been open have performed well, with same-store-sales growth surging +50% on average. Though the eye-popping same-store-sales growth of these levels assuredly reflects some shifting of demand across the calendar, it also highlights that the company continues to connect effectively with its customer and is executing well. While same-store-sales growth at these levels assuredly will fade to more reasonable levels of growth, the strong cash generation abilities will augment an already strong balance sheet and perhaps precipitate a resumption of shareholder cash return initiatives. Valuation of ~10x 2019 EPS seems very undemanding, particularly in the context of larger peers with lower growth profiles trading at multiples close to twice these levels.

TAST – Carrols Restaurants is the largest Burger King franchisee in the US. The company has over 1,000 Burger Kings and 65 Popeyes, and a right-of-first-refusal agreement with Burger King that covers many of the states in the eastern half of the US. The company hit a bit of a rough patch in 2019. A recent acquisition needed more attention than originally envisioned to bring profitability metrics up to corporate average while a double discounting snafu shortly thereafter caused the company to undercharge for many of their Whopper combo orders and led to sales shortfalls. These issues look to have been addressed and appear mostly behind the company. Even so, with shares still off over 50% from last fall's levels, TAST seems to be trading like a lot of other restaurants who are generating negative free cash flow on deeply negative same-store-sales, despite a recent update and outlook that shows otherwise. Should the company continue to drive positive comps, it seems they could generate ~$1 per share in free cash flow, a compelling value on a less than $5 stock.

2020 OUTLOOK

The K shaped recovery we discussed last quarter continues to appear appropriate as uneven economic conditions continue to produce relative winners and losers. Some companies are thriving in the work-from-home environment and have been rewarded as such. Others appear disadvantaged due to these odd operating conditions. Some of the various dichotomies in market performance we have discussed in the past continue, producing market conditions that by some measures appear somewhat strange, even if they mimic the current operating conditions of our economy – which themselves are quite strange. Even so, we continue to find many compelling values of companies that we believe should fare well in this environment.

CONCLUSION

In closing, while I know our approach will not yield outperformance each and every quarter, I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the overwhelming majority of our investable assets are invested alongside yours, we would never ask investors to assume risks we ourselves will not.

Thank you for your continued support as we work to grow our capital together. As always, we are happy to discuss our investment outlook with you at your convenience. Please reach out any time.

Best regards,

Mitchell Scott, CFA
Portfolio Manager

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1. All market and company data is sourced from Factset and company filings and is current as of 6/30/20.
2. CEF uses the S&P 500, Russell 2000, a custom Blended Small/Large Benchmark and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The custom Blended Small/Large Benchmark is provided to capture a larger proportion of small cap performance versus large cap performance (at a 3:1 ratio) due to the similarly high proportion of small caps found on the Good Businesses Focus List as well as the strategy's general preference of having an investment mix more heavily weighted towards investment in small caps. The Barclays Hedged Long/Short index (an index of equities-based hedge funds) serves as an appropriate benchmark over the long-term given the index has a similar long-term goal of capital appreciation through equities investing.
3. CEF Net Returns are hypothetical results calculated from actual gross results in a manner consistent with the 1% management fee and 18% performance fee offered to clients.

APPENDIX 1

CEF GOALS, PHILOSOPHY, APPROACH AND ALIGNMENT

GOALS – We seek to generate market-beating returns over any rolling multiyear investment horizon while minimizing the risk of permanent impairment of capital. Additionally, we seek to communicate with our investors in a transparent and straightforward manner and ask only that they accept investment risks that we ourselves are willing to take. *Given the majority of our investable capital is invested alongside theirs, we invest our limited partners' capital as if it were our own, because it is.*

PHILOSOPHY - We approach investing in public equities as an opportunistic businessman would. We spend most of our time studying businesses and building circles of competence in areas likely to offer attractive investment prospects and invest in only our most compelling opportunities. We view risk primarily as the likelihood of a permanent impairment of capital and pursue a carefully balanced willingness to trade some short-term portfolio fluctuations for the opportunity to earn higher returns over the long-term. We focus on growing, understandable businesses and seek to buy them at a substantial discount to our estimate of their intrinsic value. When we find them trading at attractive prices, we often act in size and weight our best ideas accordingly. And all things being equal, we prefer to devote more of our efforts to small stocks where we believe greater price/informational inefficiencies can often be found.

APPROACH – We invest via a long-bias hedge fund structure and concentrate our long investments in our best 10 to 15 ideas. Our work begins with a two or three-year outlook, and we only pursue investments we believe are likely to offer us a reasonable chance to generate an annualized return of 20% or better. While we pursue long-term oriented investments and seek to compound capital in a tax efficient manner, we readily acknowledge the often-turbulent markets do not always fit neatly into this framework and know some trading activity is sure to follow as a result. In the short book, we seek to generate absolute profits in a few stocks where we have uncovered a company entering financial duress or an excessively optimistic valuation where we feel their earnings outlook is likely to worsen materially. We will also use industry or market specific ETFs to mitigate market risk and will look to employ options and other opportunistic hedges when conditions appear favorable.

ALIGNMENT – We believe appropriate alignment of interests is the bedrock upon which all successful partnerships are built. Our primary means of ensuring proper incentive alignment is through significant co-investment of our personal wealth alongside our limited partners. Secondarily, we offer an investor friendly fee structure. We charge a modest management fee to support investment operations and charge an annual incentive fee on new profits only. Finally, commensurate with our fee structure which is intentionally structured such that the majority of fund earnings will be earned only if we generate compelling investment results, we commit to operating the fund as a boutique shop with a limited asset size. As many of our best investments often come from small stocks, we believe it is important to preserve our ability to take concentrated positions in our best ideas. Our size and structure ensure we are incentivized to generate compelling returns, not gather assets.

Think of it this way. *On the one hand, we are incentivized to generate the best investment results possible. On the other hand, we are unwilling to invest in a way we feel is likely to result in a meaningful loss of our own investment capital. What more could one want from an investment manager?*