CHOICE EQUITIES
CAPITAL MANAGEMENT

May 02, 2023

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated gains of +1.0% on a net basis in the first quarter. This compares to the Russell 2000's +2.7% gain for the quarter and the S&P 500's quarterly gain of +7.5%. Since its inception in 2017, the fund has generated annualized gains of +14.7% versus +6.0% and +12.2% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we provide a brief overview of events of the first quarter of 2023. We then discuss major portfolio holdings, including newly initiated core holdings in Celsius Holdings, Inc. (CELH) and SiteOne Landscaping Supplies, Inc. (SITE). Lastly, I conclude with a few thoughts on the current outlook.

QUARTERLY COMMENTARY

It was another interesting quarter, with headlines again dominated by macroeconomic developments. The quarter began positively, with most stocks benefiting early in the year from a bounce after the December decline. However, later in the quarter a run on two sizeable regional banks spread fears of a banking contagion across the investment landscape. That a digitally enabled run on these banks suffering from a classic asset/liability duration mismatch in high quality securities could occur in just a few days' time most assuredly amplified fears of financial system instability, and most stocks sold off. In the subsequent flight to safety, US Treasuries were bid up, yields fell and the increase in interest rates enjoyed a respite. Alongside the decline in yields, large cap tech stocks received renewed interest, in part from lower discounting mechanisms and probably in some part from market participant's crisis era muscle memory. Most other stocks continued to fall, with markets displaying narrow leadership with meaningful gains mostly concentrated in just a few large cap growth stocks. Small caps were up small for the quarter, again trailing larger peers.

Our portfolio performance was somewhat similar to the general small cap experience during the quarter, following a somewhat familiar recent pattern that could be described as one step forward, one step back.

PORTFOLIO COMMENTARY

Most of our core holdings remain the same as discussed in our most recent letter and are generally performing as anticipated. As considerable economic uncertainty continues to surround the investment landscape, I continue to focus our holdings on companies that can either drive growing cash flows despite the unpredictable environment or amongst those that carry attractive valuations that already account for a softening economic environment.

CROX – Last week's quarterly report was the second report in a row that seemed to sow some confusion among investors. Much like the most recent quarterly report, the company effectively surpassed expectations on nearly every metric, and then offered a puzzlingly subdued set of expectations for the upcoming quarter. In sum, the total body of work suggests a company meeting its customers with desired products at their preferred points of purchase with healthy double-digit growth across several vectors like Jibbitz, the traditional clog silhouette and HeyDude while other end markets like sandals, China, EMEALA and HeyDude in the DTC channel all enjoyed growth in excess of 20%. Today, shares trade around ~10x growing earnings, a substantial discount to most of its peers, despite being considerably more profitable.

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Industrials – Orion Engineered Carbons (OEC) and Wesco International Inc. (WCC) continue to trade with undemanding valuations. While their end markets differ, they share many commonalities. Both companies have competitively entrenched market positions and look poised to continue to grow cash flows in the double-digit levels or better. Both also pay dividends and have active share repurchase programs while also trading at single digit multiples of this year's growing earnings.

Restaurants – Signs suggest the restaurant margin expansion thesis continue to play out as expected, as restaurants have historically been slow to walk back inflation-based menu price increases with their customers by lowering prices even if incoming food costs decline. Both Papa John's Inc. (PZZA) and Brinker International, Inc. (EAT) look set to enjoy an inflection in operating margin expansion as they regain lost margin from the prior surge in food input costs.

Recently, we re-acquired shares of prior investments in SITE, again for the second time, and CELH again for the first time. In both cases the investment theses and company plans remain largely the same as in prior instances, so purchase decisions are largely driven by current expectations and valuation considerations.

CELH – For Celsius Holdings, Inc., an update is in order since our first purchases around this time three years ago, as it certainly feels a bit strange to buy back a stock at higher levels than some of our final sales a few years ago. As I noted then in the 2020 Q2 letter and as the likes of Coca-Cola, Co. (KO) and Pepsico, Inc. (PEP) and Monster Beverage Corp. (MNST) have proven over time, sugar water can be an amazing business when it works, and for Celsius, it has really worked.

When we first bought shares the company was just on its way towards besting the $100M level in sales. Today, three years later, the company looks like they'll surpass ~$1B in sales this year. This astounding multi-year triple digit level of annual sales growth will assuredly slow as the company begins to battle the law of large numbers. But as an upstart brand, the company has made a remarkably quick ascent up the global energy drink leaderboard to become the number three player in a market that continues to grow around 8% per year.

A few developments have helped drive this growth. The company has benefited substantially from increased distribution, first by demonstrating success in a democratized channel on Amazon, and then second as a beneficiary when Bang Energy was displaced which paved the way for new relationships with new direct store distributors (DSDs). Last autumn, Celsius again took another big step in furthering their distribution gains when they signed a long-term distribution agreement with PepsiCo. The investment brings the two companies more closely together and enables Celsius to further its market share gains on the back of Pepsico's vast and efficient DSD network. The partnership will enable Celsius to optimize go-to-market effectiveness, eliminating stockouts and further enable an improved margin profile. An expanded SKU count and flavor offering has followed as have increased marketing efforts, while the international channel still offers a large avenue of mostly unpenetrated growth.

Today, as before, the company continues to be more profitable while growing faster than Monster did in its comparative early days of high growth. Trading at <7x sales around recent purchase prices with less than a 4% share in its category, shares look attractively priced, especially if the company continues to track towards a high single digit share of the energy drink market as appears to be the case today.

OUTLOOK

The current investment landscape continues to be marked by significant cross currents. Inflation remains high, though trending towards more desired levels. However, as the recent banking issues highlight, the intended effects of tightening monetary policy are showing up in some parts of the more credit-dependent areas of the economy. Countless surveys and confidence measures suggest a downturn is on the horizon.

Many tried and true indicators, such as the 3-month / 10-year yield curve which has become meaningfully inverted, support these views.

It seems most everybody expects economic growth to slow, though few agree on the likely duration or magnitude of such a slowdown. Fewer still agree on their near-term market implications. (Such is the nature of economic forecasting.) Despite the forecasts, earnings continue to surpass most expectations as companies adapt and adopt cost structures and business plans to changing operating conditions. Accordingly, expectations for an earnings recession to emerge with the 1Q reporting season thus far look to have been premature or incorrect, with modest earnings growth the most likely outcome. Some areas of the economy are showing more resilience than others, and many pockets continue to show outright strength.

Turning to markets, it has been a lengthy downturn. According to the Wall Street Journal, now 223 trading days since the S&P 500 entered bear market territory with a -20% decline last June, this bear market trails only that of the 1973 decline in terms of duration, and just by a couple of weeks. Other themes discussed in prior letters continue to hold true. The valuation disparities of those stocks in favor versus those out of favor has extended further this year. Small and midcap stocks look attractively valued on most metrics, with small caps continuing to trade at more than twenty-year lows on many absolute and relative valuation metrices versus larger peers.

Our focus continues to be dedicated to bottoms-up analyses of specific stocks, and I continue to believe we are well positioned for attractive future returns.

CONCLUSION

Seeing some of you at our recent partners update meeting two weeks ago was a genuine pleasure. It was great getting together, and I look forward to doing that more frequently than we have in recent times. As I shared then in our slide presentation, I am pleased with our body of work since inception. Though I wish our efforts were producing more immediate positive results, I am even more excited about today's opportunity set and our prospects for the years to come.

Accordingly, I know our approach will not yield outperformance each and every quarter, but I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the overwhelming majority of my 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

1. All market and company data is sourced from Factset and company filings and is current as of 3/31/23.
2. CEF uses the S&P 500, Russell 2000 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 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 consistent with the 1% management fee and 18% performance fee offered to clients.

APPENDIX 1

2020 Q2 LETTER EXCERPT

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.