July 29, 2024

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated losses of -5.8% on a net basis in the second quarter, taking year-to-date gains to +7.5%. This compares to the Russell 2000's -3.3% loss for the quarter which likewise reduced year-to-date gains to +1.7%. The S&P 500 generated a quarterly gain of +10.6%. Since its inception in 2017, the fund has generated annualized gains of +13.5% versus +7.1% and +14.6% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we provide a brief summary of equities markets in the second quarter of 2024. We then highlight a couple of recent developments of companies within our portfolio by taking a closer look at Magnite, Inc. (MGNI) and providing brief updates on Par Technology Corporation (PAR), Orion Engineered Carbons, SA (OEC) and H&E Equipment Services, Inc. (HEES). Lastly, I conclude with a few thoughts on the current outlook.

QUARTERLY COMMENTARY

Looking at equities market performance, key market themes continued as 2Q could be regarded as an extension of 1Q in many respects. Large cap growth stocks, five of which today comprise 29% of the aggregate market cap of the S&P 500, again spurred the highly concentrated index higher. At odds with the S&P 500, most other stocks and nearly all other indices devoid of the large cap tech players declined during the quarter, with small caps finishing -3%. This quarter's narrow market leadership extended this trend of recent performance, with fewer than one-fourth of the S&P 500 stocks outperforming the index itself at the halfway point, a proportion not seen in over fifty years.

The primary market focus areas remained consistent from the prior period, with most market discussion centered on AI, politics, monetary policy and inflation. This past quarter though, more favorable disinflation data manifested versus that of the prior quarter, driving a shift in expectations back towards looser monetary policy beginning sometime this fall.

Perhaps the biggest difference in the two quarters could be in the level of interest in all things AI, where one could make the case that for the 90 days that were the second quarter, AI enthusiasm morphed into an outright AI vortex. Possibilities around various AI use cases and productivity enhancements have captivated public imaginations and created what seems to be an arms race mentality in corporate boardrooms, driving headlines and equity fund flows from non-AI themes towards AI themes in the process. Capital spending on AI projects is likewise set to surge, as it is estimated four large hyperscalers (Amazon, Google, Meta and Microsoft which are also four of the top five companies by market cap) intend to spend an eye-opening ~$200B this year on AI chips. The market seems intent on capitalizing these large capital flows and rewarding these recipients (which at this point is primarily Nvidia) higher trading multiples. Past mega-spending cycles such as these suggest useful and unexpected innovations will follow, likely improving standards of living for all. Less clear is which companies will reap the benefits, as often it is not necessarily the ones who have laid out the most capital.

PORTFOLIO COMMENTARY

As was the case with most stocks in the quarter, several of our holdings also gave back some recent gains. Most were immaterial individually, but together, they drove a down quarter for our portfolio. Our portfolio remains concentrated across 10 to 15 holdings as is typical, which often produces lumpy returns, an intentional feature of our portfolio construction.

HEES – H&E Equipment Services, Inc. was a primary detractor in the quarter, with shares down -23% on earnings day. 1Q results came in a bit lower than anticipated, partly hurt by weather early in the year and partly due to a lull in activity in their end markets while some of the larger mega-projects gear up to take the baton in construction activity. As highlighted previously, I believe the medium-term outlook remains attractive, as by all indication large project starts appear set to ramp in the second half of this year. With shares trading at <5x EBITDA, an attractive margin of safety remains.

OEC – Shares of Orion were also down in the quarter, at a time when the company looks to be approaching an inflection in cash flow growth. If we are paying attention to capital cycle economics, as we should be, the company should be in excellent position going forward. After years of EPA-mandated investment to clean up its plants to manufacture carbon black with lower sulfur output, the company is now in a position to leverage these investments that have kept new competitors and capital flows disinterested from creating additional production capacity within the industry. From here, a strong case can be made for high teens or better EBITDA growth in coming years, an outlook that a valuation of <6x EBITDA appears to overly discount. As capital investments taper off, we believe many of those cash flows will returned to shareholders via buybacks.

Several other company developments have been quite positive and are likewise worth highlighting.

PAR – This month PAR completed its long-awaited transition to become a pure-play restaurant technology software provider. The sale of the government business was announced and finalized earlier this month, and just last week the company closed on the TASK acquisition. Recent corporate activity now positions the company as one singularly focused on excelling as a unified commerce solutions provider to restaurant chains. After continuously building out its platform of service offerings, the company now has a full product suite to sell to potential clients, and equally importantly, an international footprint which should enable further customer wins from here.

MGNI – Portfolio holding Magnite is worth a deeper dive given the impressive list of customer wins the company has been announcing of late. Streaming players like Roku, Telus, Media Ocean and, most importantly, Netflix have all chosen Magnite to serve as their sole SSP (Supply Side Platform) to sell their ad inventory programmatically. The recent wins (which add to existing relationships with the likes of AMC Networks, DISH Media, Disney Advertising, FOX Corporation, FuboTV, LG Ads Solutions, VIZIO, and Warner Bros. Discovery) highlight the strength of Magnite's offering within the Connected TV (CTV) value chain as the largest independent – and unbiased – supply side ad exchange in the world. Though the wins have come in bunches lately, establishing this advantaged competitive position was not something that happened overnight, as CEO Michael Barrett has employed savvy, strategic acquisitions of CTV supply side peers Telaria (2020), SpotX (2021) and SpringServe (2021) to bolster this position. (More on our original views of Michael Barrett and his early moves at The Rubicon Project (which is now known as Magnite) can be found in the Appendix and here in our 4Q 2018 letter when we originally profiled our investment in The Rubicon Project.)

The timing of the wins, all announced just this year, also highlights the pace of adoption of the ad-paid model in streaming TV. With the average American household subscribing to four streaming services per month, too many people have too many streaming subscriptions. As consumers grow tired of subscribing to four (or more) platforms and paying four sets of monthly subscription fees to four different service providers, many are increasingly opting out of the subscription model and opting in to a streaming model subsidized by paid ads. As a result, ads are coming to streaming and look likely to emerge as the dominant means of monetization for television of the future, much in the way ads have been the primary driver of economics in linear television for decades. Only in the case of CTV, particularly where user data can be leveraged to match more specific ads to various users' likely interests, ads can be targeted and their impacts better measured than in the linear channels of old suggesting one day down the road the CTV ad market could meaningfully exceed what was once a mammoth sized linear TV ad market.

According to Nielsen, streaming today is the most dominant form of content consumption, commanding nearly 40% share across all channels including broadcast, cable and other means. And though over 80% of Americans consume some TV through a streaming service, Advertising Video On Demand (AVOD) share today remains only ~25%. As nearly three-quarters of CTV advertising for digitally native FAST (Free Advertising Supported TV) or OEM players (like Roku, or Samsung, respectively) is done programmatically, this suggests dollars are likely to flow steadily to programmatic and support a high teens CAGR of market growth in CTV ad spending growth for years to come.

As for Netflix, that Magnite could win the Netflix business to function as its sole SSP in CTV is impressive. That they have done so by displacing Xander, a Microsoft owned company, who Netflix just hired a little more than a year ago to provide the same service, speaks volumes to the Magnite value proposition and its ability to drive improved returns on ad spend through their superior technological offering. As promising as the Netflix win and the Good Housekeeping seal that goes along with it are, the financial implications to MGNI's future profitability are more exciting. Today, Netflix has 278M paid subscribers, with 53M opting for some level of the ad-based subscription package, up from just 15M just this past November. Industry estimates suggest Netflix is likely to earn $4B in ad revenue on a run-rate basis on their platform this year, likely growing to $5-6B+ in a few years. If half of this is transacted programmatically, some ~$2.5B to $3B of ad revenues is likely to soon pass through MGNI pipes. Anticipated take rates are subject to some debate, but our checks indicate the take rate is likely to match the full-service nature of the offering provided, suggesting the Netflix relationship alone can more than double Magnite's current CTV annual profit pool in coming years.

Magnite's focus on becoming the only independent, scaled SSP player in CTV now looks set to pay off. After stalling out around 2% last year while digesting some new customer onboarding lumpiness and investing for the growth that has produced these new customer wins, CTV segment revenue growth looks likely to accelerate to 30% or better next year. All in, Magnite looks set to benefit as a winner in CTV with accelerating revenues and margin expansion as the ad-based streaming business now begins to accelerate in earnest.

OUTLOOK

Market leadership has been quite narrow for some time now. However, very recent market activity has brought different trading dynamics as a case could be made market participants are taking more interest in other areas of the market beyond just the large-cap tech growth stocks that have performed so well of late. Certainly, there is ample reason to think change is afoot. Considering recent political events which seem to be a good reminder to expect the unexpected this political cycle, it is now a given we will have a different US president come January. Monetary policy also looks set to change from a tightening regime to one that will be loosening up later this year.

Though these are important changes that can have meaningful impacts on markets, perhaps the most important driver of change in the recent market activity is simply about earnings and where that growth is coming from, as most forward indicators currently show a broadening out of the profit cycle likely to come. Indeed, this would make sense as a broadening in the distribution of profits has typically been accompanied by a broadening out of market returns. As history tells us, stocks follow earnings over time. And starting points and valuations matter too. On these counts, there remains quite a bit of value and earnings growth in our corners of the market and in our portfolio.

The renewed investor interest around small and mid cap stocks has been welcomed. (This brief JP Morgan report underscores several elements of this dynamic by highlighting attractive durable earnings growth and attractive valuations for small and mid cap stocks.) With this cohort of stock anticipating accelerating earnings growth next year, it feels recent market interests in this area are justified, especially considering the relative valuation disparity that continues to be exceptionally large by any reasonable historical context.

CONCLUSION

I am excited about our current holdings. Even so, 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 6/30/2024.
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

2018 Q4 Investor Letter; RUBI – In small cap land, it is often said it is more important to bet on the right jockey than the right horse. (I found an interview on this subject with MicroCap Club Founder Ian Cassell interesting.) The thinking goes that the smaller the company, fewer bureaucratic layers provide a CEO with more authority and responsibility for strategic direction and successful execution of corporate aims. Greater touches with company leaders and employees provide a strong leader more opportunity to influence company culture and leave an outsized mark on company performance. While I have found this to be generally true in my experience, that does not mean we are not on the lookout for thoroughbreds too. So, what about a situation where we are betting on a jockey who is betting on his chosen horse? I believe we have that here with Rubicon Project.

The Rubicon Project is an independent ad exchange platform that focuses on automating the process of buying and selling digital ads. As a supply side exchange, the company's principal focus is on matching the ad inventory of its content publishing customers with brands and advertisers who are looking for digital real estate for their ads. Given the thousands of miniature auctions that take place to match a buyer and seller to create an impression (i.e. a successfully matched ad), the company relies on algorithms to match the best bids with the appropriate content all in a way that places ads quickly, so the content is displayed without delay. Today ~$1B of ad spend goes through the company's platform which processes trillions of impressions per month. For its role in sourcing and matching advertising demand, the company keeps a small percentage of the ad value flowing through its platform as a fee, known as its take rate.

The global programmatic ad market is large, estimated at ~$34B today. While Facebook, Google and Amazon are the largest players (who importantly also already have their own ad inventory), the rest of the industry is quite fragmented and growing strongly. Mobile is the big driver of growth today, but other uses like programmatic audio for companies like Spotify and connected tv applications suggest the industry is likely to continue to grow at a mid-teens rate in the coming years. As one of the largest remaining standalone independent ad exchange platforms, Rubicon is currently very well positioned to capture much of this industry growth. But it was not always this way.

In early 2017 when company founder and CEO Frank Addante began looking to move to the boardroom and install a new CEO, the company was facing a number of challenges. Rubicon was late to respond to the industry's move to header-bidding, an open auction format that was a change from the more insulated waterfall ad matching structure that had allowed the company to thrive on its close-knit publishing relationships. With ads effectively bypassing the Rubicon platform, the company's place in the value chain soon came under question. It was losing share, ads going through the platform were declining and take rates were shrinking. In May 2017, well-regarded ad tech industry veteran Michael Barrett joined the company as CEO in the midst of this shift in the industry. With strong credentials, including two nine figure exits and a stint as Yahoo's Chief Revenue Officer, we view his industry experience and contacts and understanding of the competitive landscape as a major plus.

So, we found one of Barrett's first moves after joining the company to be quite surprising. A few months into his tenure, he effectively cut the company in half by deciding to take their demand side take rates down to 0%. No longer was Rubicon a two-sided exchange charging fees to both parties in the transaction; instead it became a one-sided exchange focused primarily on sourcing the best demand possible for its content-providing customers. By eliminating the buyside fee, the company's role in the bid matching process is now more clearly understood as solely that of an aggregator of purchasing demand for its publishing customers. In an industry that has had its fair share of shady players who have used the opaque nature of the marketplace as a conduit to overcharge, gouge and even in some cases, defraud its customers, the company has eliminated any appearances of self-dealing that the two-sided platforms sometimes face. The eliminated buyer fees have also reduced the total cost of transacting on the Rubicon platform, which has enabled it to attract a greater access to inventory. By moving to a transparent, efficient and low-cost model, the company has positioned its platform to thrive as a one-sided marketplace focused on high volume and low cost per transaction.

These strategic moves appear aptly timed as another trend in the industry, Supply Path Optimization (SPO), has spurred many advertisers to shrink the number of platforms they are using to locate ad inventory. Buying groups such as advertising agencies and demand side platforms are concluding more meaningful relationships with fewer exchanges are preferable to the inverse and lead to a higher quality experience of placing ads and an improved ability to measure ROI. These trends and the competitive dynamics typically associated with scaled exchanges with powerful network effects suggest that ad platforms which currently number in the hundreds will likely consolidate down to five or ten in the coming years. It is likely some may exit due to the synergistic nature of an acquisition by a player with its own existing inventory as we recently saw with AT&T's purchase of AppNexus. The transaction is speculated to have occurred at ~8x multiple of sales, a level which speaks to the synergistic nature of opening up a content provider's inventory to a broader pool of buyers, as well as the conflicts of interest potentially involved when an exchange platform is not truly independent.

Rubicon's move to cut its demand side buyer fees – one of the ultimate in the category of short term pain for long term gain – has positioned the company quite well to emerge as one of the few consolidating exchanges of scale. But few investors seem to have noticed as consolidated financials continue to paint the portrait of a business in transition. As the company is still lapping tough comparisons from the prior year due to the change in business model, 3Q 2018 consolidated financials show the company posted an 18% decline in sales. But for people looking a little closer, signs of a healthy and growing business are there. The take rate has been increasing modestly while ad spend going through the platform is growing 24%. Secular growth drivers like streaming video which are associated with higher spend per ad are now coming into view with sales in this vertical growing at a 70% rate. With the company enjoying high incremental margins and expecting sales growth in the ~20% range, it likely will not take long for the financials to present a different picture. With half of its market cap in cash, shares at less than 1x EV/sales look attractive and offer a realistic path to earning multiples on our investment over the coming years.