Letter to Clients H1 2020

Clients and Friends,

This letter, originally intended to address the formal launch of Greystone Capital Management and subsequent performance during Q1 2020, will instead address the first half of the year. Please refer to the firm's website – www.greystonevalue.com – where readers will find copies of my Introductory and Founder's Letters that provide more detailed information about Greystone Capital Management and my investment philosophy. Moving forward, I'll be issuing quarterly communication to clients discussing a range of topics including portfolio updates and any other material information.

The first half of 2020 marked our first six months in operation following the formation of the firm during most of 2019. During that time period, with the help of Brent Gillett and Chris Stanley at The Investment Law Group, our administrative processes and procedures were established. We also transferred and consolidated all pre-existing accounts to the Greystone Capital Management LLC platform (where assets are held with Charles Schwab) and received numerous requests for information from outside investors who are currently performing due diligence on the firm and our strategy. Most substantially, we even managed to secure an office space, which consists of a desk located in the one spare bedroom of my house.

For new clients, the start of our relationship was a strange and volatile one. During the first quarter of 2020 investors witnessed the fastest stock market sell-off in US history (represented by the S&P 500 34% drop from February to March), only for the market to turn around and rally 16% through the end of the first half of the year. The mass wave of selling during Q1 and Q2 drove a highly correlated market decline across all asset classes, leaving some companies held in client portfolios subject to mark to market losses (including some larger positions down >40% for the year). Fortunately, these businesses were already trading below my estimates of their fair value, so the potential upside from these levels should be significant (assuming I am right about the value of our investments). Unfortunately, market recoveries do not follow predictable or linear patterns, and as a result we may experience more short-term pain before any long-term gain. However, I believe our patience will eventually be rewarded.

Returns during the first six months of the year for separate accounts managed by Greystone Capital ranged from -12% to +25%, with the positive returns skewed by newer accounts onboarded in Q1 and Q2 benefitting from post-COVID portfolio construction. The median account return was -5.1%. Since I manage a portfolio of separately managed accounts (SMA's) with irregular intake periods and varying client risk profiles, variances between account returns are expected to continue. This would change if / when I transition to a fund structure, but my preference for the time being is to manage SMAs, which allows me to keep our administrative costs and fees low.

Year-to-date results for select accounts compare unfavorably to the S&P 500 (-3.1% YTD) and favorably to the Russell 2000 (-13% YTD). Because client portfolios are invested in a concentrated way consisting of small companies mostly outside of the major indices, our returns should typically vary from the returns generated from those indices. My preference for using them as benchmarks is simple: clients can gain investment exposure to the broader market at nearly no cost, which provides me with an easy way to justify the existence of Greystone Capital. Our mandate is very clear: outperform or go away.

During difficult periods of performance, it will always be my job to take a step back from the daily financial news flow (which is always so optimistic isn't it?) and remind myself that stocks still represent shares of businesses that generate cash flows, and the value of those businesses is made up of the present value of their future cash flows, not the quoted market price during any high volume trading periods (assuming nothing has changed with the businesses themselves). While cash flow estimates and growth rates may need to be revised at times, when the entire market is experiencing a selloff as opposed to just one of our holdings based on specific news, it becomes at least a little bit easier to find confidence in the long-term earnings potential of the businesses we own, which doesn't change with a quarter or two of poor results. While the market drawdown can also be attributed to the massive economic shock we've experienced as a country, it seems as though the threat of, and impacts from COVID-19, as well as low levels of liquidity coupled with deleveraging was a large factor behind much of the chaotic price action over the past few months. Moving forward, I'm optimistic about the performance of client portfolios given the cheap valuations of our businesses, high value propositions they offer, clean balance sheets, and minimal exposure we have to the energy sector and the US consumer. I have no insight into what might take place in the short term, but valuation spreads have reached levels indicating favorable returns moving forward, and our preferred fishing pond of small and microcap stocks have been hit the hardest, providing potential opportunities for the patient investor.

Lastly, please remember that we are in this together. Aligning my interests with clients is at the forefront of my investment philosophy, and as one of the largest investors in the firm, with nearly all of my liquid net worth invested in our strategy, you can believe that anytime you're hurting, I'm hurting just as much. As stated in my Founder's Letter, you can be confident that we will always be invested alongside each other. My money isn't going anywhere, *especially* during a down year or quarter. In fact, I've added to nearly all of the positions we own during the most recent market drop, and have encouraged friends, family members and clients to add capital whenever they can.

Investing with Owner-Operators and Acquisition Based Strategies

One mention of the phrase 'rollup' or 'acquisition strategy' in investing circles and you'll most likely be met with eye rolls or gag reflexes. The reasons for this are many, as there are plenty of examples of rollup strategies or acquisitive management teams whose actions resulted in the destruction of shareholder value leading to permanent losses of capital. In my experience I've found that there are two types of addictive substances for management teams: cheap capital and their own stock, both of which can be used irresponsibly to the detriment of long-term shareholders. On the other side of the coin however, there are plenty of examples of value-add rollup strategies where incentivized managers in fragmented industries and in conservative ways can utilize capital to deliver outstanding shareholder returns over long periods of time. Examples of these businesses/strategies include Watsco, Danaher, Middleby, and Constellation Software, among others.

Smart managers who own large chunks of their own businesses, who understand acquisition economics well, and who have the speed, flexibility and capital to roll up fragmented industries can usually deliver above average results despite the industry or product/service type. Part of my idea generation process is to find and partner with these managers where we see a long runway for growth in both revenues and free cash flow, and where we can reasonably believe that our capital is being treated with nearly the same care as the manager's own money.

We currently hold four of these types of businesses in client portfolios, including CRH Medical Corp., RCI Hospitality Inc., Terravest Industries and Crawford United. While each of the four businesses operate in different industries, they share many commonalities that also help outline what I look for when attempting to find and invest in acquisition-based strategies. These characteristics include a large, fragmented industry made up of mostly small businesses and mom and pops with aging/retiring/distressed owners, high 'insider ownership' where management's ownership of company stock greatly exceeds their annual salary, the ability to purchase businesses at cheap multiples of EBIT or EBITDA given lack of deal flow, limited interest from private equity or lack of capital in the space, the conservative but not over-use of leverage in order to boost returns on equity (or capital used to purchase), and businesses that are extremely cash generative both at the acquisition and company-wide level (as measured by price or EV to free cash flow, or free cash flow yield. Should we come across opportunities that meet the above criteria such as the businesses we currently hold, the potential to compound client's capital at high rates of return for long periods of time becomes very likely as these businesses continue to execute. In addition, we are provided a margin of safety investing alongside owner/operators as their balance sheets are often conservatively financed, they show the willingness to repurchase shares when return profiles would be greater by doing that than acquiring new businesses, and they stand to gain or lose as much as shareholders through the creation or destruction of value over time. While I don't normally set out to buy companies that are overly acquisitive (I enjoy just as much owner/operators that can bring us organic growth), these situations/business models can at times offer outstanding return potential, and I am happy to own the ones we own, especially at current prices.

Portfolio Commentary/Updates

The past six months provided plenty of 'gut check' moments consisting of re-underwriting most of our company valuation expectations and measuring carefully future risk/reward profiles. Two of our top five positions declined by 40% during Q2, and at one point reached prices that *implied* potential insolvency or even bankruptcy risk. There are however two pieces of good news. The first is, in my opinion, the decline in share prices can be attributed directly to the general market-wide selloff that took place, as both businesses continue to execute well, generate cash, and have seen insiders recently purchase shares. While earnings and cash flow estimates have been revised as the economy moves through and adjusts to the impacts from COVID-19, I'm confident both businesses will see a return to normalcy by the end of the year, leaving them poised for a strong 2021 and beyond. Of note, we have not sold a single share of any position, and in fact have continued to accumulate more of some holdings at what I deem to be ridiculously cheap prices. That's the second piece of good news. Client accounts held an average of >15% cash through May, providing us with flexibility to take advantage of stock price volatility.

The above declines were offset by two new larger positions (one of which at one point doubled) both of which have settled around 25% and 60% above our initial purchase prices. I will briefly touch on the two holdings that experienced the largest price declines, and then highlight some of our newer positions.

In addition, I have written about each of the companies we own on my blog www.poundtherockinvesting.wordpress.com and encourage investors to review material there.

CRH Medical Corp. (CRHM) -50%

CRH Medical Corp. is a stock clients have owned since late 2017, and have occasionally traded in and out of the name as it's been one of the more volatile stocks in client portfolios. This is not my preferred method of trading as I consider myself a buy and hold investor that enjoys taking advantage of the magic of earnings/free cash flow growth and multiple expansion, yet the reality is that this stock at different prices represents different levels of risk, reward and forward return profiles. Despite having a steady and reliable stream of cash flows in the form of anesthesia services for GIs providing colonoscopies (even in an economic downturn or recessionary scenario, it is still wise for seniors to get regular checkups), CRHM is subject to government healthcare reimbursement risk, or the risk that their billing rates for the services they provide will decrease meaningfully with the stroke of a pen. Although the last time reimbursement rates were cut was in late 2017/early 2018 (providing more opportunity to buy), with no further cuts or re-examinations of rates coming for the next few years, the stock price has continued to fluctuate widely, going from a high of $8.25 in early 2017, to a low of $1.85 in late 2017, back up to $3-4/share in 2018 and 2019, and now back to a sub-$2.00 share price. All of this takes place during a time when CRHM has acquired multiple businesses, grown revenues and free cash flow in the high single / low double digits, and hired a new CEO to accelerate growth. In a stroke of good luck and good timing, I significantly reduced our position in CRHM in early 2020 following a doubling of the share price from our initial cost, leaving us with a decently sized cash position and coinciding with the most recent share price drop to below $1.00 due to a weak quarter and fears surrounding COVID-19. While we didn't exactly purchase at five-year lows of $0.85, clients now own CRHM once again at an incredibly cheap price that at one point over the past few weeks was implying that the company's equity would be wiped out. CRHM is now a $120mm market cap business that is set to generate $25-$40mm in free cash flow per year over the next several years growing at a high single digit rate. With a new management team in place focused on growing a complementary segment of the business, increasing the pace and volume of acquisitions, and continuing to grow free cash flow per share, CRHM has the potential to double or triple from our current cost basis. While short term results will without a doubt be impacted by the length of the coronavirus quarantine, over the long-term we should see a return to normal activity levels followed by both free cash flow increasing as well as multiple expansion. For those worried about debt levels used to make acquisitions and operate the business, CRHM has plenty of liquidity with a new $100mm facility issued by JP Morgan, and a conservative debt/EBITDA ratio of 1.34x, with interest coverage at 3.5x.

Hill International (HIL) -38%

Outside of the pandemic related issues, no business turnaround is without its fair share of setbacks. With HIL, I feel confident they are doing what's necessary to drive the business forward, generate cash and communicate the story, even if it looks as though we are taking two steps forward and one step back. COVID-19 has presented a step-back. This is unfortunate as things had been progressing nicely over the past few quarters.

Despite feeling an initial impact from the onset of COVID-19 and the related economic shutdown, HIL was very busy in the quarter, winning new business, negotiating contracts with current customers, furloughing employees, cutting costs, applying for PPP money, and negotiating lease deferrals. All-in cost savings through 2020 are expected to be $10mm in SG&A, bringing the run rate to $110mm (as opposed to previously guided $120mm). Numbers may come in lower depending on how long COVID-19 lockdowns continue, but I'm pleased with the swift and decisive actions taken by a management team facing near-term uncertainty. The biggest COVID related impacts came from projects scheduled to be awarded being deferred instead, and the collection of accounts receivables (since returned to normal in April). New bookings, which drive 20-30% of consulting fee revenue were down QoQ, with backlog taking a 7% dive from the prior quarter. $20-30mm of that backlog was made up of project cancellations, but the company hasn't seen any pricing pressure or unfavorable negotiated terms due to the pandemic. This is a positive.

Diving into some recent operating results, Q1 2020 marked the fifth straight quarter of positive adjusted EBITDA (Adjusted EBITDA was $3.2mm for the quarter on the back of -$1.2mm EBITDA before unrealized FX gains), an increase of 36% YoY. Another positive, but still a far cry from my projected $30mm+ run rate EBITDA at 10% CF EBITDA margins.

So where does that leave us as shareholders? Clearly, the market is not believing in the turnaround. The share price reflects a business in decline, assuming A/R and cash collection will be difficult, and new business will continue to decrease. I'd argue that once we return to some normalized business environment, investors should see the share price rebound in line with improved operating results. As a sanity check, HIL continues to win new business despite project deferments and the current difficult environment (this includes $30m in new bookings during one week of Q2 alone).

As a further sanity check, here's a brief highlight of the negative issues most likely being projected out to 2021 and responsible for the large share price decline, followed by mitigants:

Business is in decline, new bookings will continue to suffer - HIL generated $30m in new bookings last week alone, which probably wouldn't happen for a business in decline, also set to benefit from any infrastructure bill announcement or spending in that category

Can't collect receivables - collection activity returned to normal as soon as April (once governments realized the world wasn't ending)

Can't sustain a prolonged downturn - HIL has $23mm in liquidity with cash + term loan availability, has cut costs by $10mm, will most likely receive some stimulus money, and still has their Libya receivable to collect. In addition, global infrastructure makes up the largest portion of their business, which will hopefully see a boost from new bill announcements, or see airports/aviation sector take advantage of this reduced period of demand by undergoing maintenance capex projects and facility upgrades (happened following both 9/11 and 2008).

Price of oil will continue to impact operating results – While energy is in a strange place, and the Middle East segment makes up 30% of their business, HIL has seen minimal disruptions in that segment (95% of billable workforce is working) given most projects are tied to infrastructure and facility management.

Management/insiders are dumping shares – we've seen no evidence of large holders dumping stock, and in fact during Q2 the largest shareholder purchased another 50,000 shares at the current price level

Thinking through the above, I don't believe the current valuation is warranted. If HIL sold their entire business for 0.5x revenues, that would value the entire company above $2.50/share. That's 0.5x revenues. The amount of M&A in the space is rampant, and even sub-scale deals are taking place at higher prices.

As we've spoken about before, this situation was going to require some patience. We've built/added to our position in the $1.60 - $3.00 range and may be purchasing more shares should the price fall further. A return to a more normalized business environment, growth in backlog/bookings and continued cash collection should bode well for the share price. We have the insider buying and cheap valuation, what's left is the market's recognition of value.

New Positions

RCI Hospitality Inc. (RICK)

During the first quarter, we entered into a mid-sized position in RCI Hospitality, or as many investors are familiar, Rick's Cabaret. RICK is a publicly traded strip club business that operates a number of adult entertainment venues across the country, as well as a fast-growing military themed restaurant concept called Bombshells with a focus on the Texas military/army market.

RICK is unlike many of the investments we've owned in the past. I'm not a huge fan of the entertainment/restaurant space given the competitive nature of the industry subject to consumer preference, low barriers to entry, and high fixed cost structures making it difficult for most restaurants to weather periods of decreased demand, however, RICK does combine some elements that I find very attractive when looking for new investments. As somewhat a combination of special situation (a few non-permanent, fixable events have led to a sharp stock price decline) and good business, RICK should be able to continue to grow it's earning power and free cash flow per share at a solid rate over time. RICK is a business that I've followed for a few years now, and the current price seems to represent a very favorable risk/reward provided the business can remain structurally intact throughout COVID-19 shut down, and the management team continues to run the same playbook they've been running for the past few years. Clients were emailed a more detailed writeup outlining the opportunity and my thought process behind making the investment. The writeup as an appendix to this letter will also be available on our website.

****Update:** the largest risk to the investment is the possibility that some nightclub doors close permanently (and open clubs are forced to implement new social distancing rules due to COVID-19, making the environment less attractive) due to COVID-19 as well as online alternatives. It is possible. In the short term, management has somewhat diversified their revenues and cash flow profile through Bombshells, owns real estate with a book value that exceeds the entire market cap of the company, and could potentially benefit / grow market share during the current environment by acquiring night clubs in favorable locations for cheap prices from distressed owners. Should/when things normalize, I'd expect the company to initiate a large share buyback program in line with their capital allocation philosophy. We are monitoring the situation closely and will take any necessary actions upon the receipt of new information.

APi Group Inc. (APG)

During the quarter we entered into a top five position with the APi Group, drawn in by the management team, business quality and valuation. As a [mostly] microcap investor, APi is one of the larger businesses clients have owned ($2B market cap) but the opportunity is compelling as APi represents a high quality business trading for a cheap valuation with a management team capable of generating shareholder value for many years.

The APi Group is a holding company. They are a market leading provider of commercial safety services, specialty services and industrial services with a US focus and small operations in the UK and Canada (less than 5% of revenues). APi was founded in 1926 by Reuben Anderson, the father of former Chairman/CEO Lee Anderson. APi started out as a a small insulation contracting and distribution company and has now grown to be one of the largest specialty contractors in the US. This near 100 year old business is now a holding company to more than 40 independently managed life safety, energy, specialty construction and infrastructure companies with more than 200 locations worldwide. In addition, the track record of organic growth and accretive M&A has been phenomenal.

Today, APi operates three segments, Safety Services, Specialty Services, and Industrial Services responsible for 44%, 31% and 25% of revenues. The company performs service and maintenance related work for large facilities, with Lodging, Office and Commercial buildings being their primary end markets. Safety Services (and within that, Life Safety) is the company's golden goose segment, driving 58% of EBITDA with acyclical characteristics and an entrenched market position. The majority of safety services businesses consist of fire protection services such as sprinkler installation, emergency suppression systems, alarms and backflow devices, among others.

To briefly highlight the safety services segment consisting of what the company calls the 'life safety' market, this is an industry expected to grow a shade under 10% per year through 2025. Market growth drivers include statutory driven safety regulations, fire damage risk prevention, commercial building complexity, and large building damage costs and civilian injuries. APi has a differentiated business model (discussed a little more below) consisting of targeting service related work first (where each dollar of service work sold leads to leads to 3-4x more service dollars and ultimately relationship based new construction opportunities) that is not dependent on new facility construction activity given their focus on non-discretionary maintenance spend. As a result, a large portion of Safety Services revenue mix is recurring at 40% up from just 21% in 2008. Management has called this recurring revenue high margin business. This helps insulate APi from downturns and gives visibility into revenue/earnings. Furthermore, company filings mention Fire & Security end markets as acyclical. Management said on a recent call that Life Safety is a strong backbone to the business and enjoys a strong margin profile. Their EBITDA margin target for this segment is 12%. For acquisitions and increasing margins, APi will continue to focus on executing more life safety deals moving forward.

In addition to the above, consider the below points as parts of the investment thesis for APG:

UK SPAC with Martin Franklin as the sponsor

In 2019, APi was sold for $2.9 billion (<8x EBITDA) to J2 Acquisition Corp., a SPAC sponsored by Martin Franklin of Jarden fame. I believe that Franklin has the opportunity to create similar returns with APi as he did at Jarden utilizing the same model of organic growth and margin expansion combined with accretive M&A. Management has called APi the 'industrial version of Jarden' and feels as though the opportunity set could be even larger. From 2001-2016, investors in Jarden stocked received an overall return of 5,353% or 32% IRR over 15 years, culminating in the sale of the business to Newell Brands.

Superior business to comps with an entrenched market position and recurring revenue profile

As mentioned above, APi has grown to become one of the largest specialty contractors in the US which includes being the #1 provider of fire safety systems in the US with strong market positions in each of their business segments due to their differentiated business model. Unlike non-pure play comps and other mom and pop specialty contractors, APi Group has a wide range of blue chip customers and serves a diverse set of end markets limiting their contract risk (no contract accounts for >5% of revenues). They also have an outstanding reputation given their near 100 year history and track record, leading them to low contract loss rates (less than 1.5% of revenues) and plenty of repeat business. In addition, APi targets service revenue first which leads to relationship based new facility contracts, while other specialty contractors go through the RFP process in order to win new business, all of which is tied to new facility activity. APGs operating model has allowed them to grow revenues from $1.2B to over $4.0B during the past 10 years.

High free cash flow conversion as an asset light services business

Capex has typically been in the 2.0-2.5% of revenue range, although this might be a bit high moving forward. This results in high free cash flow conversion, lining up with management's goal of 80% moving forward. Given that APG generates a ton of cash in all market environments, the business has never needed to rely on the debt or equity markets to fund growth. Currently levered at >3x EBITDA due to the acquisition, I'd imagine we see some debt reduction over the next few years as well.

Portions of the business are acyclical having generated cash flow through economic downturns and recessionary scenarios

While APi revenues declined 15% and 9% in 2008 and 2009, the business remained cash flow positive and even grew revenues slightly during the 2015-2016 'industrial recession'. During these market conditions, APi can rely on working capital to generate cash, and revenue growth isn't tied to non-residential newbuilds as there is a large portion of recurring service revenue in the business model. Management has pointed to numerous tailwinds that should support all business lines, including much needed infrastructure investment, supporting new non-residential construction activity, providing retrofit and upgrade services to existing buildings, delivering the services required for new technologies such as 5G, and supporting the growth of life safety service contracts for existing customers. In addition, as outlined above, Life Safety recurring service revenues were only 21% in 2008 and have now grown to 40% of that segment, enabling APi to withstand recessionary environments.

High free cash flow yield

At a current price of $12.30 and $174mm shares outstanding, APG has a market cap of $2.1B. Per the most recent investor presentation, APG did $371mm in Adjusted EBITDA during TTM 2019. At a 70% free cash flow conversion, this would put UFCF at around $260mm, giving investors a current free cash flow yield of 13%. This number drops to 8% on an EV basis. This number is set to grow at a high single digit rate moving forward, and management is targeting 80% cash conversion rate moving forward.

Large discount to comps on a conservative basis

In addition to the above, APG trades at a discount to every reasonable industrial and security peer/comp that I could find on an EV/EBITDA basis, P/E basis and FCF yield basis, despite their strong market position, and above average revenue growth and EBITDA margins. While its difficult to pinpoint an exact comp given APi's revenue mix, the closest comp in my opinion, Emcor Group (EME), trades at 9.6x '19e EBITDA, 15.2x '19e EPS, and a 3.8% FCF yield. Other comps trade at around 9.5x EBITDA and 15-16x earnings with lower free cash flow yields. APi's cash generative nature, potential to increase margins and runway for accretive acquisitions should help to bridge this gap moving forward.

Short term catalyst with beefed up IR efforts and continued sell-side coverage

Recent positive developments have included the management team embarking on investor engagement initiatives, including conference participation, conference calls and webcasts. As a hardly followed 'prove it' type of story right now, these are positive developments. In addition, APG has picked up sell-side coverage with UBS and Citi, both who have price targets on the shares above $12.00.

Free options for continued M&A, buybacks

Back of the napkin valuations on continued organic growth, cash flow generation and some M&A through 2022-2023 result in a share price significantly higher than today, using a below market multiple of EBITDA or FCF. What isn't priced in is the runway for continued accretive M&A where Jarden-like returns could be achieved over the next decade. In addition, given that cash generative nature of the business, management will have the option to buyback significant amounts of shares should they choose to do so.

I'm still digging in, but even following a 30%+ share price increase, APG is still undervalued. Investors have the opportunity to purchase shares in a regional business with a market leading position in fire safety, a strong percentage of their business with acyclical characteristics (and cash generation) high single digit organic growth, with a continued runway for roll-ups, and a proven management team known for creating value in similar business models. In addition, APi has no major customer concentration, diverse end markets, a US-concentration (no geopolitical event exposure), low project loss ratios, and recurring revenue characteristics.

There of course are numerous risks to the investment including lack of clear comps, potential conglomerate discount, future dilution and recession/COVID related concerns, which I will outline in more detail in the coming weeks, but there appears to be a decent margin of safety given the cash generation, discount to comps and management alignment. I will be discussing APi more in depth on both the blog and in future letters.

Terravest Industries Inc. (TRRVF)

Clients will notice an accumulation of shares in Terravest Industries between prices of $8.50 - $11.50 during the first few months of 2020, now representing a top five position. I first came across Terravest while reading the annual report of another company (Clarke Inc., CKI.TO) that owns a large chunk of Terravest shares and has a very strong and insular relationship with the company, having placed a few Clarke managers (also shareholders) with Terravest who now oversee key aspects of their business. The importance of turning over a lot of rocks during the investment research process cannot be overstated, as a bookmarked page in a 10K, a note about taking a closer look at something, or reading a presentation can sometimes lead to good investment ideas, if taken seriously. Our ownership in Terravest seemingly came out of nowhere, and after getting to know the business and the management team, represents one of the investments I'm most excited about over the next 3-5 years and longer.

As a manufacturer of transportation equipment for the oil and gas industries, Terravest is a relatively simple business and story that seems to be managed by some very smart, capable and shareholder friendly managers. In addition, Terravest is illiquid, (as a sub-$300mm market cap business with over 30% of the float owned by insiders), has no analyst coverage, and the management team has historically been unwilling to give earnings guidance or host conference calls. As a result, Terravest is right up my alley in terms of investment criteria I look for; a boring, underfollowed microcap operating a niche business with a phenomenal management team, trading at a cheap valuation. The above factors can occasionally invite mispricings, and despite shares being up over 200% since 2014, TRRVF still appears to be undervalued relative to its long-term potential and strong capital allocators at the helm.

Terravest has met many aspects of the strict investment criteria I have for new additions to the portfolio, including a management team that thinks outside the box and is incredibly aligned with shareholders (as strongly as I've seen in the microcap space). I place an incredible amount of weight on management alignment, and their way of thinking, commentary, and actions back up everything I've uncovered through the due diligence process. I'm happy to be invested alongside a group that is more focused on the long-term opportunity as opposed to quarter to quarter results.

For all investments, the best-case scenario for Greystone Capital would be to develop long term relationships with, and be invested alongside not only talented managers, but ones who treat our capital like their own. Terravest does. Clients were emailed a more detailed writeup outlining the opportunity and my thought process behind making the investment. The writeup as an appendix to this letter will also be available on our website.

MiX Telematics (MIXT)

In early April, clients may have noticed shares of MiX Telematics (MIXT) in their accounts during one week only to see them sold shortly after. During the quarter, we entered and quickly exited a position in MIXT, for the simple reasons of not wanting to own shares in a business quite levered to the oil and gas industry given the current industry dynamics. In a fragmented industry with few large scale players, MIXT is a solid company with a strong product offering, a long track record of success, and an founder/CEO who is very much aligned with shareholders, having navigated the business through multiple cycles successfully. MIXT is currently available at what I feel is a cheap price, and their high-quality customer base, recurring revenue profile and long runway for growth most likely means the business will continue to perform well into the future. With that said, MIXT has a large exposure to the oil and gas industries through their customer base, especially in the US, where these customers represent the bulk of MiX's highest margin revenue segment, or 'large fleet' customers. I believe we are at a cyclical trough for many of these subscribers (representing a large chunk of revenues), and with so much uncertainty and carnage in the energy industry right now, I believe we will most likely see major fleet contractions moving forward, and a return to cyclical revenue/operating income lows similar to 2015-16. I realized very quickly after purchasing our shares that I had no special insight into whether the current situation surrounding oil prices is not as bad, different, or worse than 2015-16, and thought it would be best to watch things play out from the sidelines. Timing was on our side, as we did not experience any permanent losses of capital and broke even on the short-term trade.

I'm not able to remember a time when I've entered and exited a position so quickly following the completion of my research/due diligence process, but in the case of MIXT I believe it made sense to do so from a risk management standpoint. I will be monitoring the situation closely over the next 12-18 months and would be happy to re-visit an ownership position at lower prices or when I feel as though there is more clarity surrounding a large portion of MiX's customer base. Clients were emailed a more detailed writeup outlining the opportunity and my thought process behind initially making the investment. The writeup as an appendix to this letter will also be available on our website.

Broad Market Commentary

I am confused. I originally wrote this section of the letter in early April, as we remained in the midst of the COVID-19 battle, with climbing case and death counts, continued social distancing rules and the majority of states and countries issuing self-imposed shut downs of most businesses. In an unprecedented move to combat the spread of the virus, the economy essentially shut down for a period of time.

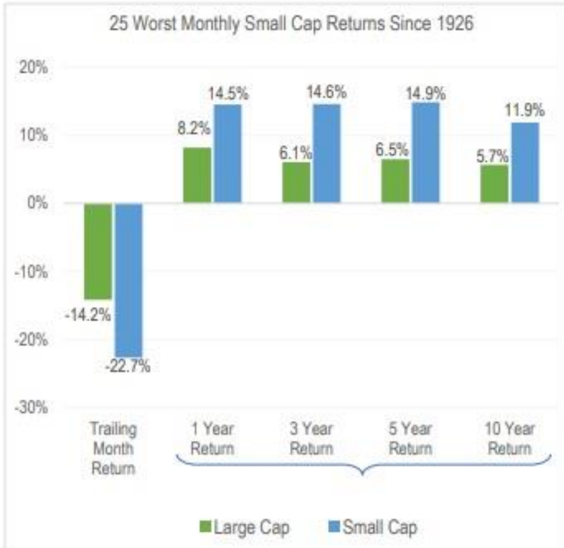
As a result, during Q1, it appeared as though we entered into a severe recession, with 20+ million Americans filing for unemployment claims (multiples of the amount filed during the financial crisis), Congress rolling out a $2 trillion economic stimulus package to the aid of individuals and small businesses, and the majority of Americans (most of who live paycheck to paycheck) scrambling to come up with the liquidity to do the most basic of things such as buy food and groceries, pay rent/mortgages, and service debt.

Yet, the S&P 500 rallied off the early March lows and was at one point up some 17% (!) in April/May aided by two or three particularly large daily gains. Currently, the stock market can be purchased for 17x earnings (a fairly low price) despite the S&P 500 at levels of record earnings and margins, with record low interest rates, and low inflation/tax rates. In other words, it feels like stocks are set to rise despite all the economic evidence pointing in the opposite direction. Stock prices are doing one thing, while the real world is doing another. It seems the current demand-side shock has yet to be priced in or was priced in temporarily and is now forecasting better days ahead. Again, I am confused.

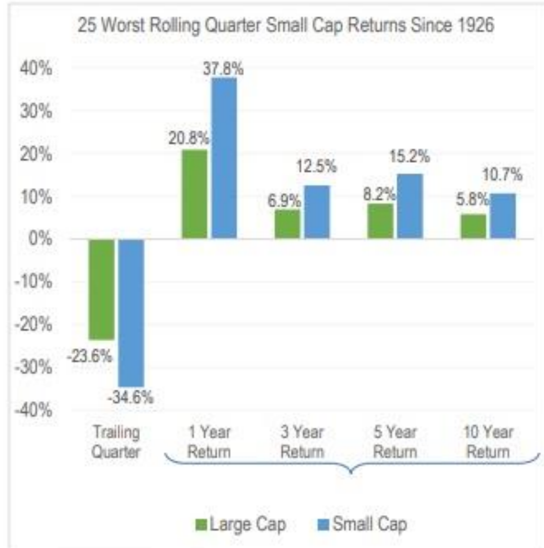
While good news in the form of a rising market is hopeful during times like these, it’s hard to feel optimistic when the areas of the economy that aid stock prices the most – employee count, productivity growth, wage growth, consumer spending, and confidence – effectively hit a brick wall, and appear to have uncertain near-term futures.

While there are those who compare COVID-19 and the resulting economic consequences to the Great Depression, the Spanish Flu epidemic, or the 1957 Flu outbreak, one thing is certain, there is no precedent here. Nobody knows what is going to happen over the next few months let alone years (including your portfolio manager), but it would be hard to imagine that the last few, or next few months won’t have a lasting and likely devastating impact on the economy and millions of Americans.

With that said, some pockets of the market appear to be offering substantial opportunity, especially in the areas of small and microcap stocks, where quality businesses with good balance sheets that generate cash have been unnecessarily beaten down over the course of the broad market selloff. There is ample data showing that small cap stocks are one of the better returning asset classes following market drawdowns. As we are experiencing now across client portfolios, small stocks tend to perform the worst as markets fall, but then significantly outperform during recovery periods. Historical forward return data, especially for small cap value shows significant outperformance compared to large cap stocks.

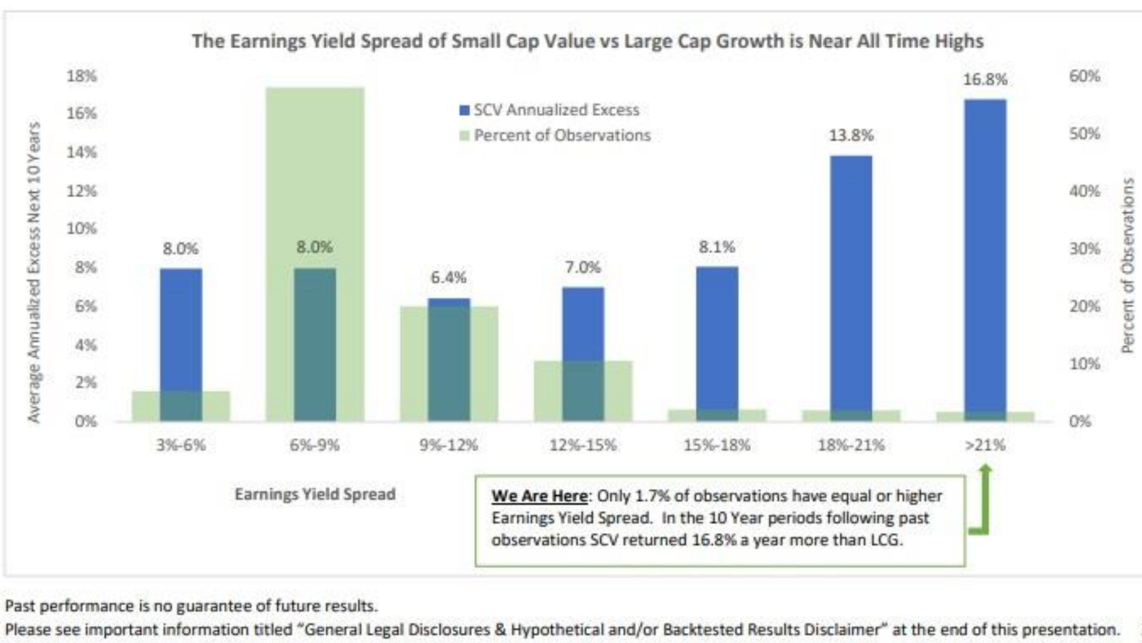


Source: Ibbotson Associates



Source: Ibbotson Associates

In addition, the spread between small cap value stocks and large cap growth stocks is near all-time highs as measured by earnings yield (or cheapest decile by P/E) of the cheapest small cap stocks to the most expensive decile of large cap stocks in the US. Historically, small cap stocks have done very well following extreme periods like this.



While I have no idea where the market will trade in the short term, we can reasonably expect to do well with our current holdings moving forward. I felt that way before the recent market drop and feel even stronger about that today. Client portfolios hold concentrated positions in quality small companies with strong balance sheets, aligned managers, growing cash flows and high customer value propositions. Furthermore, they remain incredibly cheap, with the average portfolio EV/EBITDA and FCF Yield of 9.3x and 15%, suggesting that as our businesses continue to execute and grow, over time, the market will come to value them appropriately.

Thank you for the opportunity to manage your hard-earned savings. Please feel free to reach out anytime and thank you for reading.

Adam Wilk
Greystone Capital Management, LLC
www.greystonevalue.com
Email. adam@greystonevalue.com
Direct. 302.593.4483