

Alluvial

CAPITAL MANAGEMENT, LLC

Dear Partners,

What a change a quarter can make! Investors seem to have forgotten all about the fears that roiled markets as 2018 drew to a close. These first months of 2019 have seen indexes reclaim nearly all of the ground they lost in the fourth quarter of 2018. It's astonishing that in the space of only three months, investors could value the small-cap Russell 2000 index at both 1,267 and 1,590. Surely the underlying values of the stocks that make up the index did not change by 25% in the course of a single season? The only conclusion I can draw is that at least one of these values is simply wrong, wholly unjustified by the future cash flows these companies will produce. Either the December 24, 2018 closing value of 1,267 was too cheap, or the recent February 22, 2019 high of 1,590 is too expensive. Of course, it's also possible that both values are way off the mark. Perhaps the justifiable level for the Russell 2000 Index based on future cash flows is only 900, or perhaps it's twice that. Unfortunately, we can only make our best guesses based on predicting company results and assuming macroeconomic trends. The future remains stubbornly unknowable.

TABLE I: Alluvial Fund LP Returns (%) as of March 31, 2019

	2019	2018	2017	Cumulative	Annualized
Alluvial Fund LP NET	7.8	-9.0	29.6	27.1	11.3
S&P 500 TR	13.7	-4.4	21.8	32.4	13.3
Russell 2000 TR	14.8	-11.2	14.7	16.9	7.2

Partnership began operations 01/01/2017

I do my best to pay little attention to the movements of market indexes. Like I've said time and time before, the mercurial moods of investors in liquid, high profile stocks and securities frequently fail to translate in full to changes in the prices of our holdings. If stocks and securities are ships on a stormy sea, our holdings tend to behave more like the rocks on the ocean floor. On average, they are also about as flashy and exciting as those rocks. Just as our holdings held up relatively well as markets plunged last quarter, our results this quarter appear relatively muted in comparison to market indexes. Still, I am happy to see the value of our portfolio increase in response to good news from several holdings and restored confidence in others. Earnings reports were extremely positive, and the share prices of most holdings have reacted accordingly. Several of our holdings are in the midst of important developments that will narrow the gap between their trading prices

and their underlying values. I am very excited to see what our portfolio companies can achieve in the coming quarters and years.

Our Rural Telco Complex

Alluvial Fund remains heavily invested in a small collection of rural communications providers. This industry and its companies satisfy several of our desired investment characteristics.

- **Small Size.** The collective enterprise value of the half dozen or so public small rural telcos is around \$1 billion. By contrast, the enterprise value of Shenandoah Telecommunications, a “mid-sized” rural telco, is \$2.9 billion. It’s simply impossible for investors to put large amounts of capital to work in these companies.
- **Illiquid Shares.** On a strong day, any of these companies will have \$50,000 worth of trading volume. Other days? Zero.
- **Unpopular Industry.** I am hard-pressed to imagine an industry less exciting than traditional telecom.
- **Misunderstood.** The common perception of traditional telcos is one of melting ice cubes in terminal decline. In fact, federal and state governments are underwriting a transition to a new revenue model of providing broadband services via fiber networks.

Despite appreciation in the shares of all of the various small rural telco providers over the last few years, the market still has not fully appreciated their value. What’s more, the fundamental picture for these companies continues to improve. Last month, the FCC announced another [funding increase for rural carriers via the Connect America Fund](#). Better still, the entire program is being extended for two additional years. Our portfolio companies are major beneficiaries of the increase. The biggest winner is LICT Corporation, which will see its annual support increase by *\$4.6 million*. Anyone wishing to dig into the details of the program expansion can take a closer look courtesy of this [FCC report spreadsheet](#).

Nuvera Communications remains Alluvial Fund’s largest holding. The combined effects of increased FCC funding and the 2018 acquisition of Scott-Rice Telephone will result in record earnings and cash flow in the coming years. 2019 will be a watershed year for the company. We will see a full year’s contribution from Scott-Rice, including administrative cost savings. The fourth quarter was burdened with some expenses related to transitioning Scott-Rice employees and services from Zayo. These costs will abate as the year continues. Nuvera will receive an additional \$812,000 annually from the FCC action. Interest expense will also decline. Once Nuvera’s leverage ratio declines to 2.0x trailing EBITDA, the company’s CoBank loan facility will reprice to LIBOR plus 2.25%. Because CoBank provides an annual refund of 1% of a borrower’s average loan balance in the form of patronage, Nuvera will effectively borrow at less than 4%.

I was a little too optimistic in my initial expectations for 2019 free cash flow. The company announced a capital budget of \$13.6 million for the year, the largest planned investment spend in its history. In conversations with Nuvera’s CEO, I learned the company plans to invest heavily in downtown New Ulm in order to attract additional business customers. The company also plans to build out its fiber network in Scott-Rice’s service area, which was neglected by the company’s

previous owner. Despite the higher short-term capex needs, I remain extremely confident in Nuvera's free cash flow profile. Fiber is an attractive asset in that once installed, it lasts for decades and decades with minimal maintenance. I now estimate normalized earnings per share of \$2.20 and normalized free cash flow per share of \$3.00. At a trading price of \$19, Nuvera's prospective P/E ratio of 8.5 and free cash flow yield of nearly 16% represent excellent value, even if that free cash flow yield takes a little longer than originally projected to materialize.

Our second-largest telco holding, **LICT Corporation**, continues to report excellent operating results. LICT has an advantage over other rural telcos: geography. In years past, LICT had the luck or the foresight to buy telcos in areas with growing populations and healthy local economies. While the annual effect is small, it adds up over time. Consider two different areas with the same population, one having a population growing at 1% annually, the other having a population doing the opposite and shrinking 1%. In a decade's time, the population of the first area will be 22% higher than that of the second area. That's quite a difference in potential customers, not to mention the number of businesses that likely exist to serve these populations. LICT owns multiple subsidiaries with service areas just outside growing cities. The revenue trends for telcos in suburban/exurban communities is far superior to those of, say, Michigan's Upper Peninsula or Central Kansas. (LICT has subsidiaries in both of these regions, too. Suffice to say these are not the company's growth engines.)

LICT invested aggressively in fiber over the last decade, and the investment has paid off. The company also paid down nearly all of its debt, which actually creates a bit of a conundrum. A telco should carry a reasonable amount of debt. The company could lever up and tender for shares, or pay a large special dividend, but there are obstacles to each. Insiders and other large shareholders own probably 70% of the shares outstanding, so there are simply few shares available for the company to buy. A special dividend would create a taxable event for the company's largest shareholder, Mario Gabelli. As one of the first analysts and investors to understand the business model of cable companies, Mr. Gabelli understands the value of tax deferral. Acquiring other telcos seems the most achievable and lowest-risk approach to growing the value of LICT Corporation, and I hope that is the approach the company will take.

I have reduced our holdings of **Otelco** in favor of other opportunities in the telecom sector and elsewhere. The company remains undervalued, but it is also objectively highly leveraged and faces more challenging revenue trends than Nuvera or LICT.

TABLE II: Top Ten Holdings (%)

Nuvera Communications	11.5
Syncora Holdings	9.2
MMA Capital Management	9.0
LICT Corporation	5.6
Meritage Hospitality	5.2
Calloway's Nursery	4.4
Retail Holdings	4.4
Polaris Infrastructure	4.3
Bredband2 I Skandinavien	4.3
Undisclosed Italian Company	3.5
Total, Top Ten	61.4%

Rounding out our telecom collection is **Alaska Power & Telephone**, added just this quarter. APT is a bit of an odd duck, a strange hybrid of regulated electric utility and telecom company. The company provides renewable and fossil fuel-generated electricity to many Alaskan communities, including some extremely remote outposts. Much like peers, APT has invested heavily in its fiber network and is a major Connect America Fund beneficiary. The company carries modest debt and faces little competition. Shares trade at a very unassuming valuation because of their illiquidity and the fact that the company does not fit neatly in a particular category.

Syncora and Retail Holdings Near the End of the Line

Two of our special situations are closer than ever to resolution. **Syncora**, our second-largest holding, announced it would seek a sale of its operating subsidiary or the company as a whole. I expect any transaction to garner at least \$6 per share based on the company's book value and the appetite of likely bidders. I expect a sale to occur before the end of the year. Syncora was a classic opportunity where a complicated balance sheet obscured underlying value. That value was ultimately revealed as the company disposed of non-core assets, reduced its liabilities, and simplified its corporate structure.

My personal history with **Retail Holdings** stretches back seven years, and shares have been present in Alluvial portfolios since we were established in 2014. It's honestly a little sad to think of "ReHo" winding up and leaving our portfolio! In March, the company announced an agreement to sell its largest (and thorniest) remaining asset, Singer Bangladesh. The deal closed in early April.

The Bangladeshi subsidiary's value had always been difficult to assess due to legal restrictions on the company's ability to withdraw a portion of its capital from Bangladesh. In the end, the price Retail Holdings received for Singer Bangladesh was disappointing at only \$75 million, of which \$42 million is attributable to the parent company. While the lowball sale of Singer Bangladesh reduced the upside potential of Retail Holdings shares, it also curtailed risk. The company is no longer exposed to the volatile Bangladesh economy and stock market and now holds net cash per share of \$10.75 or so, higher than the recent trading price. The company still owns a controlling stake in Singer India Limited worth \$2.60 per share. Net asset value per share is nearly \$13. Even when we assume some liquidation-related expenses, shares are trading at a meaningful discount to liquidation value. The company will not distribute cash directly in 2019 but does intend to conduct aggressive share repurchases. If the company can succeed in buying a large number of shares at a discount to NAV, the value of the remaining shares will increase. For instance, if NAV is \$13 and the company can buy back 25% of the outstanding shares at \$11.50, the NAV of the remaining shares will increase to \$13.50. With ReHo shares trading in the mid-to-high \$10 range, I expect we will achieve returns in excess of 20% over the next 12-24 months with minimal risk.

TABLE III: World Allocation (%)

United States	75.4
Sweden	8.5
Australia	5.1
European Union	4.5
Canada	4.3
United Kingdom	2.1
Other	0.1
Total	100%

When a “Premium Valuation” Is Far Too Cheap

There’s an impression that we so-called “value investors” are only interested in picking through the market’s junkyard. That we eschew fast-growing companies lacking much in the way of tangible assets, believing these high flyers will eventually fall back to earth. Investing like this is trusting in the power of mean reversion to restore fallen companies to respectability. There are many investors who have built a fortune this way, but also many who have suffered permanent losses investing in junkyard finds that turned out to be....just junk.

I believe value investors owe it to themselves not to ignore companies that trade at high multiples of earnings or book value on that basis alone. While it’s true that many of these companies will be flashes in the pan, there are others creating lasting franchises that will produce immense wealth for shareholders over the years. There are companies that require practically no capital investment to fund their growth, producing returns on capital far, far above cost. There are even companies that require negative incremental capital as they grow. Companies that are able to maintain these dynamics for the long run should trade at multiples of current earnings that would offend many traditional value investors.

Allow me to present **Bredband2 i Skandinavien AB**, possibly the company with the best and most efficient business model I have ever encountered. Bredband2 is a Swedish internet service provider. Swedish ISPs typically do not own the physical infrastructure they use to deliver service to customers. Many Swedish fiber networks are owned by municipalities, with internet service providers paying for the right to offer their services on these networks. Bredband2, founded in 1989, offers internet services to residential households and businesses on these city networks. The company’s growth has been exceptional. From 2008 to 2018, Bredband2’s revenue grew at a 17% annual pace while operating income expanded from negative SEK 2 million to SEK 41 million. Great results! But what’s truly extraordinary is how the company financed this growth. Bredband2 had invested capital of SEK 55 million in 2008. By the end of 2018, invested capital had actually decreased to negative SEK 52 million. The company managed to produce incremental annual operating income of SEK 43 million while reducing invested capital by SEK 107 million and ending with negative invested capital. That’s a feat vanishingly few businesses manage to achieve. So how did Bredband2 do it? Simple. They offer a good service that more and more people want. Bredband2 offers no-frills internet service that is fast and cheap. They cater to individuals and customers who do not need or want a lot of handholding, just reliable internet at a good price. Bredband2 has been able to take market share over time by filling a niche. More and more customers mean more and more revenue, and this creates the conditions for Bredband2’s most notable characteristic: its negative working capital cycle.

Most businesses must operate with net positive working capital. They pay to produce inventory, then sell that inventory, generating receivables. Eventually, those receivables turn into cash. At some point they must pay their suppliers. The sum of current assets less current liabilities is a positive figure, which represents cash tied up in working capital. As the business grows, it must invest more and more capital in net current assets. No so for Bredband2. When the company signs up a new customer, it gets paid in advance for things like router rental and other prepaid items. Bredband2 is a service business so it carries no inventory. Attracting a new customer results in net cash inflow to the business. Bredband2 has produced prodigious cash flow simply by attracting

new customers, and there is no indication this will stop any time soon. For every 100 kronor of revenue the company earned in 2018, it earned 5.3 kronor in profit and generated 2.3 additional kronor via negative working capital generation. Cash from working capital decreases averaged 61% of reported profits over the last five years. The result is a business that continually produces more cash flow than it does profit. Bredband2 uses this cash flow to invest in marketing and service improvement and attract even more customers, as well as reward shareholders.

With all this success, why are Bredband2 shares down 30% from their peak? 2018 was something of a “plateau” year for the company. The firm increased its staffing levels and marketing spend in order to drive revenues and profits to new levels, but this resulted in earnings coming in flat over 2017. Despite the pause in earnings growth, I expect 2019 to see renewed growth. The level of net working capital has always been a leading indicator for Bredband2’s future revenue. The company’s net negative working capital reached new lows at the end of the fourth quarter, indicating growth to come. Despite Bredband2’s incredible growth, it counts only about 5% of Swedish households as customers.

While Bredband2 appears to trade at around 15x operating income, it offers a 10% free cash flow yield, net of excess cash. Choosing to count cash generated from working capital improvements as part of free cash flow may not be a traditional approach, but I believe it makes sense in cases like this where revenues are extremely likely to continue growing at a high rate for a long time. The chance to buy a business of this quality and potential is a gift, even if it appears to trade at a premium multiple.

Newcomers of Note

The fund took positions in a pair of tiny industrial companies this quarter, **IEH Corporation** and **Hickok, Inc.**

IEH is a classic value opportunity. IEH manufactures a [specialized type of electrical connector](#) for aerospace applications. The company is well-run, highly profitable, and fast-growing with substantial excess balance sheet cash. Yet its shares trade at 4.2x trailing operating income. The biggest reason for this discounted valuation is IEH’s miniscule size and float. While the company’s market capitalization is a shade under \$40 million, insiders and one fund own 61% of shares outstanding, leaving only \$15 million available for the rest of us. Not exactly an opportunity everyone can chase.

Hickok also operates in the aerospace field by way of its July 2018 acquisition of [CAD Enterprises](#), an Arizona company that manufactures precision aircraft components. The acquisition was transformative for Hickok, more than doubling the company’s profits. Shares have reacted positively to the CAD acquisition, but the market has not fully priced in its effect. Hickok trades at a multiple of less than six times my estimate of 2019 results. The company is generating a lot of cash from CAD Enterprises and its previous lines of business, allowing it to reduce its acquisition-related debt rapidly. Much like IEH, Hickok trades cheaply because of its illiquidity. Under \$10 million worth of shares are in the public float.

Value in New Listings

New listings and IPOs are not fertile ground for Alluvial Fund. Speaking generally, we prefer to own stock in companies that can fund their growth plans without requiring substantial additional equity capital. A very high percentage of US IPOs are unprofitable companies that may not achieve profitability in a reasonable time frame. What's more, fewer small companies are choosing to undertake an IPO than in years past. The reasons are many and understandable. What small company wants to spend millions dealing with reporting requirements, all for minimal benefit? Private equity and venture capital funds stand ready to provide all the financing a company could ever need, so why bother with the hassle and expense of an IPO? Sadly, the result has been fewer opportunities for small investors and funds.

Fortunately for us, this is not the case everywhere. Multiple foreign exchanges still bring a high volume of small IPOs to market each year. While there are the usual middling-quality, loss-making businesses to be avoided, I have found many examples of profitable, well-run companies. By going public, these businesses create liquidity for their founders and can access capital to fund growth efforts. Thus far, Sweden, Australia, the United Kingdom and (much to my surprise!) Italy appear to have the most vibrant and welcoming environments for small companies wishing to raise \$5-50 million in an IPO.

Alluvial Fund has invested in an Italian company that went public in mid-2018. This company is profitable, generates cash, and has a stellar track record of growth and stewardship. I must refrain from naming the company for now as shares are illiquid and we are still building our position, but I look forward to profiling this company in future letters.

Other Updates

Including commitments, Alluvial Fund's assets have reached a new high. As always, I want to thank everyone who has entrusted capital to Alluvial Fund. The entirety of my personal assets are invested in the fund and always will be. There will be highs and lows in the years to come, but I have complete confidence our strategy will continue to produce attractive returns over the long term.

As the fund grows, I expect new opportunities will open for us to invest in previously unavailable markets and exchanges. I continue evaluate our brokerage relationships to determine how best to access these markets. If Alluvial Fund changes primary brokers, I will inform all partners of the change.

I'll be making the annual trip to Omaha for the Berkshire Hathaway shareholders meeting the first weekend of May. If anyone else plans to be there, please let me know. I would enjoy the chance to catch up in person.

While in Omaha, I will be participating in a panel discussion hosted by Willow Oak Asset Management, LLC on the topic "Value Investing in a Volatile Environment." The panel will be held on Saturday, May 4th following the Berkshire Hathaway Q&A session. For full details and sign-up info, [please use this link](#).

I hope the arrival of warmer weather is lifting your spirits as it has mine. I wish you a happy spring and I look forward to providing another update in July.

Best Regards,

Dave Waters, CFA
Alluvial Capital Management, LLC

Disclosures

Investment in Alluvial Fund are subject to risk, including the risk of permanent loss. Alluvial Fund's strategy may experience greater volatility and drawdowns than market indexes. An investment in Alluvial Fund is not intended to be a complete investment program and is not intended for short-term investment. Before investing, potential limited partners should carefully evaluate their financial situation and their ability to tolerate volatility. Alluvial Capital Management, LLC believes the figures, calculations and statistics included in this letter to be correct but provides no warranty against errors in calculation or transcription. Alluvial Capital Management, LLC is a Registered Investment Advisor. This communication does not constitute a recommendation to buy, sell, or hold any investment securities.

Performance Notes

Net performance figures are for a typical limited partner under the standard fee arrangement. Returns for partners' capital accounts may vary depending on individual fee arrangements. Alluvial Fund, LP has a fiscal year end of December 31, 2018 and is subject to an annual audit by Cohen & Company. Performance figures for year-to-date periods are calculated by NAV Consulting, Inc. Year-to-date figures are unaudited and are subject to change. Gross performance figures are reported net of all partnership expenses. Net performance figures for Alluvial Fund, LP are reported net of all partnership expenses, management fees, and performance incentive fees.

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