
# Alluvial

FUND, LP

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## Letter to Limited Partners First Quarter 2024

*The cover image shows the clock tower of Stockholm Cathedral, or Storkyrkan, in the old town of Stockholm. As the oldest church in Sweden, and indeed one its oldest buildings, the Storkyrkan has hosted coronations, royal weddings, and high profile funerals, as well as weekly mass for parishioners. It is also home to St. George and the Dragon, a massive sculpture commissioned as tribute to the titular saint following Sweden's defeat of the Danish army in the late 15th century.*

*Visitors to Stockholm will quickly note something different about viewing the Storkyrkan in person as compared to the cover image; the cathedral recently completed a years-long restoration project to its earlier, Baroque era color scheme. The main building and tower now sport a light pink exterior, and the distressed green patina of the spire has been restored to a copper red color, reversing several centuries of exposure to Sweden's harsh winters.*

*Located a short distance form the Storkyrkan, you can find one of Alluvial Fund's newest holdings: Scandic Hotels, which operates a network of hotels in Stockholm, Oslo, Helsinki, and several other locations in Scandinavia. Read the letter to learn more about Scandic Hotels.*

Alluvial

CAPITAL MANAGEMENT, LLC

Dear Partners,

Alluvial Fund is off to a good start this year, rising 6.3% in the first quarter. Comparable indexes were up between 4.3% and 5.2%. The increase was broad-based, with several portfolio holdings contributing. Since quarter's end, indexes have turned sour, with small-caps and micro-caps giving up all year-to-date gains and then some. The likely delay in much-anticipated interest rate cuts has investors feeling less sunny than they did in March. In typical fashion, Alluvial Fund is bearing up well in the fitful markets. Despite benchmark indexes falling 7-8%, I am happy to report that Alluvial Fund is down only about 2% thus far in April.

***TABLE I: Alluvial Fund LP Returns (%) as of March 31, 2024***

| | YTD | 2023 | 2022 | 2021 | 2020 | Cumul. | Annual. |
|---|---|---|---|---|---|---|---|
| Alluvial Fund LP NET | 6.3 | 15.1 | -14.9 | 31.0 | 28.4 | 144.5 | 13.1 |
| Russell MicroCap TR | 4.7 | 9.3 | -22.0 | 19.3 | 21.0 | 55.3 | 6.3 |
| Russell 2000 TR | 5.2 | 16.9 | -20.4 | 14.8 | 20.0 | 72.3 | 7.8 |
| MSCI World Sm+MicroCap NR | 4.3 | 15.1 | -19.1 | 15.8 | 16.5 | 73.9 | 7.9 |

*Partnership began operations 01/01/2017*

You may notice a conspicuous absence in our top holdings list. P10 Inc. was a top Alluvial Fund holding for several years, but in March, I decided to sell our entire position. We parted with our last shares a few days ago. This was a difficult decision, but one I believe was necessary and thoroughly considered. In short, P10 disappointed us one too many times. The early years of our P10 investment were marked by triumph after triumph as the company grew from an OTC-traded shell company to a NYSE-listed diversified alternative assets manager. But then, the trouble set in. Since its December 2021 IPO/uplisting, P10 has cut its cash flow margin target from >55% of revenue to a "mid-40%s" figure. It has managed only one additional acquisition. And management turnover has been high, with multiple higher-ups exiting and selling or registering to sell large blocks of shares. Not exactly a sign of confidence.

I still *like* P10. Their business model is one of the world's best, with phenomenal returns on capital, nearly zero need to reinvest cash flows, and long-term industry tailwinds. The new CEO is as sharp as they come, with serious deal-making credentials. But P10 has run into the tough reality that creating a true premier diversified alternative investments platform is going to be far more difficult and far more *expensive* than anticipated. They need more salespeople, more "deals" people, more people in nearly every department, and these people won't work for cheap. This investment in human capacity is worthwhile, but the financial rewards may not show up for years. Then there is the problem that credibility is rebuilt far more slowly than it was destroyed. P10 has burned a lot of investors since its IPO. When and if P10 starts to show real improvements, it could take several quarters for investors to trust the company once again and send its shares higher.

Looking around at the universe of investments available to us, I could no longer justify owning P10 over any of several other potential holdings. So I sold, and re-allocated the proceeds to multiple other ideas. Fortunately, these ideas have already contributed to the fund's returns. Funny enough, despite its recent tough run, P10 remains one of the fund's all-time best performing investments. But although I still think P10's long-term potential is quite strong, my list of "best risk-adjusted ideas" has only a few dozen entries and P10 is no longer one of them.

**New Holdings**
The first of Alluvial Fund's new holdings is **McBride plc**. Just when I thought I could not find a business more boring than our vegetable canner, Seneca Foods, along came McBride, a major European producer of private label laundry detergents and dishwashing liquids. For years, McBride was a profitable if unspectacular little company, regularly recording mid-single digit operating margins on a flattish revenue trajectory. Then, COVID and the inflationary aftermath walloped the firm, causing input prices to soar. Bad news for a company that did significant sales on long-term fixed price contracts with major supermarket chains and discount retailers. McBride survived by cutting operating costs and renegotiating sales agreements to re-price in tandem with changes in input costs. Now, economic trends are moving strongly in McBride's favor. Persistently high European inflation has led consumers to make the switch from branded cleaning products to private label products like those McBride supplies. Unit volume is up just as gross margins are rebounding. The company is using its reinvigorated cash flow to reduce debt and plans to reinstitute its dividend later this year. McBride shares have responded positively to the improved results and outlook, but not nearly enough. McBride still trades at just 4.4x my estimate of fiscal 2024 EBITDA and 5.9x fiscal 2024 normalized earnings. Both ratios will come down as net debt declines. Longer term, McBride expects to generate modest revenue growth and to increase its EBITDA margin to 10%. Today's enterprise value of £320 million could be ~3x EBITDA in just a few years. Alluvial Fund made its initial purchases of McBride shares between GBp 97 and GBp 99, believing the shares are worth GBp 200 today.

McBride's low valuation is emblematic of the London Stock Exchange's woes. In the wake of both Brexit and the UK's ongoing economic troubles, investor interest in London-listed small-caps and micro-caps has all but evaporated, leaving plenty of solid little companies trading at or near multi-year lows. I would not be surprised to find other UK opportunities soon.

Another new Alluvial holding is **Scandic Hotels**. Scandic operates a network of 280 hotels with more than 58,000 rooms, mostly in Scandinavia, naturally. These hotels are solid mid-market properties located mainly in city business or cultural districts, meant to attract the casual traveler and business traveler, not the luxury-seeker. See here, here, or here for examples. I have kept up with Scandic for nearly a decade, and I think now is a great time to be a shareholder.

Scandic's operating model is different than most. A typical hotel company builds or buys its properties, financing the transactions with property-level mortgages or portfolio-level bank debt. The financial obligations associated with these debts are predictable, but unforgiving. Principal and interest must be paid no matter how the hotels are performing. The result is significant operating leverage. Instead, Scandic opts to lease its hotels. Nearly all these leases are *variable*, with some portion of the lease payment based on hotel revenue. The result is increased lease obligations in good years and decreased in bad. Operating leverage is reduced, and the company's effective financial leverage is far lower than the balance sheet would suggest. Scandic also has a robust loyalty program, which generates meaningful pre-paid revenue and lowers working capital intensity.

***TABLE II: Top Ten Holdings, 3/31/24 (%)***

| | |
|---|---|
| Net Lease Office Properties | 8.5 |
| Fitlife Brands Inc. | 5.8 |
| Crawford United Corp. | 5.2 |
| McBride plc. | 4.7 |
| MRC Global Inc. | 4.1 |
| ECIP Bank Basket | 4.0 |
| Garrett Motion Inc. | 3.9 |
| Scandic Hotels Group AB | 3.8 |
| Unidata S.p.A. | 3.7 |
| Seneca Foods Corp. | 3.3 |
| ***Total, Top Ten*** | ***47.0%*** |

Like nearly all hotel companies, COVID was cataclysmic for Scandic. Scandic managed the crisis by issuing equity and a convertible bond. A few years on, Scandic's revenues and profits have reached record highs. The company has extinguished most of its non-lease debt and is now less leveraged than at any point in its history as a public company. But unlike other hotel companies, Scandic's share continue to trade well below pre-COVID highs and offer a double-digit free cash flow yield. Part of the discount may be explained by Scandic's convertible bond, which comes due in October 2024 and converts into common shares at SEK 43.36. Scandic repurchased one-third of the convertible issue in November 2023 and has ample financial capacity to tender for the rest of the issue prior to maturity if it chooses. Once this share overhang is addressed, I believe that Scandic's valuation will converge toward that of other European hotel operators.

Scandic's 2024 results should be similar to those of 2023. Assuming full conversion of the convertible bond, Scandic's market capitalization is SEK 12.9 billion. Enterprise value excluding leases is SEK 13.4 billion. If we treat lease obligations as rent expense (a framework that I *greatly* prefer to use) then 2024 EBITDA should come in at around SEK 2.5 billion, leaving Scandic trading at around 5.4x EBITDA. Scandic will enter 2025 with a simplified balance sheet, little corporate debt, and a robust pipeline of hotel properties to add to its network.

I have also purchased a small position in a collection of Mexican stocks. I am long-term bullish on Mexico. While corruption and lawlessness are serious issues, the country's positive demographics and growing middle class should see discretionary incomes rise in coming years. The country is also benefitting from reshoring, as US manufacturers reassess the wisdom of relying entirely too heavily on China for their supply chain needs. Like many emerging markets, the Mexican stock market is dominated by a few large multinational corporations, banks, telecoms, and holding companies. But at the small end of the market, there are some real gems that have gone largely un-noticed. Two of these are **Grupo Herdez** and **Corporativo Fragua**. Grupo Herdez is a blue-chip consumer packaged goods manufacturer. The group's salsas, dips, mayonnaise, and guacamoles are ubiquitous in Mexican supermarkets and are likely present at your local supermarket as well. Herdez conducts its business through partnerships with well-known American and European companies like McCormick, Hormel, and Barilla. The company is family-owned, allocates capital responsibly, and trades at a bargain 11x earnings. Corporativo Fragua, founded in 1942, operates over 2,400 pharmacies under the Farmacias Guadalajara brand. The company has a stellar track record of growth and profitability, increasing revenues at 14% annually and profits at 17% annually for the last decade. Corporativo Fragua is bigger company than our typical investment, valued at $4.3 billion in US Dollar terms, but it trades like an obscure micro-cap thanks to the low liquidity of its shares. Corporativo Fragua maintains net balance sheet cash and continues to open new drugstores at a rapid pace. Shares are up considerably since our first purchases, but the company remains a value at 16x 2023 earnings.

***TABLE III: World Allocation, 3/31/24 (%)***

| | |
|---|---|
| United States | 63.3 |
| Eurozone | 10.1 |
| Poland | 6.0 |
| United Kingdom | 5.7 |
| Canada | 5.7 |
| Sweden | 5.4 |
| Mexico | 2.2 |
| Other | 1.6 |
| ***Total*** | ***100%*** |

**Portfolio Updates**

In my last letter, I introduced **Net Lease Office Properties**, casually adding that I expected this holding "would be volatile." Well, Net Lease has lived up to its bidding, trading everywhere between $17 and $27 in the first quarter before finishing up at $23.80. Little has changed. The company is still engaged in marketing its collection of 54 office properties for sale. Between major sale announcements, Net Lease Office Properties' share price will move on interest rate expectations. With recent hot inflation data decreasing the chances of a June rate cut, it's no wonder shares are off their highs. Currently, the market is valuing the enterprise at around $105 per leasable square foot. I continue to think that $130 per square foot is a suitably conservative estimate of asset value, a price that would value Net Lease shares in the mid-$30s. Less restrictive interest rate policy, success in re-leasing or redeveloping lower quality properties, or a generally healthier commercial real estate environment could all provide upside to this valuation.

**Garrett Motion** delivered nice results in February. The company issued strong guidance for 2024 and best of all, indicated it would use nearly all its 2024 free cash flow to repurchase stock. The company wasted no time, buying back a whopping 10 million shares for $90 million on March 6. Garrett will continue to harvest the cash flows from its dominant turbochargers business, investing in creating products for electric vehicles and returning excess cash to shareholders. Investors seem to be waking up to the reality that while electric vehicles are a near-inevitability, it will be a long time still before internal combustion engines lose their relevance. By the time they do, Garrett Motion will have completed the transition to an electric vehicle equipment manufacturer *and* will have returned billions in capital to investors.

**MRC Global**, our equipment distributor to oil and gas drillers and gas utilities, also had good news for us. The company issued healthy 2024 earnings guidance and revealed a plan to pay off its term loan with a combination of cash flow and a draw on its asset-backed loan facility. The market responded positively, but shares still change hands at just five times 2024 operating cash flow. MRC has also announced it will provide activist hedge fund Engine Capital with a board seat. I welcome the additional oversight that Engine will provide. There is no word on progress toward resolving the situation with the unhappy holder of MRC Global's convertible preferred shares, but a resolution could come at any time and would serve as a positive catalyst for MRC shares.

**Talen Energy**, also featured in our last letter, is off to a sensational start this year. Last month the company announced the sale of the data center built adjacent to its Susquehanna nuclear generating facility to Amazon for a handsome price, plus a long-term agreement to supply the data center with carbon-free power. A few days later, the company announced an agreement to sell its Texas fossil fuel-burning generation assets to CPS Energy. These deals leave Talen with plenty of capital to return to shareholders. The planned uplisting to a major exchange later this year remains on track. In the short term, I expect Talen to continue selling off its traditional power generation assets to focus entirely on nuclear. Looking ahead, I would be surprised if Talen Energy remains an independent public company for too long. Its assets are simply too good and will attract plenty of attention.

***TABLE IV: Sector Breakdown, 3/31/24 (%)***

| | |
|---|---|
| Consumer Staples | 17.6 |
| Consumer Discretionary | 13.4 |
| Industrials | 13.1 |
| Information Technology | 12.6 |
| Financials | 10.6 |
| Real Estate | 10.2 |
| Communications | 9.5 |
| Materials | 8.3 |
| Energy | 4.2 |
| Health Care | 0.5 |
| Utilities | 0.0 |
| ***Total*** | ***100%*** |

**Hammond Manufacturing** also delivered good results, earning CAD $0.45 per share for the fourth quarter and $1.66 for the full year. The company's plant expansion is now finished, and capital expenditures will decline markedly. A strong US Dollar helps Hammond as a large portion of revenues are derived from American customers. As I write, the US Dollar is up 3.2% against the Canadian Dollar year-to-date. It's looking like another great year for Hammond. Despite the strong results and positive outlook, Hammond Manufacturing shares trade for just 6.4x earnings and at 4.6x EBITDA. Hammond shares briefly went on a tear earlier this year, surging from $8.25 at year's end to nearly $14 in early February on no news. I used the inexplicable move to sell a portion of our shares to some very enthusiastic buyers. Then just as quickly as they arrived, the buyers vanished, replaced by steady sellers who have pushed shares back to $10 or so. At current levels, Hammond shares offer excellent value.

**FitLife Brands** has been a good contributor to our results this year. CEO Dayton Judd provided commentary on the MusclePharm acquisition on the company's inaugural earnings call. Essentially, the acquisition will be worthwhile, financially speaking, if the current levels of MusclePharm product sales are merely maintained, but it will be a tremendous success if the company can reintroduce previous best-selling products. To that end, the company is bringing back the MusclePharm Combat Sport Bar, which sold 25 million units annually at its peak. It will take time to restore any meaningful portion of MusclePharm's former glories, but this looks like a good start to me.

Finally, I could not be more pleased with the results that **Crawford United** is putting up and the market's reaction. For the year just ended, Crawford United earned $3.79 per share and produced free cash flow of $4.75 per share. Shares have rallied to the low $40s this year, but still represent a bargain. Crawford's commercial air handling unit (think industrial HVAC) was the standout last year, with revenues up 23% and operating income up 130%. Results were more subdued at the industrial and transportation segment, but still up from 2022. Looking ahead, I expect continued growth at air handling, improved margins in industrial and transportation, and a solid contribution from the recently acquired Heany Industries.

**Alluvial Updates**

I have a few notable items to report. First, Alluvial Fund is closing to new limited partners. Alluvial Fund is approaching $50 million in assets, still tiny in the context of investment funds but a number that blows my mind when I think back to our founding in 2014. $50 million feels right, at least for now. It's a figure that still allows me to invest in whatever tantalizing opportunities I come across, no matter how small, but large enough that we have our choice of brokers to work with and access to company management is rarely a problem. Assuming I do my job well and the market cooperates, the fund will continue to grow in size, but without additional capital from new limited partners. Existing limited partners are welcome to contribute additional capital, but for everyone else, we will maintain a waitlist in case circumstances change.

Even as some doors close, others open. I am happy to announce Alluvial will be launching a new fund later this year! This fund will look very different from Alluvial Fund, with nearly zero overlap in holdings or strategy. Many details remain to be ironed out, but I can provide a general picture of the new fund. It will be:

- Small by design in order to access markets and securities with very limited capacity.
- *Extremely* long-term in nature, with an extended lockup period and a near total disregard for short-term performance.
- Complicated, thanks to some very unusual global securities and corporate structures. Not well-suited for qualified accounts.
- **Dedicated entirely to investing in securities backed by and deriving their value from tangible assets**. Not algorithms, networks, or brand names, but real estate, mineral resources, livestock, timber, factories and machinery, and anything else that a human being can see and touch.

This new fund won't be right for everyone, but I am excited to introduce something radically different than any other fund out there. Details will follow.

In other news, the fine people at Cohen & Company completed the 2023 audit process with their typical professionalism. We distributed the audited financial statements earlier this month. Please let me know if you did not receive a copy. I apologize that K-1s took longer than expected to complete this year. The new K-2 and K-3 sections introduced by the IRS for 2023 were a challenge for our tax preparers. Next year's tax process should wrap up more quickly.

We will host another webinar for limited partners in early May. I look forward to discussing the Alluvial Fund portfolio and strategy and to answering your questions. We will send details this coming week.

As I write in nearly every quarterly update, thank you for entrusting your capital to Alluvial. All of my own capital is invested in Alluvial Fund, and I will continue striving to put it to the best possible use. I welcome your inquiries and I hope that you and yours are enjoying good health and good spirits. I look forward to writing to you again in a few months' time.

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, 2023 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.*

***Contact***
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