CHOICE EQUITIES
CAPITAL MANAGEMENT

October 14, 2016

Dear Investor:

Please find below a review of our housing related distribution companies from the 3Q 2016 investor letter. The following commentary of these positions was produced under the Focused Distribution Strategy (FDS), the predecessor vehicle to Choice Equities Fund, LP (CEF). Please see the website for more information about CEF and feel free to contact us to learn more.

POSITION COMMENTARY

We recently mentioned we would take a closer look at the two homebuilding distributor positions we initiated in the spring and summer of 2015. On the back of BXC's gain in 3Q 2016, we now have one stock up about +10% and one down about the same amount from our original purchases. Breaking even on these two can surely be considered a disappointment at this stage in the game relative to our original expectations. But both companies continue to execute soundly as anticipated and signs from the housing market continue to support our housing recovery thesis. Additionally, as can often be the case in small and microcap stocks, both of these companies possess unique attributes that we feel are not currently being rewarded by the market, and we continue to believe a growing homebuilding industry will provide the operating environment necessary to allow both investments to realize attractive returns.

BXC – Our views on the business and the stock remain unchanged from prior reports. Management is solidly executing on the deleveraging initiative the company embarked on with the spring refinancing of their debt, and the company continues to report solid operational results. Management is pursuing a sound, locally-focused, market-by-market approach with a focus on improving returns on capital in the existing business by better matching working capital with a more streamlined distribution center network. Should the company continue to operate successfully on this strategy, we can envision a company with a dramatically improved financial profile emerging this winter. Despite the shares' lagging performance since our entry, we are optimistic these initiatives can translate to a commensurate reward in share price for our investors.

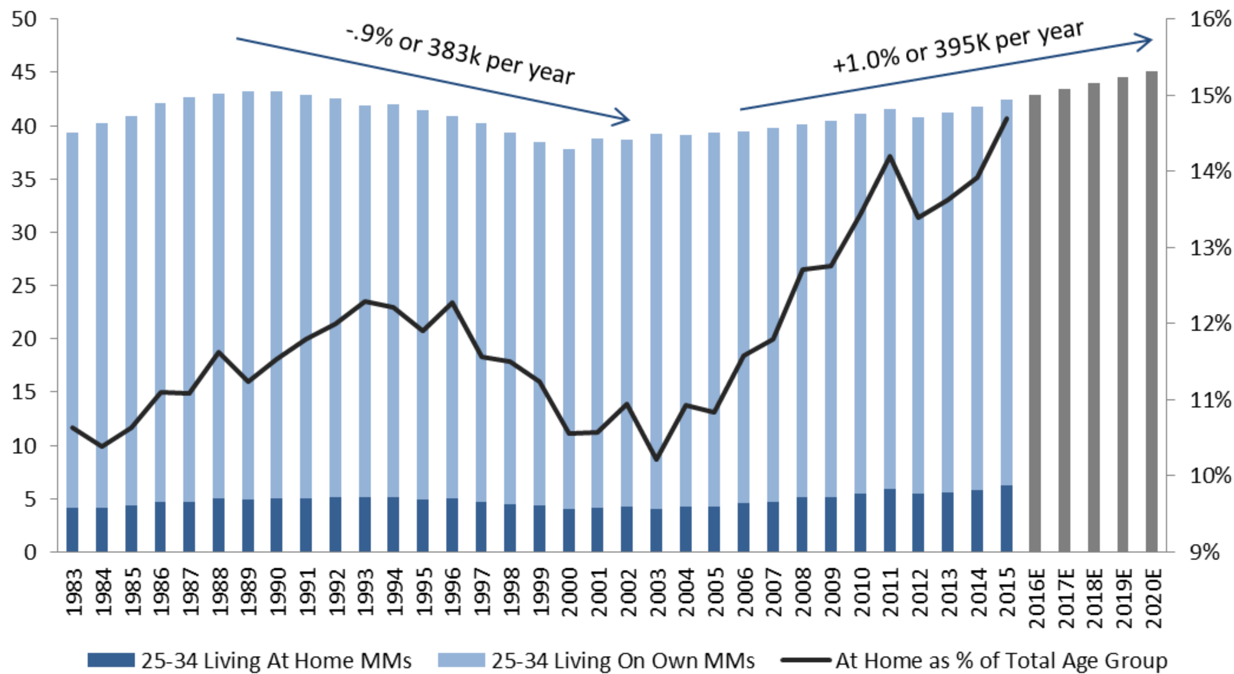
BMCH – BMC is the number two player in the highly fragmented direct-to-jobsite building materials distribution market. Despite its large size relative to the industry, it has a tight geographic footprint and only targets areas where it can be the number one or two player by size in that region. Accordingly, it only has operations in 13 states, and of those, just six account for nearly three-quarters of their properties. We feel this is a potentially overlooked positive for the company as these regions are generally healthier and more active than the whole of the U.S. homebuilding market as a result of their favorable long term trends in demographics and employment growth. The company also boasts a differentiating product called ReadyFrame which precuts and prepackages wood pieces and allows builders to reduce cost and framing time by 20% or more in some cases. This is a unique technology that affords BMC a higher margin offering that builders appreciate, particularly in the current labor-constrained environment. With a market cap of ~$1.1B, there are only a handful of analysts currently covering the stock. We believe added investor attention is likely to come in time with sound company execution.

HOUSING: THE REALLY BIG PICTURE

Most analyses of the current recovery taking place in the housing market tend to begin at the downturn that led us here. Recollections often begin with some mention of The Big Short and recall NINJA loans, subprime and adjustable rate mortgages, failed investment banks, an alphabet soup of government-

crafted acronyms like TALF and TARP and culminate with the worst economic downturn we've experienced in several generations. Distilling the episode down to one brief and necessarily oversimplified statement, the narrative largely lands at the intersection of where irresponsible lending met a long held fallacy that housing prices would never go down. This is all largely true and generally well accepted. However, there is an element of the buildup to the downturn that we feel is often overlooked which has some interesting implications for today.

The chart on the following page shows the absolute number of 25 – 34 year olds in the U.S. broken out by their living situations and is divided into those that are living on their own and those that are living in their parents' home. We focus on this group to highlight the ebb and flow of the growth in this age cohort, and also to highlight how their behavior has changed over time. It is also the age group that is most likely to buy a home for the first time, a point that has its own interesting ramifications. Traditionally, one can expect the growth in this age group to roughly approximate total population growth, a figure that has hovered reliably in the .8% – 1.4% level per year for the last seventy years.[4] However, the pattern observed over the last 30+ years points to a bit of a pig-in-a-python effect as this group's total size actually peaked in 1990 due to the fact that many of the Gen Xers that made up this age cohort are sandwiched between the Baby Boomer and Millennial generations – two groups that each ultimately grew to become the largest generation by total population the U.S. has ever witnessed.



Focusing first on the total size of this age cohort, the chart reveals much of the demand that spurred the housing bubble came from a demographic that had actually shrunk in size. Even more interesting is how dramatically the group's behavior changed as the housing market heated up. Beginning in the mid-1990s and continuing steadily on until 2005, this group of people increasingly moved out and onto their own at a proportion that ultimately became the largest sustained level on record. (US Census Bureau data is only available on an annual basis back to1983). One of the most harmful elements of all of this pull forward of

demand is that it came from a group of people who were only just entering their better earning years; this unfortunate fact means these same people are also the ones who are traditionally the most poorly equipped to handle the economic troubles they soon faced. The often overlooked point here is that while it is well known many of the wrong people were getting mortgages and entering the housing market, they were not the wrong people just because of their credit profiles. It also had a lot to do with their demographic profiles.

This is interesting for a couple reasons. For starters, it points to obvious pent-up demand for the housing market going forward from both a large proportion of people that are likely to seek housing on their own as well as a critically important age cohort that is again growing in numbers. And it also helps explain some element of our subpar economic recovery as this group (and of course many others like them and financial institutions too) had to struggle through some lean years to de-lever their balance sheets and repair their financial health. The chart also allows us to highlight some of the oddities we've seen in the housing recovery thus far, particularly in regard to the largely absent first-time home buyer, an increased number of renters and the current low rate of homeownership.

We have heard the analogy that this housing market recovery has been akin to lighting a campfire from the top. In this comparison, the top is lit, and rather than seeing the entire stack of wood quickly ignite as it normally would when a fire is properly lit from the bottom, the flames ever so slowly trickle down to the base, in a steady and slow, but long-lasting burn. This seems a quite fitting description for the current disjointed recovery. Home prices have mostly recovered though homebuilding currently remains some 25-30% below its average level of the last thirty years. The building that has occurred has been driven in large part by a historically large share of multi-family housing units, while the single family units that have been built have often targeted the middle tier of the market with homes that have been steadily increasing in size. As a result, the recovery to date has largely moved forward in the absence of the first-time home buyer. Their lack of participation has been a contributing factor to a slow and lopsided recovery, as the lower end of the new single family homebuilding market has struggled in fits and starts given the absence of this important buying group. It is also worth noting the first-time buyer's absence has had a negative impact on the move-up buyer, given the latter's dependence on new entrants as buyers for their homes intended to be sold.

These building dynamics have largely occurred as a response to the low rate of homeownership as more households have become renters and many Millennials have not yet shown an interest in buying homes at similar ages as preceding generations. This has caused some to suggest the younger generation is not interested in owning homes. We cannot dismiss that this may potentially be true at the margin, but studies continue to show that Millennials are a group that desire to own their own homes at similar proportions to prior generations. They are just moving a little slower to do so – largely for the demographic and economic reasons discussed above.

Other dislocations exist too. Many builders report they'd like to build more homes faster to meet existing demand, but suggest their pace of building is constrained by a shortage of labor, a scarcity of attractively priced lots and a limited supply of loans, particularly for the middle and lower level buyer. Indeed, almost half of the labor present in the mid-2000s has exited the industry (and many have left the country). And the pendulum of credit has swung from way too loose towards the other end of the spectrum thereby limiting purchasing prospects for many current would be buyers.

Summarizing this very big picture view, this outlook gives us a great deal of confidence that significant and structural demand exists for the services of our two distributors that serve the building community. It does not mean there are not risks to our positive outlook. (We are watching company execution, mortgage rates and consumer confidence most closely – though all currently look supportive.) What it

does mean is that the two factors traditionally most important to support housing growth - demographics and job creation - now look to be in better shape than they have looked at any point in the last 15 years. We believe this steadily blowing tailwind will provide the boost our companies need to affect their unique value propositions and gives us good reason to stick with our current investments.

CONCLUSION

As always, we are happy to discuss any portfolio holdings or our investment outlook with you at any time. Please simply reach out to us at your convenience. In closing, we are honored and privileged to have the responsibility you have entrusted in us in managing your capital, and we look forward to continuing our relationship further into the future.

Best regards,

Mitchell Scott, CFA
Portfolio Manager

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1. All market and company data is sourced from Factset and company filings and is current as of 9/30/16.