Q2 2018 | Issue 12

# Hidden Value Stocks

small caps with little or no coverage

From ValueWalk

www.hiddenvaluestocks.com

## Contents



# Introduction

Hedge fund conferences are some of the most anticipated events in the financial world, where the best minds of investing gather to share their best ideas.

However, according to a recent study, the funds touting these ideas might have an ulterior motive. According to a new report titled, Talking Your Book: Evidence from Stock Pitches at Investment Conferences, on average, a hedge fund manager that pitches a stock at a conference cuts its weighting in his portfolio within the first quarter after praising it.

Harvard doctoral student Patrick Luo compiled data from 30 investment conferences from 2008 to 2013, building a sample of 350 long and 40 short stock pitches. The data show that while stocks do outperform in the days immediately after they're mentioned at conferences, the best performance comes in the weeks prior. The paper estimates investors can earn 1% in the first two days after the pitch, but that's about it.

"The majority of the outperformance occurs before the pitches," Luo wrote in the paper. "Outperformance after the pitches are likely driven by inflows from other investors that follow these investment conferences."

This implies that funds are generally taking advantage of the buzz created by conferences to get out at an advantageous price. "Hedge funds take advantage of the publicity of these conferences and strategically release their book information to drive market demand," Luo concludes in the paper. "Specifically, hedge funds sell pitched stocks after the conferences to take profit and create room for better investment opportunities."

One of the qualities we look for when finding managers for Hidden Value Stocks is that they own the companies profiled, and are not just using the publicity to offload into a rising market. We also try to publish regular updates from previously profiled funds and positions as part of our goal to offer the most transparent stock newsletter service, and unlike many other newsletters, we publish stock returns (a full list can be found at www.hiddenvaluestocks.com/returns) .

This issue contains three fund interviews and seven stock ideas in total. We hope you enjoy the summer issue of Hidden Value Stocks and as always, if you have any questions or comments please do get in touch.

Sincerely,


Rupert Hargreaves

& Jacob Wolinsky

rhargreaves@valuewalk.com

Jacob@valuewalk.com

# Fund Updates

### Update from Dane on Daseke (profiled in the September 2017 issue of Hidden Value Stocks):

#### From Dane's Q1 letter to investors:

"...on Monday morning, February 12th, the company announced a follow-on offering of 7.4mn shares with proceeds to the company — the stock had closed at $12.98 the previous Friday. In our view, the transaction was completely botched. In our experience, banks typically pre-screen a deal with buysiders, or, at a minimum have an accurate sense of supply/demand dynamics. The transaction priced the night of Wednesday the 14th at a deal price of $10.60 – a shocking 20% haircut from deal announcement. Perhaps the company had a transaction teed up which fell through, but clearly this has resulted in a crisis of confidence. The stock soon broke deal price and ended the quarter at $9.79. This represented a quarterly 31.5% decline in the price of shares, and a 43.6% decline in warrants, which our Fund also holds.

All of this has happened against a back-drop of a flat-bed rate environment that is red-hot. According to dat.com, on April 24th "flatbed load-to-truck-ratio has exceeded 100 loads per trucl for four weeks in a row." Last week the site said flatbed load-to-truck was at record levels. Daseke is down another 13% this month and now trades at a paltry 6x EV/EBITDA. Fortunately, it can still make acquisitions at even lower multiples (although we'd be equally comfortable with them buying back their own shares). We expect the stock price to improve when the company reports what should be good numbers in the next few weeks, and we've encouraged management to authorize a stock repurchase plan."

### Update from Stanphyl Capital on Echelon (profiled in the March 2016 issue of Hidden Value Stocks):

#### From Stanphyl's Q1 letter to investors:

"We continue to own Echelon Corp. (ELON), a perpetually disappointing "industrial internet of things" networking company with approximately $30 million of annual 56% gross margin revenue and an enterprise value of approximately $2 million. In May Echelon reported yet another disappointing quarter, with Q1 2018 revenue of $7.8 million vs. Q4's $8.0 million and guided to a worse Q2, with revenue of about $7.5 million; meanwhile operating cash burn disappointingly continues at around $1 million per quarter. Echelon is now focusing its growth on "smart" commercial & municipal LED lighting (although its fab-less chip business has apparently now stabilized after a long decline), and if the lighting business accelerates (and so far it hasn't!), I think there's a chance it can hit a break-even annualized revenue runrate of $40 million by Q1 2020 (pushed back again from my earlier hoped-for timelines) at which point— assuming $12 million of remaining net cash (vs. an estimated $18 million at the end of Q2 2018) and 4.8 million shares outstanding (vs 4.54 million today), an enterprise value of 1x revenue on this 56% gross margin company would put the stock at just under $11/share. Additionally, Echelon has approximately $263 million in federal NOLs and $108 million in state NOLs, worth tens of millions of dollars if it can utilize them. So if it can pull this off (and theoretically, the market for the networking of commercial and municipal LED lighting should be huge between the U.S. and Europe), this stock could be a home run for us. So far though (as noted above) there seems to be little sign of improvement, and although the stock is now near all-time lows I won't add to the position unless the current CEO (who has had more than enough time to fix things) is replaced."

## Update from Logos LP on Luxoft (profiled in the September 2017 issue of Hidden Value Stocks) :

### From a recent Logos investor update:

The stigma that surrounds failure in asset management needs to be revisited as even juggernauts such a Buffett and Druckenmiller make big mistakes. As always, the way to avoid future failure is to embrace and learn from past failures. This piece hit home as during the month of May we exited our position in Luxoft and realized we had made a mistake. We were reminded of a few things: 1) turnarounds can take much longer than anticipated no matter how bullish one can be about the business's prospects 2) more time means a larger opportunity cost 3) sometimes being too early is the equivalent to being wrong. LOGOS

# Returns

| Edition | Fund | Ticker | Open Price | Date Pitched | Date Closed | Dividends | Current Price (1) (2) | Total Return |
|---|---|---|---|---|---|---|---|---|
| 8 | Verdad | TYO:4028 | ¥1,050 | 06/15/17 | 06/15/18 | | ¥1,120 | 6.67% |
| | | TYO:9994 | ¥1,620 | 06/15/17 | 06/15/18 | ¥42 | ¥3,455 | 115.86% |
| | GrizzlyRock | NYSE:RSO | $9.95 | 06/15/17 | 06/15/18 | $0.20 | $10.02 | 2.71% |
| | | NYSE:VPG | $17.45 | 06/15/17 | 06/15/18 | | $38.25 | 119.20% |
| 9 | Logos LP | NASDAQ: AAON | $34.85 | 09/29/17 | | $0.29 | $32.80 | -5.05% |
| | | NYSE: LXFT | $47.80 | 09/29/17 | | | $36.20 | -24.27% |
| | Dane Capital | NYSE: DSKE | $13.05 | 09/29/17 | | | $9.90 | -24.14% |
| | | NYSE: MX | $11.31 | 09/29/17 | | | $11.20 | -0.97% |
| 10 | Hayden Capital | ZO1:GR | €151.90 | 12/22/17 | | | €163.00 | 7.31% |
| | | NASDAQ: CACC | $325.00 | 12/22/17 | | | $359.00 | 10.46% |
| | Avenir Capital | HKG:0100 | $8.20 | 12/22/17 | | | $6.00 | -26.83% |
| | | NYSE: BBX | $7.90 | 12/22/17 | | $0.01 | $9.21 | 16.71% |
| 11 | Old West | NYSE: ZDGE | $3.10 | 03/27/2018 | | | $3.90 | 25.81% |
| | | NYSE: CRR | $7.52 | 03/27/2018 | | | $8.10 | 7.71% |
| | Songbird | NYSE: OXM | $76.90 | 03/27/2018 | | $0.34 | $82.90 | 8.24% |
| | | NASDAQ: GNTX | $22.60 | 03/27/2018 | | $0.11 | $25.20 | 11.99% |

(1) For closed positions this price is the price at time of close.

(2) Prices as of June 15

*Table only include the stocks profiled in the last four issues of Hidden Value Stocks. The full performance figures can be found at: https://hiddenvaluestocks.com/returns/

INTERVIEW ONE:

# Chuck Murphy
# of Liberty Park Capital

Chuck Murphy

Chuck Murphy is the portfolio manager of Liberty Park Fund, a low-net, absolute return-focused fund. Since 2011 the firm has grown from an initial investment of around $700,000 to assets under management of $85 million today. Chuck and team specialize in finding under-the-radar industrial stocks with limited analyst coverage, which require specialist knowledge to understand. After gaining 3.43% in May, for the year Liberty Park is up 2.09%.

## Could you give us a bit of background about yourself and Liberty Park?

Sure. I started Liberty Park back in 2011, and we opened it to external investors in mid-2012. We started with $700k in AUM, but we've grown steadily since then and are now at about $85 million in AUM. We have three people on the investment team and one person on the marketing/operations side.

Our fund is a low-net, long-short equity fund focused on smaller-cap industrials that aims to provide equity-like returns without the correlation to or volatility of the broader market. Our universe presents opportunities for us to exploit: below-average, sell-side analyst coverage; above-average cyclicality and volatility; and complex or multi-industry businesses that require experience to understand. We also have a unique process that enables repeatable alpha generation.

Before starting Liberty Park, I was a senior research analyst at Sidoti & Co in New York City for about seven years. Sidoti was the largest sell-side research firm in the small-cap equity space, and I covered the industrials sector. What I found over my time at Sidoti was that smaller-cap industrials were a unique ecosystem- they are volatile, cyclical, and much more informationally inefficient than most US stocks. To me, those features make a great ecosystem for an alpha-focused, absolute return strategy (not so much for a long-only, buy and hold one).

We like to say that we're the foremost experts on smaller-cap industrials in the US, but truth be told, there are few, if any, other investors who consider themselves small-cap industrial specialists.

## Can you give us some more insight into your investment approach?

Our investment strategy could probably best be described as variant perception.

We believe that stocks go up when companies deliver fundamentals that are better than consensus expectations, and stocks go down when the opposite happens. As such, we spend a great deal of time trying to become experts on the company/industry to the point where we know "the truth/reality" better than other investors.

> *"We believe that stocks go up when companies deliver fundamentals that are better than consensus expectations, and stocks go down when the opposite*

*happens. As such, we spend a great deal of time trying to become experts on the company/industry to the point where we know "the truth/reality" better than other investors.*

We also want to have a firm grasp of what expectations are baked into a stock. What causes us to buy or short a stock is when we see a situation where investors' expectations are materially different than the company's reality; we also try to have a catalyst in mind that will cause investors to realize their mistake, which will in turn, cause the stock price to re-align with reality.

This philosophy/strategy is a product of years of experience as a sell-side analyst, where I was able to watch other investors' moves, and I was able to monitor what approaches worked and what didn't. The real world experience was also supplemented by knowledge gained from some great books and commentary over the years by people like Charlie Munger and Howard Marks.

**How many positions do you tend to run in your portfolio?**

Generally, 50-60, and that's split pretty evenly between longs and shorts.

**One long position you currently own is Daseke, a stock we've profiled before in HVS. I am sure our readers would be interested to hear your side of the story?**

As your readers are probably aware, Daseke's plan is to consolidate the flatbed trucking space. We think that with the economy in the late-cycle phase and capital equipment sales very strong, demand and pricing for the movement of that capital equipment should rise significantly.

Additionally, Daseke should be able to improve operations of acquired companies and enhance its margin profile over time as the company scales.

**And one company you hold on the short side is Cooper-Standard Holdings. Once again, this is a stock we've already profiled, but from a long perspective. So, I'm sure readers would be interested to hear your short thesis?**

We've actually backed off that short recently. Our original thesis was that Cooper's products were commodities that will be under constant pricing pressure in a rising cost environment. We also saw downside from Cooper's exposure to a potential decline in US auto sales. While we're still not bullish, we think some of its self-help initiatives (sales and margins + new products) will limit the downside.

# **Liberty Park:** Stock Idea One

### Your first individual stock idea is NN Inc. (NNBR) What's the story behind this company?

Historically, NN was a low-growth, commoditized and cyclical business. One of the key products, for example, was the ball component of automotive ball bearings. The company, however, has undergone a major transformation in recent years through acquisitions and divestitures. Nowadays, the product portfolio is higher growth, higher margin and lower cyclicality. The key market now is precision components for the life science industry.

### According to your latest investor letter, you believe the market does not understand how much the company's product portfolio has changed in recent years. How has it changed, and what does this mean for the business?

Our interest was piqued when the company divested its Precision Bearing Components (PBC) segment. This segment manufactured balls and rollers used in bearings was undifferentiated from peers, and highly cyclical. With the proceeds from the PBC sale, the company acquired three businesses that perform precision manufacturing for the life sciences market that have much better margins, faster growth rates, sticky and less price sensitive customers, and much higher barriers to entry. Investors do not yet appreciate the portfolio changes because margins have been depressed by investments in growth, and startup costs for new contracts won from competitors.

“ *Investors do not yet appreciate the portfolio changes because margins have been depressed by investments in growth, and startup costs for new contracts won from competitors.*

### Could you shed some more light on these new products?

The primary new group of products is medical devices. NN is the outsourced manufacturer for a number of products designed by groups like Boston Scientific and Abbott Laboratories. The products include everything from hip implants to surgical tools.

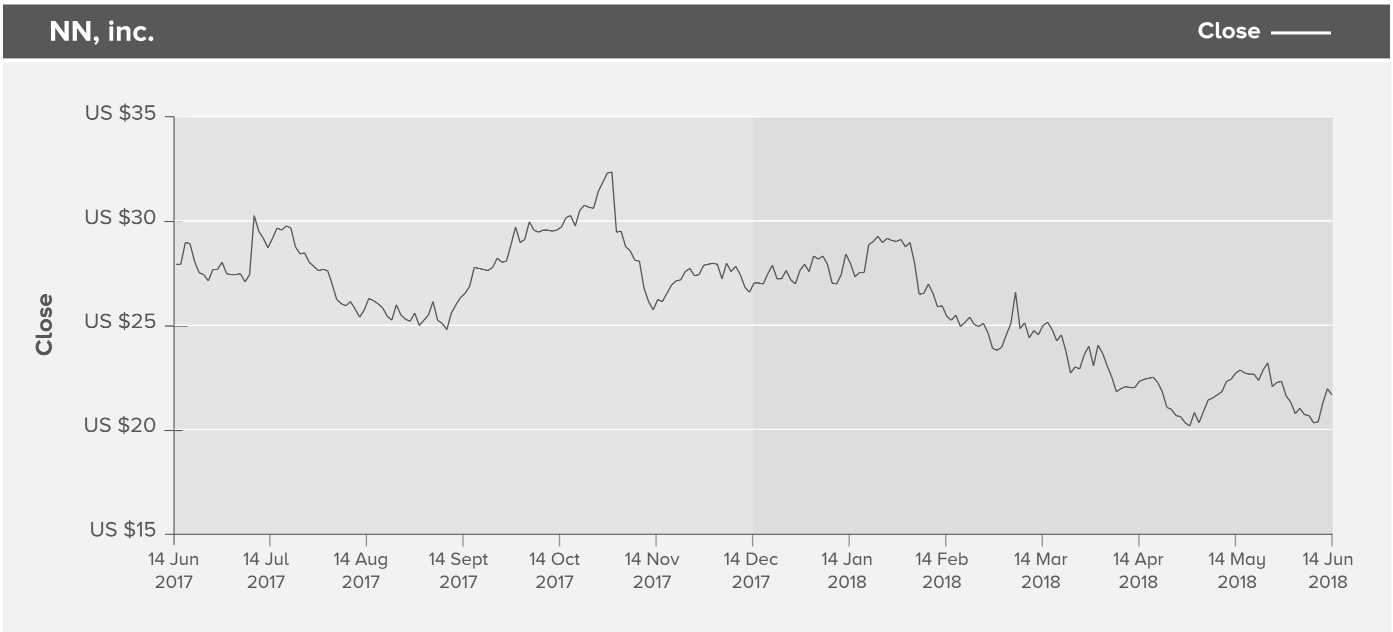
### What's the current valuation and where do you see the business moving over the next few years?

The stock currently trades at an EV/EBITDA of about 8x. That might make sense and be fair for the NN of five years ago. Given the new portfolio mix, we think a multiple of 12x or more is appropriate.

### If everything goes to plan, what's Liberty Park's estimate of intrinsic value for the business?

Applying a ~12x multiple on 2019 consensus EBITDA estimates would imply a price in the mid-$30s (from ~$20 today).

“ *Applying a ~12x multiple on 2019 consensus EBITDA estimates would imply a price in the mid-$30s (from ~$20 today).*




**Share Information June 15, 2018**

| | | | |
|---|---|---|---|
| **Market Cap.** $599m | **P/E (f)** 11.4 | **EV/EBITDA** 29.7 | **Dividend Yield** 1.30% |
| **Average Daily Volume** 153,898 | **P/B** 1.2 | **ROIC** N/A | **Debt to Assets** 193% |

## And what could go wrong that might derail this thesis?

Admittedly, NN's execution has not been great the past couple of years, and there is a good bit of debt on the balance sheet (~5x debt-to-EBITDA). We would be much more worried about the debt load with the old product portfolio and end-market exposure in place, but we think the new portfolio will handle it fine. We also think that now that the portfolio transformation is complete, management will not be distracted and can improve execution and visibility.

## 5x debt-to-EBITDA? That's a lot of debt. What are the company's plans to pay it down?

Yes, it is a lot, but we think the stock price already is discounted for it, and the new end-market exposure and product portfolio makes this level of debt much more manageable. Management has said it wants to reduce leverage to below 3x by the end of next year. We would not be surprised if it requires a modest equity raise to get there.

### Talking of management, the old NN's record isn't that good, what's changed from a management perspective to convince you otherwise?

I guess it depends how far back you are going. The current management team has been in place for a few years. Prior to their arrival, NN was uber-cyclical, minimal growth and highly commoditized. The current management team has done all of the portfolio transformation. The quarter-to-quarter execution amidst the transformation has not been great. Several quarters' results have missed management's guidance. We think this was mostly a function of low visibility of the older portfolio and distractions for management amidst the portfolio transformation.

> *"Several quarters' results have missed management's guidance. We think this was mostly a function of low visibility of the older portfolio and distractions for management amidst the portfolio transformation.*

Now that the transformation is done and visibility is better, we see better execution ahead.

# **Liberty Park:** Stock Idea Two

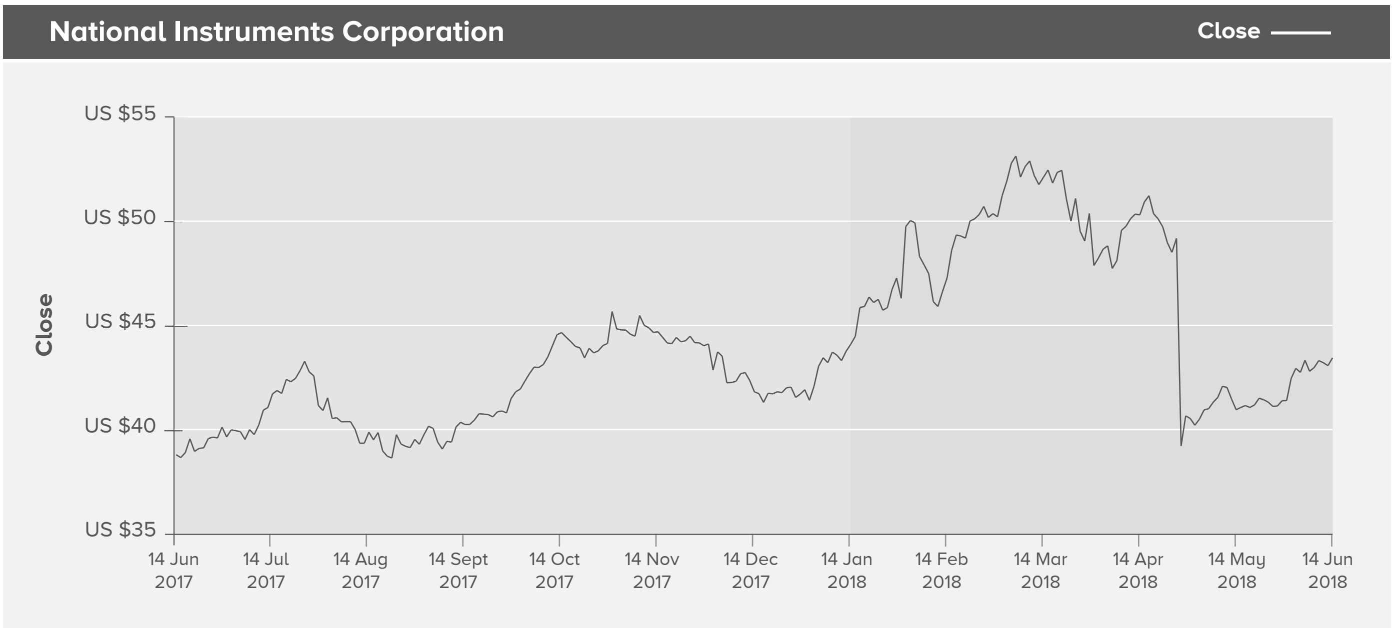
### Your second pick is National Instruments Corporation (NATI). Why do you believe this company offers value?

National Instruments' test and measurement equipment is found in almost every engineering laboratory in the world. The company pioneered the transition from box/rack-and-stack systems to open-architecture, virtual and modular systems. Adoption of NATI's approach/technology still has room to grow, and as the world becomes more digital and complex, the need for NATI's test and measurement equipment will only grow.

> *Adoption of NATI's approach/technology still has room to grow, and as the world becomes more digital and complex, the need for NATI's test and measurement equipment will only grow.*

### The business looks expensive compared to other companies profiled, are you worried about the 37x earnings valuation?

National Instruments is a low-cyclicality, secular growth story with 75% gross margins. The stock has never been "cheap," and it never will be. Not to mention, most software and software-like businesses trade on multiples of EV/Sales. The reason being that there is extreme operating leverage in the business model.




**Share Information June 15, 2018**

| | | | |
|---|---|---|---|
| **Market Cap.** $5.73bn | **P/E (f)** 37.5 | **EV/EBITDA** 23.8 | **Dividend Yield** 2.20% |
| **Average Daily Volume** 232,678 | **P/B** 5 | **ROIC** 11.5 | **Debt to Assets** -150% |

### Where do you see the growth coming from over the next few years?

Continued market share gains (from adoption of the open-architecture, virtual and modular approach) and market growth (a more digital and more complex world requires more test and measurement).

### In the age of disruption, are you worried about competitors moving on the firm's market niche?

Well, NATI usually plays the role of disruptor and innovator in the test and measurement market, so we're not too worried about new competition. If anything, engineers' reluctance to try new technologies has restricted NATI's growth.

### If everything goes to plan, what's your estimate of intrinsic value for the firm?

The stock recently sold off following less-than-stellar quarterly results. In our view, the quarter's issues were transient and the market overreacted. We see the stock regaining a 5x EV/Sales multiple, which would put it in the mid-$50s.

“ *The stock recently sold off following less-than-stellar quarterly results. In our view, the quarter's issues were transient and the market overreacted. We see the stock regaining a 5x EV/Sales multiple, which would put it in the mid-$50s.*

### The valuation does not leave much room for error if the company's growth stumbles. What's the downside potential here?

That's kind of what already happened this last quarter and what is already reflected in the stock. Not every quarter will be stellar, but we don't worry about long-term growth stumbling given the drivers I mentioned earlier.

INTERVIEW TWO:

# Noland Langford **of Left Brain Capital**


Noland Langford

Noland Langford is the portfolio manager of the Left Brain Capital Appreciation Fund (LBCA). LBCA has only been around for two-and-a-half years, but it has already made a name for itself.
It was featured as one of Prequin's 'Top Performing Hedge Funds' for 2017 and was shortlisted at the US Hedge Fund Performance Awards as the 'Best Newcomer' for the same year.

In its first year, LBCA produced a return of 134% for investors, and since inception, the fund has returned 290%, compared to the S&P 500's gain of 32% over the same period.

**The Left Brain Capital Appreciation Fund is targeting an annual return of 17%. This seems like a very high target but you've already smashed your goal for the first two years. My first question has two parts. Firstly, why did you decide on this target in the first place and secondly, what made you think you could achieve it?**

We knew that it was an ambitious target, but we had full confidence that we could achieve it because we were giving ourselves the flexibility to go where the returns were.

As we were formulating the strategy, we knew that we wanted to avoid being trapped in a style box. A lot of funds miss out on opportunities when they're labeled as value, growth, small-cap fund and all of the buying opportunities are in emerging markets or credit. We felt that if we focused on a targeted return instead of a style box, it would make us really look hard at the long-term upside potential of the securities we looked at.

The 17% number felt right from a marketing standpoint as well as an investment standpoint. If we could produce 17% returns, net of fees, we could return $5 million to investors for every $1 million they invested after 10 years. A 5x return over 10 years in a simple figure that sticks easily with any investor. But make no mistake, we knew that with the right strategy, this number was feasible.

**A gain of 134% in your first year is nothing short of outstanding. Why do you believe Left Brain has been able to succeed where others have failed?**

The fund launched at an opportune time. The start of 2016 was one of the worst starts to a market year on record. But with discord came buying opportunity. And that's where the flexibility in our fund's mandate was ideal.

*"The fund launched at an opportune time. The start of 2016 was one of the worst starts to a market year on record. But with discord came buying opportunity. And that's where the flexibility in our fund's mandate was ideal.*

With oil falling to under $30 a barrel and the systemic risk-off mentality, there was a lot of distress in the high-yield bond market. We knew that many of these companies were financially sound and that the price was well disconnected from the actual level of risk. In many cases, we bought bonds at 60-70 cents on the dollar for companies still making timely interest payments. This meant that we were locking in yield-to-maturities of 18%-20%. We knew this was a rare opportunity, so we went in as hard as we could. Our call was well rewarded by the end of 2016 when the market normalized and prices jumped back up closer to fair value.

### What makes you think the firm can continue to compound at the targeted rate?

We've had some very exceptional months along the way. We tell our investors that no one can ever expect these things to happen all the time. That said, we feel very good about our ability to continue our outperformance in the future.

We've been managing investment accounts for a long time through our RIA arm, applying many of the same strategies. The result has been very strong. And our capabilities have only grown over time. When we first started, it was just me, our proprietary security evaluation platform (Jarvis), and a desk full of annual reports. Now, I have a deeper research team helping me find even more opportunities in a challenging market.

We've also grown confident through our performance in recent months. When the stock market plunged, we were able to remain pretty resilient. We don't necessarily focus on protecting downside risk, but our individual positions are strong enough to stand tall when the markets buckle typically. If we can continue this, there isn't any reason we can't move in an upward trajectory.

Finally, our strategies continue to evolve as we grow. Our smaller size enables us to target securities that large funds overlook because they wouldn't be able to take large enough positions. The ability to concentrate our capital in a few good ideas has added to our performance and our risk metrics in a significant way.

### How do you go about selecting assets to buy? Can you give us some insight into your process?

At the end of every week, we rank about 900 securities that we track. We then upload that file to Jarvis. Jarvis narrows this down, based on proprietary factors. That usually gives us a list of up to a dozen ideas to evaluate.

When we like a company, we don't just automatically go for the stock. We look across the entire capital structure to see if there are more attractive entry points. These can include bonds, preferred stock, etc. Often, we find additional opportunities that present higher upside value.

A security needs to be attractive on multiple fronts before we decide to buy. It needs to be fundamentally attractive, have solid technicals and meet some quantitative measures that we think will allow it to outperform.

We run a focused, concentrated fund of 25-30 names in the equity book and fewer in the bond book. We want to fill our portfolio with only the most attractive securities.

### A high allocation to bonds, more specifically Valeant bonds has certainly helped performance. Can you tell us about your fixed income strategy?

Most of the market spends their time on investment-grade bonds (BBB or above). But there are many well-known, very strong companies that sit below that rating. We aren't necessarily a high-yield shop, but we're more than happy to go after quality companies that the rest of the markets mistakenly overlook.

There are very few mispriced investment-grade bonds, but you can find a lot of attractive opportunities in high-yield because the pool of potential buyers is smaller. Also, bonds are still traded manually. The pricing discrepancies are a lot more common, opening up a lot more opportunity.

Valeant was a bold call. We started building our position after the bulk of the bad news came out and the stock fell to $8. Why were we so confident about such a beaten name? Because we liked the new CEO, Joe Papa, and his message about making debt reduction the company's top priority.

Bonds were trading at 70-75 cents on the dollar. At that price, the yield-to-maturity was over 10%. We had done our research and knew that their Bausch & Lomb arm was a very stable franchise that also made up over 50% of Valeant's business. With this and the deleveraging, we assessed that the upside was 50% if we were right and that the downside was 10% if we were wrong.

*"Bonds were trading at 70-75 cents on the dollar. At that price, the yield-to-maturity was over 10%. We had done our research and knew that their Bausch & Lomb arm was a very stable franchise that also made up over 50% of Valeant's business. With this and the deleveraging, we assessed that the upside was 50% if we were right and that the downside was 10% if we were wrong.*

A lot of potential for relatively low risk – hence why we put a lot into this position, which paid off.

As interest rates rise, high-yields and Treasuries will be negatively impacted. But, high-yield bonds tend to do well here for two reasons. First, the higher coupon helps insulate holders from rising rates. Second, interest rate rises are reflective of improving economic conditions. This means that companies are in a better position to pay down debt, raising the likelihood of credit rating upgrades.

High-yield bonds are much more sensitive to economic conditions than interest rate hikes. Thus, the high-yield markets are a fruitful place for investors to seek returns.

## What's your largest equity position today and why do you like it so much?

Netflix (NFLX) is our largest equity position at the moment. It's been a favorite of the market for quite some time – we like it for a lot of different reasons. The potential for revenue growth is high: Netflix has 120 million subscribers, paying an average monthly rate of $10. The pricing power is underappreciated.

We think they could raise prices 10 times (i.e., 10 one-time increases of $1) before they see significant churn. For every $1 that Netflix increases its subscription price, that's $1.5 billion that's added to the bottom line annually (120 million x $1 x 12 months).

*"We think they could raise prices 10 times (i.e., 10 one-time increases of $1) before they see significant churn. For every $1 that Netflix increases its subscription price, that's $1.5 billion that's added to the bottom line annually (120 million x $1 x 12 months).*

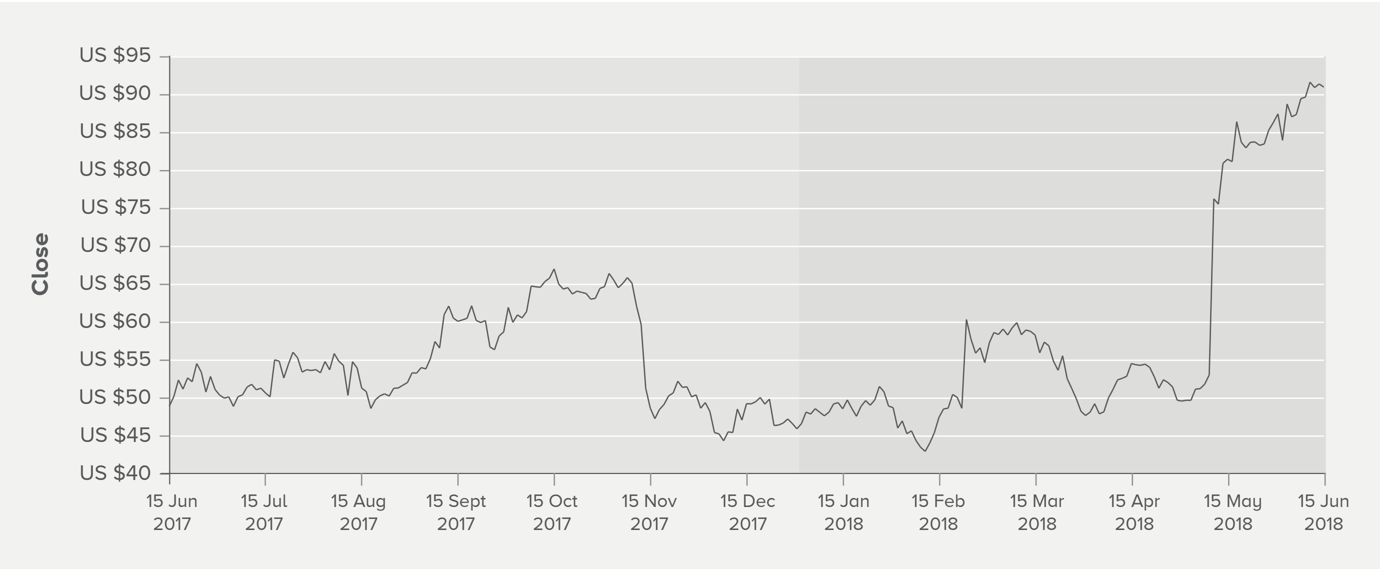
If you put a conservative 20 P/E ratio on those earnings, you get $30 billion in increased market value with every $1 increase.

## Do you have another idea that most investors haven't heard of?

The Trade Desk (TTD) is a name that most investors haven't heard of. We highlighted the company at our October 2017 RIA client event. The shares are up 90% year-to-date. Most of the appreciation came after their 1st Quarter earnings release last month.

The Trade Desk operates a platform for programmatic advertising. Advertisers desire to place their product/service in front of potential customers. They also want to track who's watching, when they're watching and whose responding so that they can spend their ad dollars effectively. Advertisers also want to target, and segment who their message goes to. And, they want to do that across various mediums: TV, radio, the internet, etc. Trade Desk's platform allows them to do just that. And, they are not affiliated with any of the ad agencies so that advertisers can trust the platform because The Trade Desk is independent with no ad inventory to sell. And, they provide analytics for decision making.

## The Trade desk, Inc.




## Share Information June 15, 2018

| | | | |
|---|---|---|---|
| **Market Cap.**<br>$3.8bn | **P/E (f)**<br>42.1 | **EV/EBITDA (f)**<br>42.8 | **Dividend Yield (ttm)**<br>N/A |
| **Average Daily Volume**<br>1,236,189 | **P/B (ttm)**<br>14.4 | **ROIC (ttm)**<br>25% | **Debt to Assets (ttm)**<br>- 420% |

What we really like is the Trade Desk is already profitable. Q1's revenue growth was 100%, and it produced EBITDA of $6.3 million and GAAP net income of $9.1 million. It's rare for a small high growth company to be showing positive net earnings in the hyper-growth stage. They are normally plowing all of their revenues back into their business to support their growth. And, with a market cap approaching $4 billion, uncontested leadership in the high growth programmatic industry with a total addressable market of $650 billion, we think the shares have a lot of headroom in the years ahead.

INTERVIEW THREE

# Choice Equities

Mitchell Scott

## Mitchell Scott, CFA: Choice Equities

Choice Equities Fund (CEF) is an investment partnership that seeks to generate market-beating returns over any rolling multi-year investment period while minimizing the risk of permanent impairment of capital. The fund invests through a concentrated, long-bias portfolio which typically consists of 10 – 15 equity longs, frequently of the small-cap variety.

Choice Equities approaches equities investing like an opportunistic businessperson and seeks investments offering the potential to double or better over a three-year time horizon. Launched as an independent and standalone investment management firm in January 2017, CEF has compounded capital at 18% per year on a net basis since inception in July 2013.

### To start, can you give our readers a bit of background about yourself and Choice Equities?

Sure, this is my third stop in the investment profession, but it's the first time I've been able to drive the car with both hands on the wheel. I got into the business in 2009 when I joined Anchor Capital, a concentrated micro/small-cap focused fund that was just starting out. Three years later, I moved to a larger shop, KDI Capital Partners, where I was for five years until I launched Choice Equities as an independent and standalone operation at the beginning of 2017. Both firms have been successful, and each stop was instrumental in forming my views about how to construct Choice Equities.

Being a part of a startup at Anchor Capital, I learned a lot about what it takes to build the business from scratch. It's not easy and sometimes you have to wear a lot of hats. I also learned a lot about being resourceful and where to find and how to develop an edge. But probably most importantly, I developed a real appreciation for how fertile the hunting grounds can be in the small/micro-cap space. There are always companies undergoing significant and sometimes radical change and there are more than one's fair share of bargains to be found. Once you know what to look for, success is often just a matter of turning over rocks.

At KDI Capital Partners, which was on the 2015 Barron's top 100 hedge fund list in the long-bias category, I came on board as the firm's distribution analyst. This was another great learning experience for me as I focused on a coverage list which was arranged somewhat uniquely by business model while I was there. The nearly 40 companies on my list spanned a few different verticals, so in some ways I benefited from acquiring knowledge of a few different industries as a generalist. But I also benefited by becoming an expert in the distribution business model where I learned a lot about what to look for in terms of competitive dynamics regardless of industry.

KDI is also where I started running the portfolio that is now Choice Equities, which I like to think combines the best elements of the investment approaches from each of my prior stops. Both places put a lot of emphasis on portfolio concentration, a concept I wholly agree with. And I do believe the long-bias structure employed at KDI is an advantaged one. But at KDI I was a member of a larger team and the organizational structure there dictated that I devote my efforts to only those companies on my coverage list. While being intensely focused on a relatively small list certainly has its advantages, especially in terms of honing one's skills as an analyst, I couldn't help but feel like we were missing out on a lot of big opportunities. We had good success there but with a growing though still small fund, I was motivated to see what else we could find in the target rich small-cap space. With that in mind and with the good graces of the folks at KDI, I went off on my own and started Choice Equities.

## What's your investment strategy and why did you decide on this approach?

We run our portfolio as a concentrated long-biased hedge fund, with an emphasis on small caps. We try to buy well-run and growing companies that we believe can double or better in three years. Expanding on that a bit, we believe those companies score well on four critical success factors we call the Four M's: Moat, Management, Money Flows & More Reinvestment Opportunities.

We like to own 10 – 15 companies at a time and will pursue opportunistic shorts for profit only. We will also use options and market or index hedges as shock absorbers to the portfolio if we believe they can help us protect capital or more safely hold a larger gross portfolio exposure.

Our charge is to compound capital at the highest and safest after-tax rates of return. I believe if all investors were tasked with this singular goal, they would arrive at a structure that looks a lot like this one. There would be an overarching focus on risk which we define as the likelihood of a permanent impairment of capital. Investors would want to minimize the likelihood of a sustained loss so that they could harness the powers of compounding interest. But they would also be willing to tolerate some variation in those returns and attempt to capitalize on price volatility as long as they were adequately compensated for it and had reasonable assurances their capital was ultimately safe. Finally, they would want to employ a concentrated portfolio and focus on an inefficient space, so they could really understand the risks of the companies in the portfolio and make their best ideas count.

This framework encourages us to follow to an approach I have described as "investing like an opportunistic businessperson" which I believe helps us stay true to Ben Graham's maxim that "investment is most intelligent when it is most businesslike."

“ *This framework encourages us to follow to an approach I have described as "investing like an opportunistic businessperson" which I believe helps us stay true to Ben Graham's maxim that "investment is most intelligent when it is most businesslike."*

Ours is a simple but effective approach. It suits my personality and beliefs about investing and is also the one I have the most experience using.

## Before we move on, could you give us some more insight into the qualities you look for in 'opportunistic shorts'?

We will short on occasion, but it's not our principal focus. Over the last 242 years in America, the bulk of the money has clearly been made on the long side, and I'd like to be on the right side of that. I think shorting is harder, and I'm not just talking about only versus the long side. I think it's also gotten harder versus its own history from other periods as recently as ten to twenty years ago as there are more participants in the market on the short side. I often describe it as twice the work with twice the risk for half the return. With this mindset you may say why even bother and it'd be a valid question. But as with most things, there is a time and a place. It also encourages us to remain intellectually honest and helps us steer clear of man-with-hammer syndrome. For these reasons, I did not want to preclude it from the strategy. Though we don't spend a great deal of time or effort intentionally looking for shorts, if we find something that looks totally out of whack, we are not afraid to participate.

## Can you give us an example of something you found that was totally out of whack?

Sure, this one is still a live position, so I'd prefer not to mention it by name. But we initiated a position in an online furniture-oriented retailer earlier this spring. In this case, it looked like valuation had become completely divorced from the fundamentals of the business. The company had consistently traded near a valuation of ~.2x sales for the last four years until it announced new endeavors in far afield areas of blockchain applications like bitcoin. The company's valuation suddenly exploded to ~1x sales and shares quintupled last fall even as their core operations continued to struggle. When the dust started settling on the bitcoin mania, we initiated a position.

### Talking of bitcoin, are there any stocks/ sectors you won't look at in general?

Emphatically, yes. There are all sorts of things we won't do. No bugs. No drugs. If it's something you need a PHD to understand, we're going to pass. I am also very hesitant in looking at anything that is a straight commodity play due to their inherent unpredictability. Generally speaking, we want to stay in areas inside of our circle of competence where we can develop an information edge.

The framework around our idea sourcing is engineered so that we can say "no" to a lot of things quickly. Even though we're only looking to add one or two names in a typical quarter, this approach allows us to look at a lot of ideas and really hone in on one when it fits our criteria.

When looking at a new idea, I generally ask myself three questions. In order, they are: 1) what is the potential return on time here? 2) can I do fundamental primary research on this? and 3) does it fit our Four Ms framework?

> *“When looking at a new idea, I generally ask myself three questions. In order, they are: 1) what is the potential return on time here? 2) can I do fundamental primary research on this? and 3) does it fit our Four Ms framework?*

To expand a bit on these questions, the return on time framework is basically composed of two components. Component one is, is this a potential multi-bagger over a three-year time horizon? To me, this is all about making sure we're focusing our efforts on things that can be truly impactful to our performance. Component two is, how quickly can I understand it? If it's going to take too long to figure out or do proper due diligence on the idea, then we'll be better off passing and looking at other opportunities.

The second question is all about evaluating our ability to gather information on a given opportunity relative to our peers. For all our investments, I want to conduct exhaustive fundamental and primary research. I want to touch the companies, know why their customers choose them and understand management's motives and incentives. As you move down the cap scale, information becomes less ubiquitous and our likelihood of building a true edge increases. This kind of work doesn't happen overnight, so we like a multi-year investment horizon and a big opportunity, simply because it takes time to execute on all these elements.

The last question falls back to our investment framework which is really the most critical piece of our process from a risk management perspective. I only want to own companies that I'm comfortable holding or adding to in the event of a price decline. If the company isn't well-run and growing or the company's prospects aren't improving, we will pass and move on to something else. From a risk perspective, if you buy growing companies for less than they're worth, this provides you a margin of safety and means time is on your side.

Summarizing these points, I don't like overly complicated things. I try to find things that look like obvious bargains that smack you in the face when you see them. In most of our investments, the situation generally boils down to isolating two or three critical questions. If we can answer those satisfactorily, the investment might be a go.

If the investment thesis can't be explained in two to three sentences, it's probably not a great idea.

> *“If the investment thesis can't be explained in two to three sentences, it's probably not a great idea.*

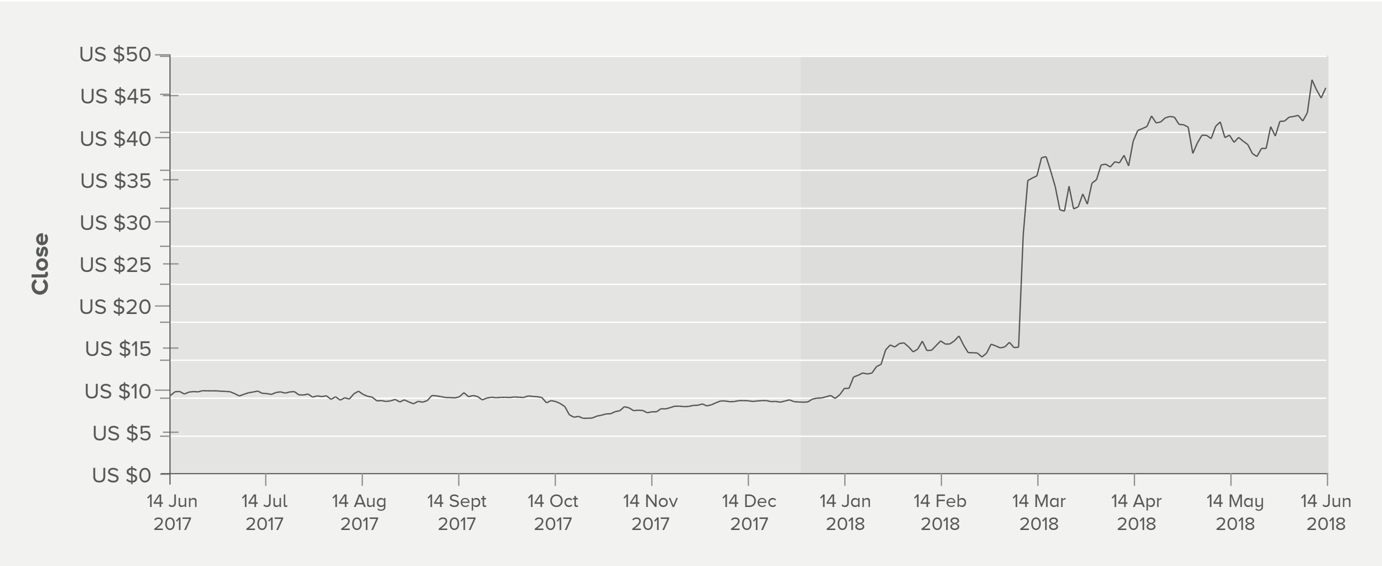
### Can you walk us through the investment process for one of your current holdings?

BXC/Bluelinx is a good one and topical too. It's not often you can say that a company that just quadrupled is still a buy. And this one started out like so many of our other investments do. I must have said "no" on this one at least three different times. But I kept watching it and monitoring events and they kept adding impressive people to the management team. The fact these well-credentialed people would leave good jobs and go to a company most would have described at the time as having iffy prospects became like the string of yarn the cat pulled on. As these things kept gnawing at me, I started digging.

It's worthwhile to note that in this type of situation, which was a turnaround, I pay a tremendous amount of attention to our second M, Management. Who is the CEO? What is their background? What kinds of people are joining the team? Are they qualified? Did they have other alternatives? Did they follow somebody from a place where they had previously worked together? If some of these elements are present, that's a powerful signal there's potentially a big opportunity at hand. For someone to follow a prior boss to a new company, that's not only an affirmation of that person's leadership abilities, but it also indicates those people believe there is a high probability of a successful outcome. I believe it's hard to overweight the importance of these actions; after all, these people are quite literally voting with their lives.

I'd seen this pattern before in other successful investments, and when I saw it emerging again at Bluelinx I got really interested. It helped that I already knew the industry quite well having had other investments ongoing in the area. As we dug in, we of course talked to current management, former employees, industry peers and investment bankers, etc. Many suggested the company's future was permanently impaired.

**Bluelinx Holdings, Inc.**




**Share Information June 15, 2018**

| | | | |
|---|---|---|---|
| **Market Cap.**<br>$407m | **P/E (ttm)**<br>5.3 | **EV/EBITDA (ttm)**<br>24.2 | **Dividend Yield (ttm)**<br>N/A |
| **Average Daily Volume**<br>320,399 | **P/B (ttm)**<br>18.4 | **ROIC (ttm)**<br>5% | **Debt to Assets (ttm)**<br>110% |

But I viewed the situation differently. My view was a talented team was coming in to improve operations at a company that was operating in an industry bouncing around near multi-generational lows. At the time, single family housing starts, the most critical input to the company's growth, were really only starting to recover. Adjusted for population growth, they were just barely coming off 50+ year lows. Though the company had a lot of debt, it was all backstopped by valuable assets in the form of inventory and real estate. The real estate component was probably the most interesting aspect of the investment at the time as the full value didn't show up on the company's books because the marks dated back to the 1980s due to the company's winding corporate history. All in all, when we first invested we were buying the company around $.30 to the $1 on NAV and below my calculation of theoretical liquidation value. There were no sell side analysts covering it, and I felt we had established an information edge on a company that looked like one thing to many, but something entirely different to me.

Unfortunately, this investment got off to a rocky start. We were two quarters early and started buying somewhat aggressively right in front of the small-cap downturn that emerged in 2015. We of course double and triple checked our work. But nothing other than the price suggested the investment thesis was wrong, so I knew we just had to wait it out and maintain conviction. Slowly but surely the envisioned catalysts began to unfold and the company we originally bought as cheap on asset value was beginning to emerge as cheap on earnings. This past winter a few other developments occurred, one of which was the exit of their controlling shareholder which gave us an attractive opportunity to add to our position.

## And you think it's still attractive? What's your outlook for the firm over the next 12 – 24 months?

The outlook is quite positive. As I mentioned, this began to look cheap on this year's earnings which I thought may come in around $2 a share when it was entering the year. That's clearly not a bad purchase considering the secondary offering priced at $7 in October. But then when they acquired their larger peer this March, that outlook got even better.

It's a pretty impressive deal. They were doing $44 million in EBITDA on an LTM basis and bought their larger peer who had a $60 million EBITDA run rate. And because the businesses are so similar and much of the distribution center networks overlap, there are huge cost synergies available by rightsizing the network to match the new footprint of the combined businesses. They think they can get $50 million in synergies which means they are also effectively de-levering the company through the process. The math suggests $8 of earnings power will emerge sometime next year.

## And what could derail your thesis?

Management will need to prove that they can execute on the synergy case the deal is built on. While this is a new challenge for this team, they have proven to be highly effective operators thus far and have also generally leaned on the conservative side in terms of their communication with investors.

The synergies come almost entirely from cost cuts and the rightsizing of the distribution center network which gives me greater confidence they are realizable than they would if they had been built around revenue or cross-selling initiatives. The greatest risk in my view would be the housing market rolling over. This is out of everybody's control and not something I am expecting, but it would delay the company's ability to realize the earnings' power from the recent acquisition.

## Sounds like an exciting opportunity. Moving back to your investment process and the '4 M's,' can you offer a bit more insight into what you're looking for in a moat?

I'm primarily looking for some quality that gives the business some durability, or some reason to believe the business will still be here tomorrow (and preferably in better shape than it is today). This obviously can come in many forms; a valued brand, economies of scale, network effects or customer switching costs are the major sources.

Much of our work has focused on distribution companies which can frequently benefit from a flywheel effect of increased scale. As they attract new customers, they aggregate buying power which enables them to offer lower prices and in turn attract more customers as they share their purchasing advantages.

> *“Much of our work has focused on distribution companies which can frequently benefit from a flywheel effect of increased scale. As they attract new customers, they aggregate buying power which enables them to offer lower prices and in turn attract more customers as they share their purchasing advantages.*

Lately we have had success in identifying companies that have strong brands but have experienced temporary execution issues or have fallen out of favor for one reason or another.

**When you're looking for the best management teams, what qualities are you on the lookout for? Do you require managers to be substantial investors in the business themselves?**

Well, I certainly prefer for them to be substantial investors in the business, but it's not a required element to greenlight an investment. What is required however, is a sensible pay package using shareholder friendly incentive metrics that puts us as minority investors in as close alignment as possible with the management team. The consistency of this principle never ceases to amaze me. You always, always, always get what you incentivize.

In terms of evaluating a team, we look for two things. The first is operational execution ability. We need to find some reason to believe management can execute on the goals they are targeting. Normally, we can evaluate their track record, either at that company or at a prior place, but we need to believe they have the right strategy in place and that they can execute on it. The other critical element is capital allocation acumen. At a minimum we want to see that they understand this concept which we can do through conversation, but we prefer to be able to point to an identifiable track record that indicates this understanding.

**I'd like to end this section by asking what has been the biggest mistake you've made at Choice, and what did you take away from the experience (how have you refined your investment process?)**

While it has become a very profitable investment for us, it is hard not to view the trading strategy around entering the BXC position as a significant mistake, particularly considering the impact it had on performance. We have only had one year of underperformance and that came in 2015. This result was nearly entirely driven by our large position in BXC that ended the year with a very unfavorable mark. While we have had our fair share of mistakes, I have generally been very averse to taking losses and for the most part have done a good job of not allowing any single position to cost us too dearly. Though we have been proven right on value and have ultimately been compensated for it, 2015 was still a rough year and a major learning experience.

Since then, I've made two major changes. I used to run the portfolio as a five to eight stock vehicle. That's a lot of concentration, even for me. The principle reason is on the capital preservation side. If you have a big position go against you, it can hurt. Even if it is only price risk, the portfolio might not be in the position you want it to be when other opportunities come along. The second reason is on the return side. We try to own good growing companies that are undervalued with catalysts or other good news on the horizon. That can be hard to balance with just a few names and a multi-year investment outlook. If you have a large position that doesn't produce for a while, that's a big opportunity cost. These things become a little easier to balance with 10 – 15 names.

I have also made a point to adjust our position entry strategy, and we now seek to space out our buys over both time and price levels. This is a more conservative approach, and we have certainly left some money on the table as a result. Still, on an odds-adjusted basis, I feel our chances of success have improved. Generally, we are looking for big meaty moves and are often trying to buy our companies at inflection points. If we are right on value, there is likely plenty of time for us to add once the market starts to come around to our view.

# **Choice Equities:** Stock Idea One

### You've picked Drive Shack (DS) as your first small-cap idea. How did this company first arrive on your radar?

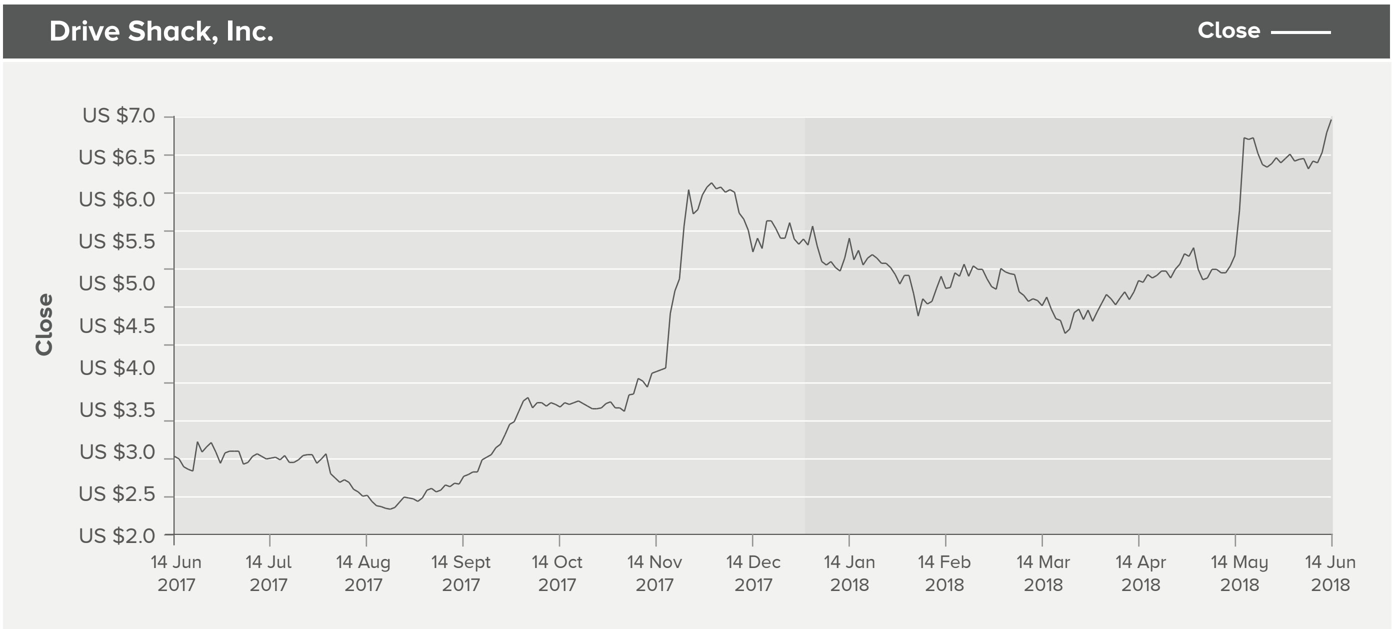
Drive Shack is actually the first non-distribution company I added to the portfolio. I first learned about it one morning when I was reading the local paper when I found out there was one coming to my hometown here in Raleigh. I started looking into it and learned it was converting from a REIT named Newcastle owned by Fortress to a C Corp company focused on the golf business. This turned out to be a pretty easy one to get good information on in part because one of their first locations would be here. I soon learned the company would have a representative in town for an upcoming Board of Adjustments meeting in downtown Raleigh to address the final zoning requirements to get permitting for their upcoming site.

Though the meeting was open to the public, needless to say, I was the only investor there trying to learn about Drive Shack. This turned out to be a helpful point of due diligence.

At the time, shares were selling off pretty hard as the investors that had been in the REIT for the hefty dividend began scrambling for the exits after the company adopted the C Corp structure. In many ways, the setup offered exactly what we're looking for in our investments: limited downside and big upside. The company was in transition, but value was backstopped by the balance sheet and the American Golf business.

There was indiscriminate selling from dividend investors, but the company had a big opportunity in front of them with the golf entertainment business. The chairman was buying heavily in the open market, but there were no sell side analysts around to tell the story.

*"There was indiscriminate selling from dividend investors, but the company had a big opportunity in front of them with the golf entertainment business. The chairman was buying heavily in the open market, but there were no sell side analysts around to tell the story.*



| Share Information June 15, 2018 | | | |
|---|---|---|---|
| **Market Cap.**<br>$468m | **P/E**<br>N/A | **EV/EBITDA**<br>N/A | **Dividend Yield (ttm)**<br>N/A |
| **Average Daily Volume**<br>126,445 | **P/B**<br>3 | **ROIC (ttm)**<br>N/A | **Debt to Assets (ttm)**<br>26% |

## Let's dive into the four critical success factors you mentioned earlier. How does the company score on:

### Moat:

#### What is the moat?

The moat, which in this case is an emerging one given the infancy of the company and the concept, will be driven by its brand. Top Golf invented the category and has a real first mover advantage. But the category is a growing one, and it certainly looks to have room for a fast follower like Drive Shack.

#### Do you see the moat expanding?

I do, but you'd have to say it'd be coming from a low base as the company only got their first site in the ground earlier this spring. The concept itself dates back to 2001 in England, but it didn't really start picking up steam until the last five years or so with TopGolf now having about 40 properties in operation. The opportunity is a big one and both companies suggest the total addressable market could be in the 100s after factoring in potential expansion abroad. The facilities, which cost $25-30 million to build, aren't cheap and provide some barrier to entry. As Drive Shack broadens out its footprint, it seems natural to expect steady execution to support a growing brand in a large category.

#### What risks are there to the moat?

Some have suggested a lethargic golf industry isn't good for this concept. I actually think that plays in your favor as the game of golf tries to bring new players to the game with offerings that are more casual, take less time and are better suited to the tastes of the Millennial generation. As with all companies and particularly those in the entertainment and hospitality space, the company simply must execute and provide an experience its customers enjoy. TopGolf certainly has the better brand at this point, but the opportunity is large and should be able to accommodate two players.

### Management:

#### Who's in control?

Sarah Watterson is the CEO. At 30 years old, she is young, but she has a fantastic resume. Wes Edens, founder of Fortress and part owner of the Milwaukee Bucks, is Chairman of the Board and from what we gather is heavily involved.

#### What do you like about them?

Mr. Edens has clearly had a successful business career, so that's an obvious plus. And the company itself looks to be making the right moves so far. They have exited the distressed debt business and look intent on exiting the golf course business. Those proceeds will be used to finance their move into the golf entertainment business, a sound strategic move that suggests strong capital allocation acumen. They have also adopted the C Corp structure and eliminated the external management contract that is somewhat common in REITs but frowned upon by C Corp shareholders. It appears they are getting this company ready for primetime and an institutional quality shareholder base.

#### How long have they been there?

Both Sarah and Wes have been with the company since it was Newcastle with Sarah originally signing on at Fortress in 2011.

#### How much stock do they own (if applicable)?

Wes Edens owns 6.8 million shares or ~$44 million worth at recent prices and has recently been buying more. Though he is already wealthy from his prior endeavors, it is nice to see him buying in the open market. As a 10%+ shareholder, he stands to benefit significantly if the company is a big success.

## Money Flows

The facilities cost $25-30 million to build and on average are expected to do something around $5 million in EBITDA per site suggesting solid cash on cash returns in the 20% range.

## Reinvestment opportunities

### Where are the opportunities?

The original focus is on domestic sites and the company has plans in the works to have five in operation over the coming year. They have suggested a pace of five new builds per year is reasonable in the near term.

### How is the company funding growth?

Initially the growth will be funded with the proceeds from the exit of the golf course and distressed debt businesses which we estimate could leave the company with $230 million to $250 million of cash to spend. This should provide enough capital to put another nine facilities in the ground. Beyond that, we anticipate cash flows to fund future expansion opportunities.

### Risks to reinvestment?

Oversaturation or new competition is a risk but that looks unlikely based on the current market penetration levels. The facilities also take 9 months or more to build, so it takes a while to get these sites up and running.

### So after considering all of the above, what sort of growth rate to you expect the company to be able to achieve over the next few years and how does that factor into the current valuation?

Assuming successful execution, upside is not difficult at all to imagine. With 10 sites in the ground at some point over the next two years, they could do $50 million of EBITDA. Applying a 15x EBITDA multiple to that would suggest a stock price a little north of $10.

“*With 10 sites in the ground at some point over the next two years, they could do $50 million of EBITDA. Applying a 15x EBITDA multiple to that would suggest a stock price a little north of $10.*

Certainly a 15x multiple is a hefty one, but given the white space and potential trajectory of earnings, it doesn’t seem too unreasonable.

### And finally, what’s your downside scenario if the firm does not grow as expected?

In a downside case, the 10 facilities may only earn $4 million of EBITDA and warrant a 10x multiple which would suggest a ~$5 share price.

# **Choice Equities:** Stock Idea Two

### Your second pick is Reed's Inc. What first attracted you to this opportunity?

This one came through the network like many of our ideas do. I was talking with a fellow investor about a few names this spring and he mentioned this one, suggesting it was worth a look given the situation may have changed. I started digging in and began to get pretty interested. One of the first things I did was check some of the online investor communities I am in, SumZero, Value Investors Club and MicroCap Club. The commentary, which in a lot of cases follows the lifespan of the company in real time, was quite revealing and you could practically feel the investor fatigue around this story.

Chris Reed, the company's founder, had really done an impressive job creating the category and building a big lead as the nation's top ginger beer provider, but they had their share of missteps too. The most costly was an ill-fated and strategically questionable foray into expanding their manufacturing operations with a major investment into a new plant in 2015. Not only did this divert capital away from marketing spending and brand building initiatives, but it also brought operational execution risk into the picture. Later that year the company began having problems fulfilling its commitments to customers, and the company got pinched with added costs and lost sales. Long story short, a giant mess ensued which ultimately led to the installation of a new board and management team last summer.

### And how does the company score on your '4 M' criteria?

#### Moat:

### What is the moat?

The moat in this case is also a brand. Despite the prior execution issues, Reed's Ginger Beer is still the number one player in the ginger beer category. It's a niche little market that is growing nicely around mid-teens percent per year and is benefitting from a number of trends in the cocktail and craft beverage market. Virgil's, the company's craft soda line also has a strong market position in a category that is potentially underpenetrated that is also growing nicely around mid-single digits per year.

### Do you see the moat expanding?

I do, but there is also work to be done to restore the company's reputation. With the problems in 2015 and 2016, the company left a lot of commitments to retailers and other distribution partners unfulfilled. The new management team looks to have their eye on the ball and has realized the importance of restoring and developing these relationships. With stability returning to company operations, the company will soon begin devoting a greater focus of their efforts towards marketing, something which the company has really done very little of, particularly of late.

### What risks are there to the moat?

As I mentioned, the ginger beer category is on trend and growing nicely, so competition has naturally followed. Gosling's is the competitor with the next highest market share, and the two brands are well out in front of others. However, it's worth noting that Gosling's doesn't use actual ginger in their ginger beer, a factor that seems to be becoming more important as consumers seek products with higher quality and more authentic ingredients. Bundaburg, an Australian company, is a wild card and definitely needs to be monitored, especially considering their recent distribution deal with Pepsi. Other craft players have emerged though few operate at any substantial scale. The possibility exists the company missed its window to dominate the category and new competition has regained lost ground. But still, Reed's remains in a strong position along with Goslings, and is currently the only scaled player that offers ginger beer with actual ginger in it.

#### Management:

### Who's in control?

Val Stalowir became the CEO last summer. He was brought on by new Board Chairman John Bello.

### What do you like about them?

I like that they've both done this before. Val Stalowir has good experience in the branded beverage space and also has demonstrated an ability as a proven operator in prior CEO roles. John Bello has also done very well in this space. He founded SoBe which was ultimately sold to Pepsi. And he was Chairman of the Board at Izze when it was also sold to Pepsi.

> *“I like that they've both done this before. Val Stalowir has good experience in the branded beverage space and also has demonstrated an ability as a proven operator in prior CEO roles. John Bello has also done very well in this space. He founded SoBe which was ultimately sold to Pepsi. And he was Chairman of the Board at Izze when it was also sold to Pepsi.*



### How much stock do they own (if applicable)?

Accounting for options and RSUs, Val Stalowir has about 1.6 million shares in total, so that's a nice carrot for him if they can capture the growth of the category. John Bello owns about 700k shares, much of which he received through his participation in a rights offering last year. While he owns a decent amount, he has recently been adding to his stake in the open market.

## Money Flows

The company is in the midst of a transition to an asset light strategy. The sale of its L.A. based plant will finalize the move away from the capital-intensive manufacturing operations and going forward the company will devote most of its resources towards marketing and brand building. The cash flows had a big hiccup a few years ago but look to be more predictable on a go forward basis. The company has appropriately chosen to focus on only their most visible brands, Virgil's and Reed's, as these two categories are growing at mid-single digits and mid-teens levels annually, respectively. These figures are most reflective of our base case, though we certainly see the potential for these lines to outperform their categories.

## Reinvestment opportunities

### Where are the opportunities?

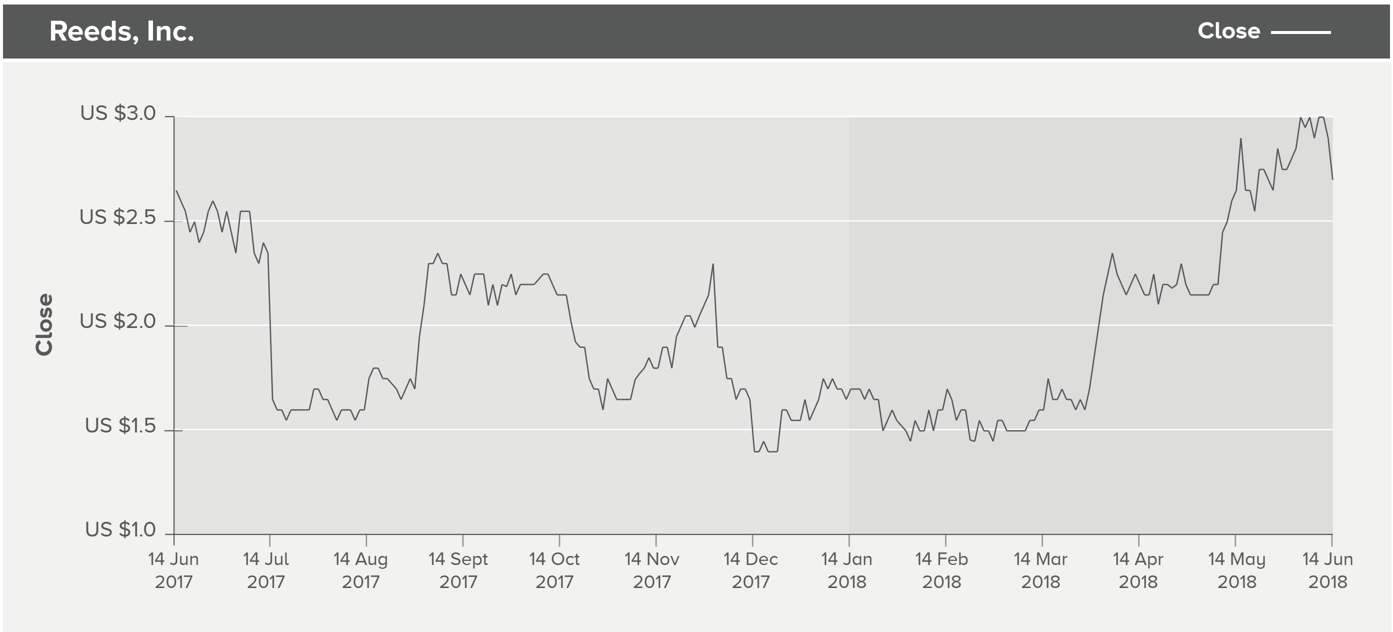
Presently the company is most focused on its ginger beer and craft soda brands. I would expect that to remain the case in the near term. Further down the road, other possibilities may exist which present some optionality, but the greatest near-term return on their incremental investable dollar will certainly be had by furthering the leadership position of its two solid, but under-nurtured brands.

### How is the company funding growth?

New management came in on the heels of a rights offering backed by an activist investor, but now that the balance sheet is in better shape, they will self-fund their marketing dollars from internally created cash flows.

### Risks to reinvestment?

It could turn out that competition in the space negates the return or effectiveness of a marketing campaign. This is something we will have to monitor. But for now, we hold the view their customers value their product and think awareness and a lack of availability have been the biggest impediment to greater growth.




**Share Information June 15, 2018**

| | | | |
|---|---|---|---|
| **Market Cap.** $67.6m | **P/E** N/A | **EV/EBITDA** N/A | **Dividend Yield** N/A |
| **Average Daily Volume** 22,359 | **P/B** N/A | **ROIC** N/A | **Debt to Assets** 377% |

## How does all of the above reflect in the company's current valuation?

Valuation has expanded recently, in part driven by the realization much of the ongoing enterprise risk has likely been alleviated after their true near-death experience prior to the recapitalization last year. Takeout multiples over the last ten years have tended to occur around the 2 – 4x sales level. We think the company could potentially double sales in three to five years. A takeout around those levels would imply a stock price in the $5 to $8 range.

*"Takeout multiples over the last ten years have tended to occur around the 2 – 4x sales level. We think the company could potentially double sales in three to five years. A takeout around those levels would imply a stock price in the $5 to $8 range.*

## If there's no takeover, what's the downside risk?

If the company has in fact missed its window and is unable to grow as expected, an exciting return is unlikely to result. But with improving operations that will be generating cash, the company will no longer be in a position where it will have to depend on the kindness of strangers. So aside from price volatility, we think fundamental downside doesn't run too far below recent trading levels.

# Command Centre Idea

**Jay Smith runs a long-biased hedge fund which hunts for deep value in micro-cap stocks while shorting fraudulent ones .Jay formerly ran a broker-dealer and has experience in the investment banking industry having worked at top banks such as DLJ and Wasserstein Perella .Jay has an MBA from Wharton and a BSBA from Washington University.**

Command Center (CCNI) is a temporary staffing company that, with the assistance of a new Board and a new CEO, should generate improved financial results (after generating anemic growth under previous leadership) going forward and, more importantly, sell itself at a large premium to the current stock price.

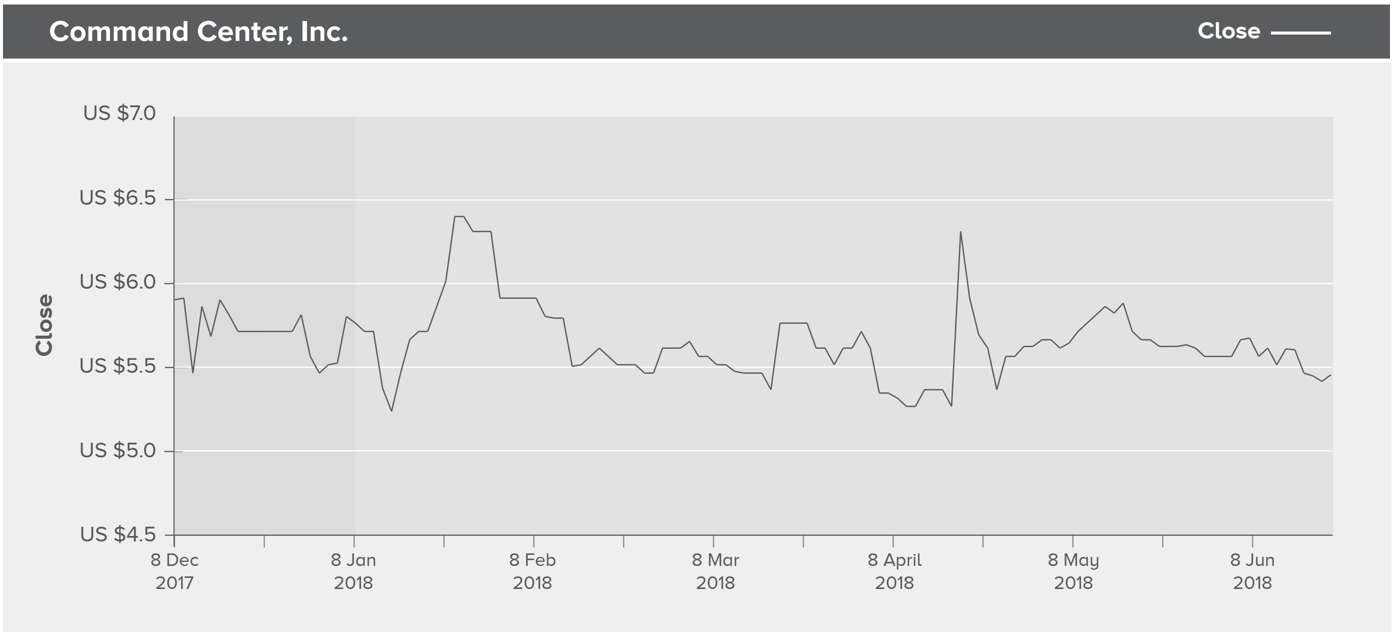
The stock trades at 4.8x our LTM adjusted EBITDA, and EBITDA should increase in the coming months. Pro forma for readily identifiable cost savings, the stock trades at 3.8x LTM adjusted EBITDA and the company has hired bankers to sell itself.

*“The stock trades at 4.8x our LTM adjusted EBITDA, and EBITDA should increase in the coming months. Pro forma for readily identifiable cost savings, the stock trades at 3.8x LTM adjusted EBITDA and the company has hired bankers to sell itself.*

The company is also buying back stock but is limited in its ability to buy back as much as it would like due to trading volume restrictions. We believe the stock trades so cheaply because it is small, illiquid, has historically traded on the OTCBB (but was just uplisted to Nasdaq), has no analyst coverage, has historically done little investor relations and suffers from investor fatigue

Command provides flexible on-demand employment solutions to businesses in the United States, primarily in the areas of light industrial, hospitality and event services. Through 67 field offices in 23 states, the company provides employment annually for approximately 33,000 field team members working for over 3,200 clients. The company directly benefits from an improving job market. For more information about Command Center, go to commandonline.com.

Under the previous CEO, CCNI generated very little organic revenue growth despite the incredibly strong job market in the US. Last year revenue increased only 1% excluding the impact of an acquisition. We believe the company grew so little because the former CEO was a cost-cutter, not a revenue grower and because he was very focused on fighting off a threatened proxy fight which was eventually launched by Ephraim Fields, one of the company’s largest shareholders. Fields wanted to replace management and the Board. The end result of his proxy fight was that the CEO was replaced as were four of seven Board Directors (including the Chairman).




## Share Information June 15, 2018

| | | | |
|---|---|---|---|
| **Market Cap.**<br>$27.5m | **P/E (ttm)**<br>47.6 | **EV/EBITDA**<br>10.1 | **Dividend Yield**<br>N/A |
| **Average Daily Volume**<br>8,700 | **P/B**<br>1.5 | **ROIC**<br>18% | **Debt to Assets**<br>N/A |

The company generates meaningful free cash flow as it has minimal capex requirements, virtually no debt and any increase in revenue should have a material impact on the company's profitability. Net cash represents approximately 22% of market cap so we believe the company is overcapitalized and if a sale does not occur, the company will more aggressively return capital to its shareholders through a tender offer or special dividend.

## Sale of the company

We think the company will be sold because:

Bankers have been hired to advise the Board's "Strategic Alternatives Committee"

A strategic acquirer should be able to pay a significant premium for the company and still have the deal be accretive

The Board and large shareholders appear to want a sale of the company

The new CEO is incentivized to sell the company

Last year, before the proxy fight, the board created a Strategic Alternatives Committee, we believe in response to receiving a buyout offer. The Committee "is empowered to identify and evaluate strategic opportunities available to the company, which may include a sale, acquisition, or other value-maximizing transaction. The Committee has engaged the services of an investment banking firm to assist the Committee in fulfilling this assignment."

We believe the committee is and its bankers are actively pursuing a sale of the company but that the sale process was put on hold while the proxy fight was ongoing. Now that the proxy fight has been resolved, we think the bankers will be hard at work selling the company.

Our confidence that the company is pursuing a sale was strengthened by earlier this month when in announcing Q1 earnings, the new CEO stated: "In the coming months, as part of our continuing Strategic Alternatives Process, we plan to carefully evaluate multiple opportunities to drive and unlock value for shareholders."

We also think the new CEO's contract signals the sale of the company. He has a one year contract with no change of control bonus but a bonus upon the sale of the company of the greater of (a) 0.5% of the sale of the equity of the company or (b) $200,000.

## EBITDA Analysis

Reported LTM adjusted EBITDA is $4.2 million. However, that includes $360k of non-recurring expenses related to the proxy fight, so adding that amount back implies $4.6 million of adjusted EBITDA.

We believe an acquirer can achieve significant revenue benefits/cost savings from two buckets:

Easily quantifiable : Eliminate CEO, CFO, General counsel, Board, Audit, other public company expenses

Less easily quantifiable: Run branches better (should be easy to do), eliminate HQ rent expense, eliminate some of 30 employees in corporate office, eliminate middle management, close duplicate offices, etc.

**Based on 2017 results, we estimate bucket #1 to total over $1.0 million in cash as follows:**

| | |
|---|---|
| CEO compensation | $275,000 |
| CFO compensation | $210,000 |
| General counsel comp | $205,000 |
| Board of Directors comp | $195,000 |
| Audit/tax expenses | $200,000 |
| Other public co expense | $100,000 |
| **Total** | **$1,185,000** |

We have not tried to quantify bucket #2 but believe it would amount to a significant figure.

The new CEO started April 2, 2018, so his impact was not reflected in Q1 results. Q1 is seasonally a weak quarter due to winter weather. We believe the former CEO significantly harmed morale at the branch level and that Mr. Coleman should be able to repair some of the damage within the organization. Coleman has for the past few years been a director at Hudson Global, a worldwide provider of highly specialized professional staffing, so he understands the importance of maintaining high morale within a staffing company.

## Valuation

| | |
|---|---|
| Enterprise Value/LTM Reported Adjusted EBITDA of $4.2 | 5.2x |
| /plus :proxy expense of $370k | 4.8x |
| /plus bucket #1 cost saves of $1.2 million | 3.8x |
| /plus bucket #2 cost saves (TBD) | TBD |

## Stock buyback

We believe the stock's downside is minimized by the company's buyback program. Like many microcaps, the company is not able to buyback as much stock as it would like because of volume limitations. However, as the below table shows, the company has been buying stock at prices above the current stock price. The company's has $4.5 million of availability under its buyback program.

| Month | Total shares | Average Price per Share $ |
|---|---|---|
| Mar-18 | 7,100 | 5.62 |
| Feb-18 | 10,541 | 5.83 |
| Jan-18 | 4,820 | 5.75 |
| Dec-17 | 12,152 | 5.88 |
| Nov-17 | 22,634 | 5.65 |
| Oct-17 | 22,625 | 5.3 |

# Disclosures