



July 24, 2019

Dear Investor:

Markets resumed their upward climb in 2Q with large caps again leading small caps as can be seen in the accompanying performance table. Large caps in the S&P 500 have now posted a gain of +10.4% over the last twelve months compared to a loss of -3.3% for the small caps in the Russell 2000 over the same period. Interestingly, this ~14% divergence in performance now stands at levels just shy of the greatest disparity seen in the last 30+ years. By comparison, our portfolio had both winners and losers in the quarter, netting out to -.5% net performance for the quarter. This latest update now means \$1 invested in our portfolio since becoming independent in 2017 is worth \$1.49 versus our Small/Large blended benchmark of \$1.24.

EXECUTIVE SUMMARY

In this letter, we will highlight the notable performance drivers in the quarter as usual with closer looks at Destination Maternity and Bluelinx. We will then discuss new portfolio addition PAR Technology before closing with a few thoughts on the outlook.

NOTABLE PERFORMANCE DRIVERS

Our lumpy performance continues to be just that, with up and down months this quarter netting out to just under flat performance. Reed's Inc. and SiteOne Landscaping were the largest positive contributors to the quarter, adding +3% and +2% respectively. SiteOne continues to execute its rollup strategy as it expands on its wide leadership position in landscape supply distribution, and Reed's shares have performed well this year as management has demonstrated good progress in revitalizing the company's category-leading brands. We point our readers to our follow up [interview](#) with Hidden Value Stocks just last month for a complete update on Reed's as well as Drive Shack. The interview also contains a deep dive on holding Rubicon Project.

Other small gains were offset by a -3% loss in Destination Maternity (DEST), a position we exited and Bluelinx (BXC), where recent additions into a falling share price detracted -2% from performance in the quarter.

DEST – Regarding Destination Maternity, after the company's 4Q 2018 report which I described in our last letter, I determined that I wanted to see at least one more earnings report from the company before I made any further decisions on how to manage our position. Sentiment was rotten after the 1Q report featured mixed results and soft margins, but I reasoned the share price gave little credit to an interesting niche brand pursuing an appropriate strategy to capitalize on its value. After an in-depth review of their earnings results, I thought it'd be reasonably likely we'd see stronger gross margins and improving trends in their eCom business in the upcoming quarter, and that investor perceptions could change in a hurry with only a moderate improvement in performance.

Of course, at the time I made this decision, I did not anticipate the market would go through the worst month of retail share [performance](#) in the last ten years. I also did not anticipate further changes at the board level that would undermine my confidence in operations underway in the C suite. Real time reads on mall traffic going meaningfully negative would further weaken my confidence in the situation. With these signposts emerging after making the original decision to hold, I began to trim our position in anticipation of upcoming results and cut exposure in other retail names, limiting other losses there to less than half a percent.

When the company announced quarterly results, gross margin was indeed better. Unfortunately, little else was. With diminished confidence in the outlook, I chose to exit our position. Generally, our investments in the turnaround / temporarily depressed fundamentals category have paid off well for us. A key guiding principal has been to invest only once the business's fundamentals have stabilized. Importantly this critical turning point frequently marks the low in price, even if it can be hard to judge in real time. As I review our investment here and particularly our entry point last summer, it is clear I misread DEST's then double digit eCom sales growth as sustainable and indicative of the fact the business had stabilized. Moving on.

BXC – As for Bluelinx, we have recently been rebuilding our position in shares given the current setup again looks quite compelling. One reason is because shares look like quite a bargain in the low \$20s versus near term earnings power of \$7. Another reason is the market's strikingly similar treatment of their recent acquisition to a prior well-regarded acquisition by fellow building product distributor Builders Firstsource ("BLDR" or "Builders"). Though Builders is a one stepper primarily focused on serving builders as their end market customers and Bluelinx is a two-stepper focused on serving lumberyards as their end customer, the parallels that can be observed from the market's treatment of Builders' acquisition of peer ProBuild in 2015 appear too numerous to dismiss.

Investors initially loved the ProBuild acquisition, and it's not hard to see why. Builders' paid a full 10x EBITDA for a quality company, but massive cost synergies realizable from consolidating the two overlapping networks suggested their effective purchase price would be closer to 6x EBITDA after a successful integration. The combined entity would be more than three times as large and benefit significantly from economies of scale in purchasing, footprint rationalization, logistics and an expanded product offering. The new company would become the second largest distributor serving the building products space, and perhaps more importantly, would be the largest in most of their geographical markets. Once synergies would be realized, the company anticipated cash flows would be up over three-fold. Shares quickly doubled.

Six months later, sentiment would change abruptly. Shares would soon be cut in half. Housing market conditions would soften, and the company's expected cash flows would be rerated down on the back of slower end market growth. Shareholders that once praised the company for using debt instead of equity to finance the deal would shift their focus to the debt load and softening end markets instead of the potential earnings accretion. And then a new factor would emerge that would perhaps prove most poisonous to sentiment about the merits of the deal: revenue dissynergies.

Despite the dissynergies' relative surprise, their emergence is not an illogical outcome given the natural tendency of buyers to want a few competing sources of supply, particularly in times of relative disruption that can often accompany acquisition integrations. Think of it this way. If buyer A in town B wants to source product C competitively, buyer A will likely get a couple quotes, a process often colloquially referred to as "three bids and a buy". If distributor X, Y and Z compete to supply those bids and distributors X and Y who are the generally preferred suppliers join forces, it seems reasonable that distributor Z may win some incremental business, if only so buyer A can ensure a consistent source of supply of product C as needed. Though these changing purchasing allegiances are a deterrent to the realization of the targeted synergies, they often prove temporary as price and service will eventually win the sale. Given the purchasing power distributors X and Y gain from consolidating operations, these lost sales can often be recaptured as business disruptions subside once operations have been integrated.

But in the case of BLDR, even though the revenue dissynergies would prove marginal relative to the cost synergies and in many cases temporary, the cash flow shortfall from prior expectations and questions around the synergy case would be enough to cause investors to doubt the merits of the deal. Many would

dismiss it as a top of the cycle misallocation of corporate resources - until just a few quarters later when sentiment would again swing. Interest rate increases would go on hold. Housing market conditions would improve. And Builders' would begin to show clear execution on the ProBuild synergy case. Ultimately the originally expected cash flows and earnings stream would show up. It would turn out that the synergies which had been doubted, had only been deferred. Shares would triple.

So how does this compare to Bluelinx thus far? It looks like we may be about halfway there. Shares enjoyed their big surge last spring as investors greeted the highly synergistic deal with great enthusiasm. But two quarters later surging interest rates would curtail growth in the housing market. Investors expectations of near-term cash flows would be revised down, and shares would ultimately get cut in half. In the 1Q 2019 report, a few revenue dis synergies showed up, causing some to doubt the merits of the deal.

So, where do we go from here? As always, it's impossible to know for sure. But there are many positive signs. Interest rates have come in meaningfully from year ago levels, suggesting housing conditions may again start improving in the back half of this year consistent with the six to nine month lag in improvement we have seen in recent declining rate environments. Lumber mills have curtailed production at some of their of less profitable mills, rationalizing supply and likely putting a near-term bottom in on lumber prices. And we have already seen considerable improvement in gross margins from purchasing synergies which will likely continue. Though the coming 2Q report will not be great from an organic growth perspective given still negative year-over-year growth in housing starts, it will likely mark an inflection point to improving conditions. It will also feature nearly \$60M in proceeds from real estate sales that will help pay off the debt used to finance the deal. Counting real estate monetization proceeds and expected cash flows from operations, we see an opportunity for the company to pay off their term loan in its entirety by the end of next year, leaving it with a normalized capital structure featuring only a moderate revolver to finance working capital needs. So soon, we'll have clean consolidated financials, and maybe even some sellside analyst coverage shortly thereafter. The setup again looks quite attractive.

PORTFOLIO ACTIVITY

PAR – PAR Technology is a company I have been intrigued with for a while now. When shares fell after the company announced a capital raise via a convertible debt offering in early April, I thought it was worth taking a closer look. Thinking of just the person to chat with about this one, I immediately reached out to my friend Jeff Brock, restaurant [guru](#) and founder of [Hargett Hunter Capital](#), a restaurant-focused private equity shop here in Raleigh. I asked him about Brink, the company's cloud-based Point of Sale (POS) offering. When Jeff told me that one of the first things he did after he acquired young concepts Bellagreen and ChopShop was to rip out their old POS systems and replace them with the Brink product, I knew we were on to something interesting.

So what is PAR? Founded in 1968 by John Sammon, PAR which stands for Pattern Analysis and Recognition, was originally focused on providing outsourced research services to corporations and particularly the U.S. government. As a result of a perhaps unfocused but opportunistic corporate history, this sleepy company is currently organized into three corporate segments.

The first segment, government contracting, is the business around which the company was originally built. It is a contracting business where PAR provides IT services and solutions to the department of defense, military, etc. This segment is a completely standalone business that has been a reliable generator of cash which the company has typically used to fund projects in other segments.

In the 1980s, PAR added its second segment: Restaurant Point-of-Sale computer systems. In this segment, PAR sells two things: a physical POS terminal that they assemble in their upstate New York warehouse

and an on-premise software package called PixelPoint. In addition to McDonalds, the legacy segment customer list also includes Taco Bell, Subway, Jack-in-the-Box, Hardees and Pizza Hut.

Finally, Par's third and most interesting business segment is Brink. This unit started in 2014 when PAR acquired Brink Software, a small entrepreneurial operation out of San Diego. The Brink offering accomplishes many of the same POS functions as the legacy hardware business, but the software component is delivered via the cloud and accordingly offers a few critical advantages. For one thing, updating software is seamless with an off-premise offering as it can be initiated from the cloud and updated onsite without any further physical software or hardware add-ons. Additionally, customers get to convert their large and lumpy and sometimes difficult to forecast hardware capex spend to small ongoing monthly payments that are highly forecastable. This business has already turned into a fantastic acquisition, with sales up 25-fold since it was acquired. But we think Brink may be just hitting its stride.

Today Brink has around 8,000 installed restaurants and an impressive customer list. This list includes new customer wins in growing concepts like Sweetgreen, Mod Pizza and Cava but also established concepts like Arby's and Five Guys. Focusing on the U.S. market first, there are a little over 300,000 quick serve and fast casual restaurants. Brink is currently focused on the Tier 1 and Tier 2 segments, which total ~170,000 locations as their core competency and differentiation comes from not only their ability to serve these multi-location customers successfully, but also their ability to handle these large-scale integrations seamlessly. We note our research indicates Brink is the only cloud POS provider who has successfully completed a 1,000+ store rollout, of which Brink has two to its claim. Given existing relationships with customers with a total restaurant count near 35,000 restaurants today, they appear well positioned to continue to convert both existing and new customers alike to the Brink solution.

Looking out over the next year or two, we think it's conceivable that Brink could sign up at least 20,000 restaurants. Beyond this, we see upside potential to this number from wins in the tier three category, and looking further out, international expansion. In addition to restaurant growth, we also think Brink could grow their monthly recurring revenue (MRR) per customer. Currently they earn just under ~\$200/month from their cloud customers, or around \$2,000 in average revenue per user (ARPU). Given the POS offering is typically regarded by restaurateurs as the brain or control center of the restaurant, we believe other add-on functions like food temperature monitoring, delivery optimization or inventory management features could be added into the Brink software package driving MRR higher. And the company is currently planning on introducing a payments solution which would be further additive to MRR.

So, the opportunity is immense. And the company appears well positioned to capitalize on it based on their well-regarded Brink offering and existing customer relationships. Importantly, we have also come to develop a favorable view of management as CEO Savneet Singh appears to be doing all the right things since becoming full time CEO in December 2018. In his short time there thus far, he has instituted an organization-wide focus on return on invested capital and has taken important steps to improve corporate communication by providing greater transparency to investors. Notably, he has the company focused squarely on the Brink offering.

Given the multiple business segments, we believe it's best to look at PAR as a sum-of-the-parts story. The government business throws off around \$8M in free cash flow per year. We think a 9x multiple on free cash flow is reasonable, implying a valuation of \$72M. The restaurant business excluding the Brink software component generated ~\$125M in revenue last year. Assuming a .7x multiple of revenues on this business which has an approximate two thirds to one third weighting of hardware to recurring revenues, we see value of ~\$88M in this segment.

But the real promise lies with the cloud-based Brink software business. The market is currently putting a great deal of value on these types of high growth SAAS revenue streams, in some cases with exorbitant sales multiples of 15x or higher. With Brink, however, we think an elevated multiple of sales is justified due to the growth and market penetration. Looking out to the end of 2020, we see an opportunity for Brink to be in 20,000 restaurants with their software offering. Assuming MRRs of \$200 to \$250 and a 10x sales multiple, an elevated but seemingly prudent level for a business early in its infancy with sales growth likely continuing to double on an annual basis, we see a business with \$480-\$600M of value. We note we exclude any incremental lift in MRR from a payments business the company expects to launch later this year, even though we believe it's possible this could one day become the largest revenue driver for the company in a blue sky scenario.

Adding up all the pieces and accounting for a recent convertible debt offering, we see a credible path to a valuation around \$36 to \$43 next year. With a cost basis in the low \$20s on a position initiated shortly after the convertible offering, we look forward to seeing management execute on what looks to be a truly unique opportunity in front of them.

2019 OUTLOOK

Today's environment is an interesting one. It seems we again have a dual speed domestic economy with some echoes from the 2015/2016 period. Many industrial businesses are importing weakness from abroad as they delay purchasing decisions due to trade uncertainties while the consumer appears generally healthy. Current indications suggest we will likely narrowly avert another brief earnings recession, partly due to stronger performance from more domestic oriented businesses. As a case in point, consider that S&P 500 companies with 50% or more of their sales sourced domestically appear poised to grow earnings in the low-single digit range versus their more internationally focused counterparts expecting negative mid-single digit earnings growth.

At the same time, we have recently seen small cap equities significantly underperform their larger peers. As we look to the past to inform potential conclusions about the future, we see three episodes since the Russell 2000's 1984 inception of such extreme underperformance. Though this is hardly a statistically significant number around which one can draw definitive conclusions, we note in subsequent quarters the small caps did ultimately catch up with their larger peers. Will they close the gap again as they have in prior instances? Of course no one knows for sure, but a growing economy, improving liquidity conditions and a moderate discount in relative valuations support their case.

Regardless of the market's gyrations in the short term, I believe our eclectic portfolio looks to offer greater value and appears set to perform well in this environment. Though our holdings will assuredly be influenced by the market direction in the short term, in the medium to longer term, our performance will be driven by the business results of these specific companies and the unfolding of the catalysts that lay in front of them.

CONCLUSION

In closing, while I know our approach will not yield outperformance each and every quarter, I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the overwhelming majority of our investable assets are invested alongside yours, we would never ask investors to assume risks we ourselves will not.

Thank you for your continued support as we work to grow our capital together. As always, we are happy to discuss our investment outlook with you at your convenience. Please reach out any time

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 6/30/19.
 2. CEF uses the S&P 500, Russell 2000, a custom Blended Small/Large Benchmark and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The custom Blended Small/Large Benchmark is provided to capture a larger proportion of small cap performance versus large cap performance (at a 3:1 ratio) due to the similarly high proportion of small caps found on the Good Businesses Focus List as well as the strategy's general preference of having an investment mix more heavily weighted towards investment in small caps. The Barclays Hedged Long/Short index (an index of equities-based hedge funds) serves as an appropriate benchmark over the long-term given the index has a similar long-term goal of capital appreciation through equities investing.
 3. CEF Net Returns are hypothetical results calculated from actual gross results in a manner consistent with the 1% management fee and 18% performance fee offered to clients.

APPENDIX

CEF GOALS, PHILOSOPHY, APPROACH AND ALIGNMENT

GOALS – We seek to generate market-beating returns over any rolling multiyear investment horizon while minimizing the risk of permanent impairment of capital. Additionally, we seek to communicate with our investors in a transparent and straightforward manner and ask only that they accept investment risks that we ourselves are willing to take. *Given the majority of our investable capital is invested alongside theirs, we invest our limited partners' capital as if it were our own, because it is.*

PHILOSOPHY - We approach investing in public equities as an opportunistic businessman would. We spend most of our time studying businesses and building circles of competence in areas likely to offer attractive investment prospects and invest in only our most compelling opportunities. We view risk primarily as the likelihood of a permanent impairment of capital and pursue a carefully balanced willingness to trade some short-term portfolio fluctuations for the opportunity to earn higher returns over the long-term. We focus on growing, understandable businesses and seek to buy them at a substantial discount to our estimate of their intrinsic value. When we find them trading at attractive prices, we often act in size and weight our best ideas accordingly. And all things being equal, we prefer to devote more of our efforts to small stocks where we believe greater price/informational inefficiencies can often be found.

APPROACH – We invest via a long-bias hedge fund structure and concentrate our long investments in our best 10 to 15 ideas. Our work begins with a two or three-year outlook, and we only pursue investments we believe are likely to offer us a reasonable chance to generate an annualized return of 20% or better. While we pursue long-term oriented investments and seek to compound capital in a tax efficient manner, we readily acknowledge the often-turbulent markets do not always fit neatly into this framework and know some trading activity is sure to follow as a result. In the short book, we seek to generate absolute profits in a few stocks where we have uncovered a company entering financial duress or an excessively optimistic valuation where we feel their earnings outlook is likely to worsen materially. We will also use industry or market specific ETFs to mitigate market risk and will look to employ options and other opportunistic hedges when conditions appear favorable.

ALIGNMENT – We believe appropriate alignment of interests is the bedrock upon which all successful partnerships are built. Our primary means of ensuring proper incentive alignment is through significant co-investment of our personal wealth alongside our limited partners. Secondly, we offer an investor friendly fee structure. We charge a modest management fee to support investment operations and charge an annual incentive fee on new profits only. Finally, commensurate with our fee structure which is intentionally structured such that the majority of fund earnings will be earned only if we generate compelling investment results, we commit to operating the fund as a boutique shop with a limited asset size. As many of our best investments often come from small stocks, we believe it is important to preserve our ability to take concentrated positions in our best ideas. Our size and structure ensure we are incentivized to generate compelling returns, not gather assets.

Think of it this way. On the one hand, we are incentivized to generate the best investment results possible. On the other hand, we are unwilling to invest in a way we feel is likely to result in a meaningful loss of our own investment capital. What more could one want from an investment manager?