CHOICE EQUITIES
CAPITAL MANAGEMENT

January 22, 2024

Dear Investor:

I hope this letter finds you well. Choice Equities Fund generated gains of +10.6% on a net basis in the fourth quarter, bringing year-to-date net performance to +3.0%. This compares to the Russell 2000's +14.0% gain for the quarter and year-to-date gain of +16.9%. The S&P 500 generated a quarterly gain of +11.7%, bringing year-to-date gains to +26.3%. Since its inception in 2017, the fund has generated annualized gains of +13.4% versus +7.3% and +13.4% for the Russell 2000 and S&P 500, respectively.

EXECUTIVE SUMMARY

In this letter, we provide a brief summary of equities markets in 2023. We then discuss two recent portfolio acquisitions, Bluelinx Holdings, Inc. (BXC) and Par Technology Corporation (PAR). Lastly, I conclude with a few thoughts on the current outlook.

QUARTERLY COMMENTARY

Equities were up strongly in 4Q. Disinflationary data points gathered momentum, spurring the Fed to put the most aggressive rate hiking cycle in 40 years on hold. Expectations of lower rates produced a meaningful relief rally across nearly all asset classes. A bit of multiple expansion followed for equities, also at a time when it looks like a new profit cycle is beginning to emerge after several consecutive flat to moderately negative quarters of earnings growth.

Most market participants will likely remember 2023 as the year of the Magnificent Seven. The group's exceptionally strong price performance, up over 100% if taking a simple average, significantly bettered most stock cohorts across the market spectrum. It is often said that stocks follow earnings. If such is the case, 2023 may be the finest example of this in recent history. After a down year in 2022, in aggregate the Mag 7 group produced strong earnings growth, likely accelerating to over 40% for the back half of the year. Meanwhile, earnings growth for the S&P 493 was negative through most of the year, as it was for small and mid-cap stocks. That there will be relative winners and relative losers in a given year is unsurprising; it is always this way. That the dispersion in performance was this wide further widening pre-existing valuation disparities, was remarkable.

Within the markets, 2023 was an exceptionally choppy year. Most non-Mag 7 stocks did very little in aggregate except for the last two months of the year, despite several large moves across a fairly wide trading range. The Russell 2000 ultimately generated an attractive return of 16.9% for the year, despite being negative on the year halfway through November.

Despite the challenging backdrop that prevailed most of the year, I still anticipated better results in the portfolio. My decision to focus our portfolio primarily in low multiple stocks was not rewarded much this past year. In some cases, quality companies trading at cheap valuations stayed cheap and out of favor, and we did not experience the good fortune to have this value realized in our portfolio. In others, in a market that was highly discriminating and ultimately punished earnings misses with double the normal price decline and the most negative subsequent price performance since 2011, we experienced declines when the odd earnings shortfall did materialize. In prior years when we have experienced strong results, it has usually been driven by a handful of holdings that were significant contributors. For this year, we had few outsized contributors.

PORTFOLIO COMMENTARY

I continue to make efforts to optimize our portfolio, trimming stocks that have appreciated or exiting a few entirely to make way for new holdings. Croc's Inc., (CROX), Wesco International. Inc. (WCC) Orion Engineered Carbons, SA (OEC), Magnite, Inc. (MGNI), Stagwell (STGW) and Shake Shack, Inc. (SHAK) and others remain. We added a few new positions last quarter that are worth discussing as well, two of which have been holdings before.

BXC – Bluelinx is a company we have owned before and one that looks quite different today than it did prior to the pandemic. As a building products distributor delivering primarily lumber and millwork and various engineered wood products that go in new homes and support repair and remodeling needs, the company fulfills a major need in the homebuilding supply chain.

Over the last couple of years, two major changes have occurred. The company has flipped their product mix (from previously ~80/20% structural/specialty to ~30/70% structural/specialty today. Structural product gross margins (primarily lumber) range from 8% – 10%. Specialty gross margins (primarily engineered wood products and millwork, etc.) range from 17% – 19%. With the two product categories requiring similar costs to serve and offering comparable pull-through margins, the company now aspires to achieve an EBITDA margin of 10%, versus a pre-pandemic aspiration of 5%. Additionally, pre-Covid, the balance sheet was levered, though the company was asset rich. Today on the back of the Covid boom, the balance sheet is now in great shape. The company recently repurchased 15% of its shares, and just put another share repurchase authorization in place for a similar amount.

Depending on the level of share shrink from the buyback and assuming topline volumes grow in the mid/high single digits on the back of similar single-family housing starts growth, earnings could again inflect meaningfully higher, perhaps surpassing $25 in a couple years.

PAR – Par is organized into three operating segments. The Brink business, a SAAS point-of-sale (POS) platform for quick-service restaurant operators, is the most important. Sales have been growing rapidly on the back of new customer wins and aided by acquisition with adjacent product rollouts in payments, back office, loyalty, online ordering and drive-through offerings that all connect to a restaurant's point-of-sale (POS) operating software.

Customer wins have been accelerating, partly aided by the recent signing of Burger King's US locations, which may be followed by international locations at some point down the road. It now looks increasingly likely that Par/Brink will be the winner-take-most player in the POS market for the large quick-service restaurant segment, with additional wins among large, scaled customers offering continued attractive growth. High margin annual recurring revenue (ARR) revenue in this segment has grown from less than $20M four years ago, to north of $150M on a run-rate basis ending this past year when factoring in domestic Burger King locations. Today, Brink generates ~$5/share of ARR on a run-rate basis and could accelerate meaningfully beyond $200M+ in 2025.

Though the company has periodically talked about a sale of its government business (a defense contractor with more than $100M in profitable sales around which the corporate entity was first built) in the past, it now seems a sale relatively soon is increasingly likely. The government business is performing well and could fetch ~$100M or more, which the company can put towards furthering their Brink growth plans. Additionally, the Brink business segment is now much farther along, and thus the company looks better positioned to move forward with the sale. A hardware business providing restaurant customers a range of terminals, portable tablets, payment devices and various hardware pieces remains, profitably contributing over a $100M in sales to the corporate entity as well.

OUTLOOK

Current forecasts call for a new profit cycle to emerge both up and down the market cap scale as earnings growth resumes for most US equities. The worst of inflation's adverse effects look to be in the rearview mirror, and a strong case can be made the economy is back on a path towards normalization.

Valuation disparities across market caps remain, with small and midcaps remaining remarkably cheap by historical context. (The Appendix contains a few charts highlighting these conditions.) It has been tough sledding for much of the last two years in this area of the market. Earnings have declined for much of this time and multiples have consistently compressed across the space. However, looking forward, outsized earnings growth for many appears attainable as these companies lap easy comparisons from difficult years stemming from high inflation. Thought of as a stock, one might say the whole cohort could be trading as trough on trough (trough multiples on trough earnings – often a very attractive setup, particularly when earnings growth resumes).

Taking a bigger picture look back across our first seven years now, one might characterize asset class returns as seven years of lean for small cap stocks versus seven years of plenty for large cap stocks. (The Russell 2000 has generated a 7.3% annualized return since the beginning of 2017, versus the S&P 500 annualized return of 13.4%.) Despite the lack of relative performance tailwinds, I'm generally pleased with our results in totality, in which we have more than doubled the aggregate return of the Russell 2000 along the way. More importantly, I remain focused on the path forward, thinking of process improvements, opportunities missed and things we can do to maximize our odds for sustained strong performance in our next seven years.

Recent history invites particular introspection. I continue to believe our approach and portfolio orientation offers us the best chance of meaningfully outperforming our market comparisons over a sustained period of time. Of course, the flip side of that same coin means a concentrated portfolio also invites the likelihood that we may be out of sync for extended periods of time as well. Though it is true in the short run that the market is a voting machine and in the long run it is a weighing machine, paraphrasing Ben Graham as he so famously stated, it is also true that sometimes value is not realized or recognized in a time frame that fits our convenience.

Businesses and markets continue to adapt and learn, and so must we. With recent history in mind, merely owning cheap stocks of quality businesses may not always be enough; it seems that more thoughtful consideration could be paid to the path that we, and our portfolio holdings, follow in order to realize our goals. Such considerations invite a renewed focus on navigating stock path risks and being even more attentive to the pace and magnitude of potential stock price declines given changing liquidity and drawdown tolerance profiles of other investors in the market.

Regardless of any process tweaks, I continue to think our overall approach is quite sound, and that over time we will be best suited by focusing on the most attractive values available by buying quality growing businesses at discounted valuations. Today, many of our holdings, like Croc's or Bluelinx, are low multiple stocks. Some of these holding types were not rewarded in 2023. But earnings look biased higher, and I believe the stocks are likely to follow them.

CONCLUSION

I am excited about today's opportunity set and our prospects for the years to come. Even so, I know our approach will not yield outperformance each and every quarter, but I continue to believe it will be well worth our while over the long haul. Perhaps more importantly, given the overwhelming majority of my 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.

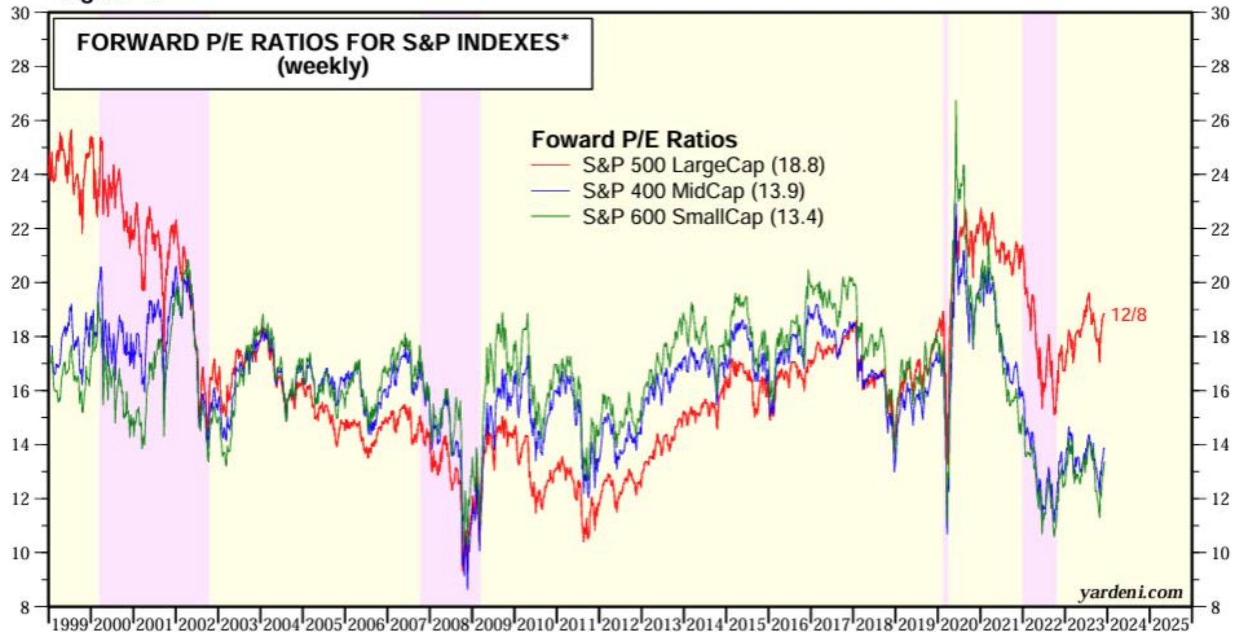
Best regards,

Mitchell Scott, CFA
Portfolio Manager

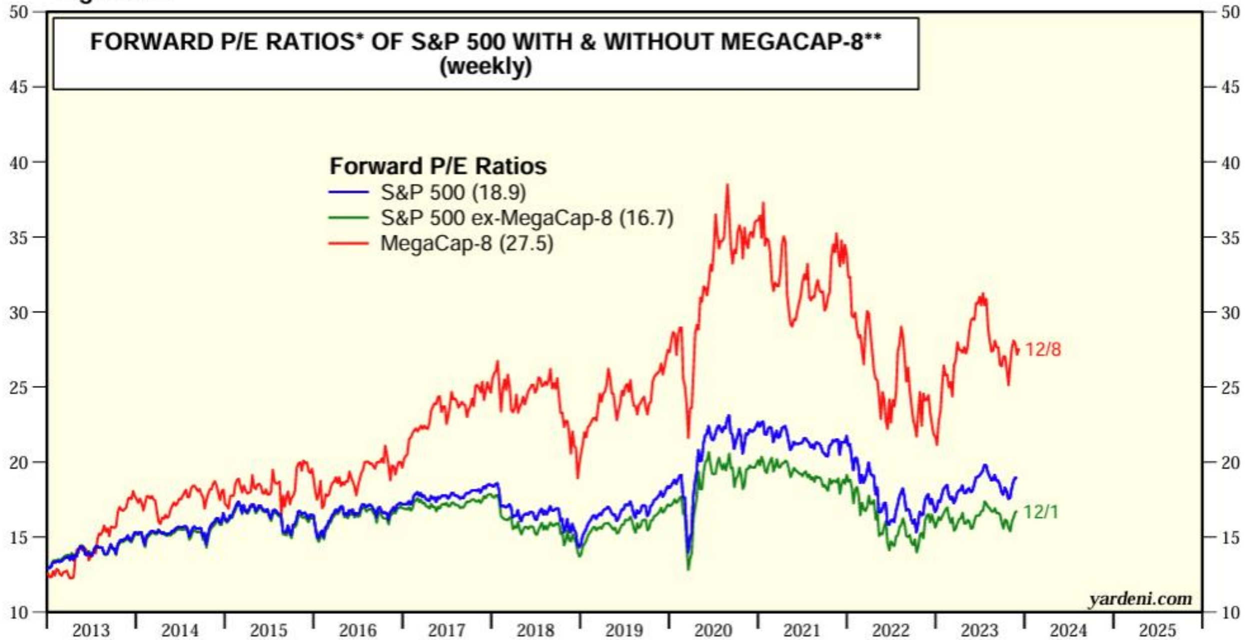
1. All market and company data is sourced from Factset and company filings and is current as of 12/31/23.
2. CEF uses the S&P 500, Russell 2000 and the Barclays Hedged Long/Short indices as its primary benchmarks. The S&P 500 and Russell 2000 are common large and small cap US equities-based indices. The 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 consistent with the 1% management fee and 18% performance fee offered to clients.

APPENDIX

Yardeni Research



* Price divided by 52-week forward consensus expected operating earnings per share.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv.



* Price divided by consensus forward earnings forecast.
** MegaCap-8 stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.
Source: I/B/E/S data by Refinitiv.