Alluvial

CAPITAL MANAGEMENT, LLC

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Second Quarter 2018 Letter to Alluvial Fund, LP Limited Partners – July 20, 2018

	Alluvial Fund, LP (Gross)	Alluvial Fund, LP (Net)	S&P 500 TR	Russell 2000 TR	Alluvial Fund, LP (Net) vs. S&P 500	Alluvial Fund, LP (Net) vs. Russell 2000
YTD 2018	**2.7%**	**1.9%**	**2.6%**	**7.5%**	**-0.7%**	**-5.6%**
2017	38.5%	29.6%	21.8%	14.7%	+7.8%	+15.0%
Cumulative	42.2%	32.1%	25.0%	23.3%	+7.1%	+8.8%
Annualized	32.5%	20.4%	16.0%	15.0%	+4.4%	+5.4%

Partnership began operations 1/1/2017

Top Holdings	**%**
Nuvera Communications	8.3%
BlueLinx	6.8%
Otelco	6.1%
MMA Capital Management	5.7%
School Specialty	5.7%
Syncora Holdings	5.6%
LICT	5.5%
Bredband2 I Skandinavien	5.1%
Calloway's Nursery	5.0%
Total, Top 10:	**53.8%**

World Allocation	**%**
United States	79.8%
Sweden	8.6%
Canada	5.2%
Mexico	3.9%
Poland	1.6%
Other	0.9%
Total	100.0%

Dear Partners,

The quarter just ended was a lackluster period for Alluvial Fund, LP. While market indexes turned in respectable gains, Alluvial declined 0.8%. Though certainly frustrating, this is not at all unusual for a portfolio made up of esoteric and obscure holdings. As I have often stated, partners should expect to experience periods of uninspiring returns in the pursuit of superior long-term results. Now and then our holdings will zig as the market zags. I pay little mind to the short-term movements of the securities we own, provided the underlying companies are performing as expected. In that regard, our holdings have been wholly satisfactory. The market eventually rewards successful businesses. All my investable assets are invested in Alluvial Fund, LP and always will be. I remain highly optimistic on the prospects of the stocks and securities we hold, especially as we enter another season of earnings reports.

The Losers

Syncora Holdings cost us the most this quarter. In a classic "buy the rumor, sell the news" scenario, Syncora shares fell 14%. The company's achievements in the quarter were notable. The company not only found buyer for its toll road assets, but also closed its large reinsurance transaction with Assured Guaranty. The company also made significant progress toward paying down its holding company liabilities. Right on schedule, Syncora has become a cash pile with a massive tax asset attached—and not just a cash pile, but a deeply discounted one. Syncora now trades at roughly half my estimate of book value. It remains to be seen how management will treat the company's small remaining insurance operations, and what they will do with the company's free capital. To this point, management has not done a good job articulating its strategy, and investors are understandably applying an uncertainty discount. I believe this discount will begin to narrow as the company reveals its roadmap.

It's tough to find a more textbook example of "political risk" than **Polaris Infrastructure** provided for us this quarter. Shares of Polaris declined 21% as Nicaragua was rocked by protests against President Ortega. Tragically, the protesters were met with violence from government and paramilitary forces and many were killed. The situation remains fraught, but I don't expect Polaris's Nicaraguan operations to be impaired by the unrest. For one, Polaris's San Jacinto geothermal plant is critical infrastructure and generates a material portion of the country's electricity, at low cost. Nicaragua, like many central American countries, is energy insecure. A large portion of Nicaragua's electricity is generated from high cost, inefficient, polluting sources like burning fuel oil. Reducing its reliance on these sources in favor of superior alternatives like geothermal power is a major goal for Nicaragua. What's more, the development of the geothermal industry in Nicaragua relies on funding from the World Bank. I do not believe that Nicaraguan leaders would do anything to jeopardize their relationship with the World Bank, which is a major source of cash for development and poverty relief in the nation.

At around CAD 12, I believe investors are applying an absurdly large instability discount to Polaris Infrastructure's shares. My estimate of the net present value of cash flows to equity for the remaining years in Polaris's power purchase agreement is just over CAD 20 per share at a conservative discount rate of 15%. This ascribes zero value to the company's Casita-San Cristobal geothermal concession, which the company plans to develop in cooperation with the Nicaraguan government.

Hopefully, the situation in Nicaragua will be defused in the short term with pro-democracy reforms. Local institutions including the Catholic Church and business groups are attempting to force the government to come to the negotiating table. There is a chance that Nicaragua descends into total chaos, but I believe fearful investors are vastly over-estimating the chances of this worst-case scenario. Earlier this month the company confirmed that operations have not been affected by the tumult, and quarterly revenue set a record.

Hoteles City Express also turned negative this quarter, falling 14%. I haven't mentioned Hoteles City Express before, but I am incredibly optimistic on this Mexican hotel developer' prospects. Over the last fifteen years, Hoteles has expanded from only 5 hotels to 139 properties. These limited-service hotels are located in fast-growing areas and designed to appeal to business and budget-conscious travelers who nonetheless desire quality lodging. The economics of building these hotels are favorable. Within three years of construction, City Express hotels yield annual net operating income of 12% of construction costs. By comparison, limited-service Mexican hotels trade hands at an NOI yield of 8-10%, depending on age, condition, and location. Having built scores of these hotels all across Mexico, Hoteles City Express's earnings and cash flows have multiplied over the years.

And yet, the company's trading price does not reflect its value. The biggest reason for this undervaluation is the company's development business. Because Hoteles City Express is always adding additional properties, trailing financial results always under-report the company's profit potential. It takes three years for a new property to stabilize, and until then the property will under-earn. So Hoteles City Express is doomed to appear less profitable than competitors who refrain from development activities and stick to owning or purchasing seasoned hotels. Early this year, Hoteles management announced a savvy solution to address the issue: a REIT! Hoteles City Express would float a minority interest in a REIT named FIBRA STAY, selling 42 of its mature properties to the REIT. Hoteles would use the resulting cash inflow to accelerate its development activities and growth. As the company's hotels reached optimum profitability, they would be sold to the REIT, and the cycle would accelerate. This arrangement would neatly solve the company's difficulty in appealing to the market. Investors who wanted an attractive and growing cash yield could invest in the REIT, while investors who wanted more exposure to the company's hotel development pipeline could continue to own Hoteles City Express. Alas, uncertainty over the fate of NAFTA, plus the Mexican elections combined to create an unfavorable pricing environment and the REIT offering was pulled. Hoteles City Express stock has fallen on investors' disappointment, but I believe the company will return with a REIT offering at a more auspicious time. Until then, the company will continue to develop new properties, and earnings and cash flow from its existing properties will increase.

Before I proceed to happier discussions of rising stocks, just a word on a meaningful headwind for our portfolio this quarter and year-to-date: currencies. Last year, the weak dollar was a tailwind, increasing the value of our foreign holdings. This year, quite the opposite. The Euro declined 5.7% this quarter versus the US dollar. Other currencies were down even more. The Swedish krona fell 7.5%, the Mexican peso slipped 7.9%, and the Polish zloty was still worse, down 8.4%. In the short run, currency movements will add to and detract from Alluvial's results, sometimes materially. In the long-term, the impact of currencies will be dwarfed by performance, positive or negative, of the securities I select for our portfolio. However, in order to avoid creating an unacceptably high level of foreign currency risk, I do intend to continue enforcing an informal limit on foreign currency-denominated investments. Unless exceptional opportunities present themselves, this limit is one-third of our portfolio.

The Winners

Now let's discuss what went right. The market is beginning to see the value in some of our portfolio holdings. **BlueLinx** was the biggest beneficiary of that trend with shares up 15%. The market being what it is, shares rose into the mid-$40s before falling substantially. These moves between the $30s and $40s concern me little. BlueLinx is a leveraged company, so small changes in enterprise value will have a magnified effect on its share price. We are looking for far more than $45 or $50, anyway. For BlueLinx stock to be reach the $80+ level I believe it deserves, the company will have to achieve the goals it outlined when it purchased Cedar Creek. Cost efficiencies must be created, and the company must make progress in paying down the debt it took on to achieve the business combination. Management is well-incentivized to achieve these goals, but they will not happen overnight. I will be watching for progress toward these goals in coming quarters.

School Specialty also contributed, gaining 17%. The company announced it has achieved the necessary number of shareholders for a NASDAQ listing, and is working to uplist as soon as possible. School Specialty is a classic example of a tiny company with illiquid shares in an unpopular industry—school supplies, really?—that nonetheless is doing the basic blocking and tackling of profitable business growth. The company recently made a small acquisition to speed that growth and continues to work on operating efficiencies and better working capital management. Even with the advance, shares continue to trade at a single digit multiple of earnings, with plenty of growth levers remaining to be pulled.

Then there was **Nuvera Communications,** which also moved upward this quarter. Nuvera is the former "New Ulm Telecom" of which I am so fond. It makes me a little sad to see the company change its name from the wonderfully distinctive New Ulm to the blandly corporate Nuvera, but I understand the change. Nuvera wants to be known as a forward-looking provider of broadband connectivity to individuals and businesses, not a hidebound wireline telco in a quiet section of Minnesota. Community banks are now practically the only category of stocks where company names remain largely tied to local geography. The world spins on.

Nuvera provided us with multiple pieces of good news this quarter. The company announced it would receive more A-CAM funding, and not just a little bit. The increased annual A-CAM funding comes out to 32 cents per share, pre-tax. Not a small amount for a company with a share price around $18! Based on its healthy profits and robust outlook, the company lifted its dividend 20% to 12 cents quarterly. The company also announced just today that its proposed acquisition of Scott-Rice Telephone was approved by the FCC and will be completed on July 31.

I value Nuvera shares at $25, and I consider the company our holding with the most upside per unit of risk in our portfolio. That's why Nuvera is and is likely to remain our top position. I continue to be very optimistic on the prospects of our other rural telcos, Otelco and LICT Corporation. I was able to buy a good-sized block of LICT shares from an estate this quarter at an attractive price.

Special Situations and New Holdings

We had a few special situations pay out this quarter. The largest was Ash Grove Cement, of which I bought shares in early February at an average cost of $513.31. In June, we received dividends of $100.80 per Ash Grove Share and merger compensation of $447.23, for total cash of $548.03. Our total return was 6.8% for an IRR of just under 22%—a nice trade, but it gets better. We are still waiting for a final payment to be received once Ash Grove's net working capital is calculated as of the closing date. This final amount should be at least $9 per share. Trades like these are not as common as I would like, but worth buying when they come around now and then. Alluvial Fund is currently invested in two liquidation scenarios and another merger transaction. The merger in question has closed, but we are still waiting to receive cash.

There are a few new holdings in our portfolio, though I hesitate to discuss them in detail given their low liquidity. For now, suffice to say that one is a company with substantial real assets, trading well below liquidation value with a respected activist investor now at the reins. The other is a Scandinavian business services company with a remarkable track record of growth, trading at a very undemanding valuation. Better still, this company requires practically no capital to run or expand and has a history of returning substantially all earnings to shareholders. More details will follow in future letters as I build Alluvial Fund's position in each.

Other Portfolio News

Other holdings in the Alluvial portfolio reported meaningful news during the quarter and after. **Retail** Holdings NV announced another $1 distribution to be done this November as this long-running liquidation story enters its final chapters. **MMA Capital Management** issued shares to the Hunt Companies at $34, completing the transaction announced in January. I am stunned that shares are changing hands at $26 given the incredible value being built at MMA. I am buying hand over fist. **Meritage Hospitality Group** announced excellent growth in revenues and operating profits, rebounding strongly from a soft quarter one year ago. Shares of Meritage have sold off this year on fears of excess leverage and increasing debt service, but these robust earnings should help allay those concerns. Finally, **Contura Energy** announced a merger with Alpha Natural resources to create the nation's largest producer of metallurgical coal. The resulting company will be well-financed and extremely profitable. I expect the company to announce plans to return additional capital to shareholders shortly after the merger is achieved.

Parting Notes

I am very happy to announce that Alluvial has hired our first employee, Tom Kapfer. Tom joins me from another Pittsburgh asset management company. Tom will be taking on many administrative and operational responsibilities and will assist me with research and due diligence. Like me, Tom has lived in the Pittsburgh area for most of his life. He and his wife have a 2-year-old son and are expecting another child later this summer. Tom is an all-around great guy and will be a true asset to Alluvial. Tom's e-mail is tom.kapfer@alluvialcapital.com, should you wish to contact him for any reason.

Based on capital commitments, I expect Alluvial Fund, LP to exceed $22 million in assets at the end of this month. I am immensely proud of our growth, and humbled by the trust the partners have placed in me to manage their hard-earned capital. It is a responsibility I take seriously, and I will continue to devote each day to identifying the best value opportunities for our portfolio.

Alluvial Fund continues to seek partners who take the long-term view and are happy to be invested in some very unusual places and securities. If you know any qualified investors who meet this description and may be interested in investing in Alluvial Fund, LP, please feel free to pass this letter along to them.

I hope you enjoy the rest of the summer and I will report to you once again in October. By that time my wife and I will be the parents of a new baby girl!

Best Regards,

Dave Waters, CFA

Alluvial Capital Management, LLC

Disclosures

Investment in Alluvial Fund are subject to risk, including the risk of permanent loss. Alluvial Fund's strategy may experience greater volatility and drawdowns than market indexes. An investment in Alluvial Fund is not intended to be a complete investment program and is not intended for short-term investment. Before investing, potential limited partners should carefully evaluate their financial situation and their ability to tolerate volatility.

Alluvial Capital Management, LLC believes the figures, calculations and statistics included in this letter to be correct but provides no warranty against errors in calculation or transcription.

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Performance Notes

Net performance figures are for a typical limited partner under the standard fee arrangement. Returns for partners' capital accounts may vary depending on individual fee arrangements.

Alluvial Fund, LP has a fiscal year end of December 31, 2017 and is subject to an annual audit by Cohen & Company. Performance figures for year-to-date periods are calculated by NAV Consulting, Inc. Year-to-date figures are unaudited and are subject to change.

Gross performance figures are reported net of all partnership expenses. Net performance figures for Alluvial Fund, LP are reported net of all partnership expenses, management fees, and performance incentive fees.

Contact

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