Punch

A BOUTIQUE INVESTMENT ADVISORY

Punch Small Cap Strategy Commentary
First Quarter 2016

Overview

The past twelve months have been difficult ones for the small-cap market. From its peak in June of last year to its trough in February, the Russell 2000 declined over 25%. In the first quarter alone, this index declined 16% before rebounding sharply and ending down 1.5%. And while the Russell 2000 is down 13% over the last nine months, the large-cap S&P 500 is actually up 2%.

While figures like these aren't pleasant, the silver lining is that, in our experience, markets like these can offer long-term investors the opportunity to put capital to work at attractive prices. We tend to lick our chops when we encounter markets like this. When volatility picks up, emotions run high, and there is angst among investors, stocks can become mispriced and value can appear.

Unsurprisingly, there has been a fair amount of rotation in performance during this market rout. The healthcare and energy sectors, which were once market darlings, have reversed course and are leading the declines in a big way.

Performance (net-of-fees)	*Punch Small Cap*	Russell 2000
Q1 2016	*-0.94%*	-1.51%
Trailing 12 Months	*-6.87%*	-9.76%
Trailing 5 Years	*9.17%*	7.20%
Since Inception*	*9.74%*	7.21%

Inception date: March 31, 2002

Our long-time underweight in the expensive and popular healthcare sector continued in the first quarter. After exiting two of our four healthcare holdings, we exited the period with only 4.5% exposure to this group. Despite recent declines, healthcare stocks as a group remain above their long-term average valuations, and we are comfortable remaining underweight here.

The energy sector, which has been an outright disaster over the past 18 months, is now entering its third year of declines (down 39% in 2014 and another 43% in 2015). While we have up to now had difficulty finding attractive opportunities that fit our investment philosophy, the longer the pain continues in energy, the more interested we become.

Top Five Contributors Holding	Average Weight (%)	Total Return (%)	CTR (bps)
Carmike Cinemas	2.8%	31.0%	69
Rouse Properties	0.7%	22.7%	55
Magellan Health	1.4%	6.6%	46
Landauer Inc.	2.2%	1.4%	43
Westwood Hldgs	2.7%	13.7%	35

Bottom Five Contributors Holding	Average Weight (%)	Total Return (%)	CTR (bps)
EW Scripps Co	3.8%	-18.0%	-76
INTL FCStone	3.1%	-20.1%	-72
Lithia Motors	3.3%	-18.0%	-69
Gentherm Inc.	2.4%	-12.3%	-35
Digi Intl.	2.0%	-17.1%	-34

Positive Contributors in Q1 2016

Our top two contributors to performance in the first quarter were both takeovers, and both were taken over by strategic acquirers in their respective industries. We have noted an increase in takeover activity this year already, and we wouldn't be surprised to see this trend continue given attractive valuations and cheap financing.

Carmike Cinemas (CKEC, $750mn market cap) is the fourth-largest movie theater circuit in the country, and on March 3rd the company announced that it was being acquired by AMC Theaters, the second largest circuit. The $30 takeover offer was at a 20% premium to the pre-announcement stock price.

We have long thought that a strategic combination between Carmike and a larger movie circuit would make sense given economies of scale in the mature movie industry and Carmike's unique focus on smaller markets, which limits geographic overlap. As the company's recent proxy filing shows, management apparently

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thought this made sense too, as they had had serious conversations with AMC several times over the past few years.

However, we were disappointed by the $30 offer from AMC, which values the company below historical acquisition multiples, below the stock's 52-week high, and even below the $37 price that AMC was apparently willing to pay for the company a year ago. Despite our frustration with the offer price, we think the deal has a high likelihood of being completed later in the year at $30, and we have been reducing our position in the stock.

Rouse Properties (RSE, $1.0bn market cap) is a REIT that specializes in owning and operating Class B malls around the country and was originally a spin-off from the behemoth mall REIT General Growth Properties (NYSE: GGP) shortly after its emergence from bankruptcy in 2012.

We like spin-off situations and keep close tabs on all small-cap spin-offs because they can present interesting value opportunities. For one, some spun-off companies are not well-known in their early days as a public company since few investors are familiar with the new entity and there is often a dearth of information on them. Also, many spin-offs experience selling pressure shortly after issuance as shareholders of the parent company dump the new shares that they did not actually purchase. Artificial selling pressure and an information vacuum are usually a good recipe for security mis-pricings.

Rouse Properties also suffered from a third behavioral bias against its shares: the secular decline of the shopping mall industry. It is a well-documented phenomenon that there has been significant over-building of shopping malls in the U.S. over the past thirty years, and that many Class B and C malls are struggling and closing. For much of its life as a public company, Rouse struggled to command much of a valuation in the market as a result, we believe, of these negative associations with the industry. However, we liked the Rouse strategy and management team who were heavily incentivized to acquire malls with attractive structural characteristics—generally being the only enclosed shopping center within 100 miles—and to invest in them to improve performance. Importantly, Rouse also had the backing of Brookfield Properties, one of the largest real estate conglomerates in the world, who owned one-third of the company's shares. In the end, it was Brookfield who took over the company, tendering for the two-thirds of the shares it did not already own at $18.25 per share.

Negative Contributors in Q1 2016

Our largest detractor from performance in the quarter was T.V. broadcaster **EW Scripps Co. (SSP, $1.3 bn market cap),** a stock that has declined nearly 20% this year. Scripps has suffered alongside the broadcast peer group, as several industry-wide concerns have been weighing on shares.

First, the fear of "cord-cutting" seems to be accelerating in the media industry, as consumers are increasingly shifting away from cable and towards on-demand media consumption. Recent announcements by content companies like ESPN that they are launching their own direct-to-consumer apps and channels have intensified fears that the traditional T.V. ecosystem is under pressure.

Second, election years are extremely important to broadcast companies as political advertising is a significant source of profit for them. So far in 2016, political spending has been disappointing with several campaigns running limited television advertising and shifting ad dollars online.

Our view is that the broadcast business is indeed in transition, but that Scripps has several advantages as this sea change plays out over the coming years. Scripps is run by a veteran management team lead by CEO Rich Boehne who has seen several industry shifts over the decades. Mr. Boehne was a significant force behind the company's move into content years ago, which led to the formation of Scripps Networks (SNI), now an independent $8 billion company. Scripps' focus today is on gaining scale by consolidating the industry and also acquiring digital assets in order to push more content online. We think both are smart moves. To help in this transition, the company has one of the best balance sheets in the industry (net debt of only 1x ebitda) and generates prodigious free cash flow.

We hosted management in our offices in March for an update meeting and came away with the conclusion that many of these concerns are overblown and that there may be some catalysts for Scripps' shares in the coming year.

Another headwind to our portfolio in the quarter was our pair of automotive-related companies, **Lithia Motors** and **Gentherm Inc**. Lithia is chain of automotive dealerships mostly located in smaller markets around the U.S. Gentherm is an auto parts supplier with a unique technology that provides heated and cooled seats in passenger cars.

There is a growing consensus among investors that car sales may be peaking at current all-time record levels, and that automotive stocks may be vulnerable. While we don't pretend to have insight into where car sales are headed next year, we do know that the average age of a car in the U.S. is still over 11 years, and that as long as employment continues to improve, car sales are not likely to fall off a cliff.

Aside from the macroeconomic concerns, Lithia and Gentherm both have business models we like. Lithia operates in smaller markets where it can be the only dealer for a certain vehicle brand, creating a mini-monopoly in its markets. Gentherm is the worldwide leader in heated and cooled technology for car accessories and is expanding the applications for its proprietary technology outside of cars and into consumer products and medical devices. We like both management teams for their track records of growth and capital allocation, and neither stock is expensive at this juncture.

Initiations and Exits

We initiated one new position and exited two in the fourth quarter, bringing the total portfolio to 45 stocks as of March 31.

Our lone initiation in the quarter was **CSW Industrials (CSWI, $500mn market cap),** a Dallas-based industrial products company that produces adhesives, lubricants, paint products, and other chemicals. CSWI was a spin-off from another portfolio company of ours, Capital Southwest Corp (CSWC), although we did not purchase shares in either company until after the spin-off was effected late last year.

CSWI is a collection of industrial products businesses all sharing the similar characteristics of being niche products with strong brands, which gives them a good deal of customer loyalty. In addition, these are high value, low-cost consumable products that are often used by tradesmen in maintenance and repair situations. Because of these characteristics, the business has historically produced wide operating margins (15-20%) and strong returns on capital. The company has a new CEO in the person of 53-year-old Joe Armes, who has a private equity background and we believe brings a great deal of enthusiasm and acumen to the business. He was the architect of the separation of CSWI and CSWC, a move which has already unlocked value at the company.

Our two exits in the quarter were both healthcare stocks, and both were stocks we had owned for the better part of the past five years.

We initiated a position in **Five Star Quality Care (FVE, $200mn market cap)** back in 2011 after the company executed a secondary offering that was not well received by the market. After researching Five Star, our conclusion was that the company, an owner and operator of assisted living and independent living facilities for seniors, was a decent business that generated stable cashflow and had some growth potential as the industry recovered from the recession. Also, Five Star owned a portfolio of real estate assets whose market value was well in excess of the company's market cap, giving zero value to the business of operating these facilities.

Our mistake was a simple one: mis-judging the quality and incentives of the management team at Five Star. Despite perennial undervaluation of

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the shares by the market, and our repeated conversations with management about that issue, management appeared to show little interest in taking the steps we considered important to allocating capital in an intelligent manner that would unlock value for shareholders. We suspect their interest was mostly in growing their asset base, which conveniently grew their management fees as well. Management owned only a token amount of stock, and showed little regard for shareholders. Our lesson on Five Star was to dig harder into the details of management's track record and incentives, and set the bar higher when looking for management teams with which we want to partner.

Magellan Health, Inc. (MGLN, $1.7 bn market cap) is a managed-care organization that focuses on behavioral health and specialty pharmaceutical services. We originally initiated a position in the stock in late 2008, and added meaningfully to the position in 2009, when healthcare stocks were under the dark cloud of Obamacare reform. Most of the HMO industry was under pressure back then given the uncertainties of their business models in the new regulatory environment, and stock valuations were at levels not seen since the last regulatory scare in the mid-90s of "Hillarycare." While we were attracted to the public-market valuations on these businesses, we had no special insight into where reform might lead.

Magellan seemed to be one of the safest bets in the industry: a niche focus on specialty services, 25% of its market cap in cash with no debt, and a 15% free cash flow yield. We decided to take advantage of elevated valuations in the healthcare sector to exit this holding that appeared to us to be fairly valued.

Outlook and Conclusion

While the past twelve months have been difficult for small-cap investors, we believe that the current environment has created some unique opportunities to invest in attractive businesses at valuations that offer a margin of safety. With the decline of many healthcare and energy sectors, we also believe that there are signs of a resurgence in value-oriented strategies that have underperformed growth-oriented ones over the past several years. We are not having difficulty finding interesting investment ideas these days and think that this bodes well for returns in the years to come.

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