Punch

A BOUTIQUE INVESTMENT ADVISORY

# Punch Small Cap Strategy Commentary
# Second Quarter 2015

## Overview

The Punch Small Cap Strategy had strong performance in the second quarter of 2015, with a total return above the benchmark (+3.1% compared to +0.4% for the Russell 2000 Index). On a year-to-date basis, the Punch Small Cap strategy has produced a total return of +9.4% compared to +4.8% for the benchmark.

Stock picking continues to be the source of most of our historical and current alpha (+297 bps contribution in Q2 2015), while sector allocation was a slight headwind (-11 bps) this quarter. We continue to have meaningful variances from the benchmark in sector allocations.

Our two biggest sector variances turned out to be headwinds in the quarter, as healthcare was by far the best-performing index sector during the period (+5.8%) and consumer discretionary lagged the index (-0.4%). For some time now, we have been significantly underweight the healthcare sector (average weight of 8.1% vs 16.0% for the Russell 2000), as well as significantly overweight the consumer discretionary sector (average weight of 26.4% vs 13.7%).

**Performance (net-of-fees)**

| | *Punch Small Cap* | Russell 2000 |
|---|---|---|
| Q2 2015 | ***3.09%*** | 0.42% |
| YTD | ***9.41%*** | 4.75% |
| Last 12 Months | ***8.74%*** | 6.48% |

We continue to like the prospects for many of our consumer discretionary names, and are finding reasonable values in that area as our most recent addition to the portfolio was a performance boat manufacturer. In healthcare, we are simply finding a dearth of undervalued companies as the rising star (bubble?) of biotech shares has pulled valuations to unreasonable levels for the entire sector.

28 (60%) of the 47 stocks held in the strategy in the quarter outperformed the benchmark return in the second quarter.

## Positive Contributors in the Quarter

Our top contributor to performance in the quarter was **Nautilus Group Inc. (NLS, $700mn market cap),** a maker of exercise equipment under the Nautilus, Bowflex, and Schwinn brand names. In a quarter where many sporting goods retailers' stocks did not fare well (CAB -11%, DKS -9%) and the broader consumer environment remained lackluster, Nautilus continues to buck the trend as it moves into the third year of its turnaround under new CEO Bruce Cazenave. With a refocused product lineup, new product introductions like the TreadClimber and MaxTrainer, and renewed financial discipline, the company is taking advantage of its strong brand recognition and rich product innovation heritage to produce impressive financial results. Sales are showing accelerating growth, particularly in the direct-to-consumer segment, and this growth is translating into excellent operating leverage, with operating margins closing in on 20%. The company remains debt-free and is producing ample free cash flow. While the stock isn't cheap at nearly 2x sales and 17x operating income, we believe it remains under-followed and under-owned by most institutional investors. We have trimmed the stock several times, including once in the second quarter as the stock made was making 52-week highs.

**Top Five Contributors**

| Holding | Average Weight (%) | Total Return (%) | CTR (bps) |
|---|---|---|---|
| Nautilus, Inc. | 2.86 | 40.86 | 0.96 |
| The Hackett Group | 1.85 | 51.35 | 0.79 |
| LendingTree Inc. | 2.02 | 40.35 | 0.75 |
| Pzena Inv Mgmt. | 3.38 | 20.90 | 0.68 |
| TrueBlue Inc. | 3.06 | 22.79 | 0.62 |

Our second-best contributor to performance in the quarter was **Hackett Group (HCKT, $400mn market cap),** a business consulting firm based in Miami, Florida. What originally attracted us to this company was its strong free cash flow and willingness by management to buy back significant amounts of its own stock by means of

multiple dutch tender offers. Additionally, the company pays a healthy dividend and regularly acquires smaller consulting practices at attractive valuations. Over the past couple of quarters, the company has seen its struggling European consulting practice (20% of revenues) show signs of improvement after management changes and a restructuring of that division last year. Also, late in the second quarter, Hackett signed an agreement with software behemoth Oracle to sell its proprietary business intelligence (BI) database to corporate customers. As the stock has reacted favorably to these developments, we have trimmed the position several times, including once in the second quarter.

Our third largest contributor to performance was **Lending Tree, Inc. (TREE, $950mn market cap).** Lending Tree is an online lead generation company that operates several well-known consumer finance websites (most prominently, LendingTree.com) and provides referrals to lenders. While the company's core business of matching mortgage borrowers with lenders is mature and growing by single-digit rates, new lending areas like student loans, personal loans, credit cards, and small business loans are growing rapidly and have attractive contribution margin economics. The business has benefitted from improving credit conditions generally and has seen excellent pricing power as its well-known namesake continues to attract consumers. Despite a tripling of the stock price over the past year, the company is still only covered by two sell-side analysts and its top shareholders remain Liberty Media Corp (24% owner) and CEO Doug Lebda (16% owner).

## Negative Contributors in the Quarter

Our largest detractor from performance in the second quarter was **Monotype Imaging (TYPE, $950mn market cap)** which remains our single largest technology holding in the portfolio. We believe the Monotype business model of licensing typeface fonts to consumers and enterprise customers is one of the best we have seen in the tech industry because their products have long life cycles, are well-protected as trademarks, and are largely agnostic to changes in technology (print, web, smartphone, automotive, etc). Owing to its significant market share in this defensible niche, the company regularly produces 30% operating margins and significant free cash flow.

**Bottom Five Contributors**

| Holding | Average Weight (%) | Total Return (%) | CTR (bps) |
|---|---|---|---|
| Monotype Imaging | 2.49 | -25.82 | -0.77 |
| Carmike Cinemas | 2.92 | -21.01 | -0.70 |
| E.W. Scripps Co. | 4.33 | -9.27 | -0.48 |
| TechTarget Inc. | 1.69 | -22.55 | -0.44 |
| Alamo Group Inc. | 2.48 | -13.34 | -0.38 |

In the first quarter, the stock declined on concerns that their largest end-market supplying typeface to copy machine displays (roughly one-quarter of revenues) was declining faster than expected. While this market is surely in secular decline, currency headwinds and weakness in Europe contributed to a particularly bad quarter which should improve as these headwinds abate. Strong growth in Monotype's other end markets are offsetting much of this weakness and will continue to do so as they represent a larger portion of the overall business. We recently added to our position here.

Our second largest detractor from performance in the quarter was **Carmike Cinemas (CKEC, $700mn market cap),** the fourth-largest movie theater chain in the country with strategy of focusing on small-town markets with limited competition. Late in the first quarter the company announced that it was abandoning its effort to sell its stake in movie advertising company Screenvision after an announced deal with competitor National Cinemedia was blocked by the Department of Justice. Some investors had bet that the sale of Screenvision would pave the way to a sale of the entire Carmike company, so heading into the second quarter there was something of a "takeover premium" in the shares. With those hopes effectively dashed, many arbitrage investors exited the stock, taking the price down over 20% in the quarter. Fundamentally, Carmike is expected to have one

of its best years in some time this year as movie attendance is up strongly and recent acquisitions are bearing fruit. With the decline in shares, Carmike is now the cheapest publicly-traded movie theater in the peer group and we continue to like their long-term strategy and competitive position.

Our third largest detractor from performance was T.V. broadcasting company **E.W. Scripps (SSP, $1.9bn market cap).** The company completed its merger with Journal Communications (JRN) and subsequent spin-off of its newspaper assets on April 1st and is now the 6th largest T.V. broadcaster in the country. While this reorganization has created some complexity around the company in the near-term, we believe that there are several upcoming catalysts for the shares, including a strong 2016 election season, growing re-transmission fees at the company, and continued consolidation in the media space. The stock remains attractively valued at approximately 8x enterprise value to two-year average ebitda.

## Initiations and Exits

In April we initiated a new position in an energy-related company called **Corenergy Infrastructure Trust (CORR, $375mn market cap)** which is structured as a REIT and pays over an 8% dividend yield. The company is unique in that it is the first and only REIT to have a focus on energy infrastructure assets, including pipelines and storage facilities. While the strategy is similar to a master limited partnership (MLP), there are several benefits to being a REIT including simplified shareholder reporting, an advantageous tax structure, and the ability to execute triple-net leases to energy operators. Because there are few clear comparable companies to CORR, and because the strategy is relatively new (they converted from a BDC in 2012), the shares remain attractively valued at 8x p/ffo with over an 8% dividend yield. Given its focus on high barrier-to-entry, long-lived assets with recurring cash flow and little commodity price risk, CORR is an excellent way to gain exposure to the washed out energy sector with limited operating risk.

In June, after we took our initial position in the company, Corenergy announced an equity offering and acquisition of a large ($245mn) offshore pipeline system in Louisiana, and also announced its intention to raise its dividend by 11% per share. While the stock declined by over 10% on concerns that the company was entering into this triple-net-lease arrangement with a distressed E&P company (EXXI), we spoke with management and came away confident that the acquired asset fit well with management's criteria for long-lived essential infrastructure assets with stable cash flows that are supportive of a rising dividend per share. We added to our position in the company on the weakness.

**Malibu Boats (MBUU, $350mn market cap)** is our newest position in the Punch Small Cap Strategy and is the leading performance-boat manufacturer in the world. Relatively new to being a public company, Malibu had its IPO in January of 2014 but has remained majority-owned by its private equity owners, which we believe has contributed to its discounted valuation relative to other public boating companies. While boat manufacturing is a deeply cyclical business, the number of boats sold in the U.S. today remains well below the historical average. In addition, the performance boating segment has seen significant market share gains since the recession with the introduction of "surf gate" technologies which have made water sports like wake surfing easier and more popular.

Largely owing to current management team, the company is also run efficiently, with strong free cash flow, and minimal net debt.

In May, we exited technology holding **Datalink Corp. (DTLK, $210mn market cap),** which is a Minnesota-based storage and networking reseller and consultancy. We had owned shares of the company since March of 2011, and over that period the stock had slightly underperformed the benchmark Russell 2000 Index (+51% vs +58%). What initially attracted us to Datalink was its

high customer loyalty as a trusted advisor to companies who needed help designing and implementing storage solutions, as well as management's stated intention to consolidate the fragmented reseller market and gain scale in a relatively low-margin business. While the company has executed three good-sized acquisitions since 2011, the pace of M&A has been slower than expected. Also, as the company's average deal size has grown, quarterly results have become *less* predictable, not more predictable, and with the unpredictable nature of the business and resulting low-multiple valuation that such a business is likely to receive, we decided to move on after the company reported a disappointing first quarter.

## Outlook and Conclusion

Considering that there have been several significant headwinds to our strategy so far this year, we have been pleased with performance in 2015. The meteoric rise in healthcare shares (+19% year-to-date and +77% over the past two years) has been driven largely by biotech and pharmaceutical shares, which is an area we have been avoiding for some time now because of rich valuations and high investor expectations. Additionally, the outperformance of growth stocks over value in the Russell 2000 Index (+8.7% vs. 0.8% year-to-date) has benefited momentum stocks but left many financials and consumer discretionary shares behind.

In this environment, we have been quick to trim our winners that appear to have turned into momentum stocks and are looking more assiduously than ever for those shares that have been left behind by the momentum crowd but still have attractive niche businesses that are well capitalized and generate strong cash flow.

We are spending more time looking at community banks these days, which to us look like the antithesis of momentum stocks, as well as some special situation turnarounds. In small cap investing, significant changes like a new CEO, a business divestiture, or a new strategic direction can go unnoticed or underappreciated for some time, especially when there are few analysts or portfolio managers paying attention to a company that was long ago written off as "un-investable." We relish the opportunity to learn more about a company than others care to in these situations. The flurry of spin-off activity in the market today is also presenting us with lots of new ideas to monitor and we are digging into several of these situations at the moment should investor apathy towards these shares present us with compelling values. As always, we continue to attend numerous conferences and make regular road trips to visit with small public companies in out-of-the-way places and often find that we are the only ones to do so in years.

**Sector Allocation (average for Q2 ending 6/30/15)**

| Sector | Punch Small Cap | Russell 2000 | *Difference* |
|---|---|---|---|
| Consumer Discretionary | 26.37 | 13.69 | ***12.68*** |
| Financials | 26.24 | 23.61 | ***2.63*** |
| Telecommunications | 2.36 | 0.75 | ***1.61*** |
| Industrials | 14.82 | 13.34 | ***1.48*** |
| Consumer Staples | 4.34 | 3.07 | ***1.26*** |
| Energy | 3.19 | 3.61 | ***-0.42*** |
| Utilities | 0.00 | 3.39 | ***-3.39*** |
| Materials | 0.00 | 4.30 | ***-4.30*** |
| Information Technology | 12.79 | 17.94 | ***-5.15*** |
| Health Care | 8.11 | 15.99 | ***-7.88*** |

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