October 26, 2020

Dear Partners and Friends,

Maran Partners Fund returned +13.6% in the third quarter, net of all fees and expenses, which brings its year-to-date return through three quarters to -1.3% net.[1] Over a more meaningful period of three years, the fund is up +38.5% net (+11.5% compounded) vs. the Russell 2000 Total Return Index of +5.4% (+1.8% compounded), bringing Maran's outperformance to +970bps per year. The net returns of our limited partners in our three- and five-year lockup share classes, with commensurately reduced fees, are even better.

Small caps and "value" stocks have been out of favor to a historic degree. That said, I haven't been tempted to shift styles or to chase performance in today's "hot" sectors. I'm pleased that the fund has been able to make headway and generate positive returns over the medium to long term even while the market has mostly shunned our favored hunting grounds. When the tide turns, I believe we will be well positioned.

Special situations (as discussed in our last quarterly letter) as well as core long positions (many executing on "buy and build" strategies) contributed to the positive performance in the quarter. I feel good about our positioning going into year-end and the coming year, having added several new core positions, and with several existing core positions continuing to grow in value and trade at undemanding valuations. We also have a few smaller positions that I believe are highly asymmetric, one them trading at ~1x 2019 free cash flow.

Several portfolio companies have made value-enhancing acquisitions in the past few months, while others have repurchased shares at compelling valuations. These are each tangible demonstrations of value creation at work.

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Portfolio Update

At the end of the quarter, our top five positions were, in alphabetical order, Clarus (CLAR), Pure Cycle (PCYO), Scott's Liquid Gold (SLGD), Whole Earth Brands (FREE), and one position that remains undisclosed. Our top 10 long positions accounted for 83% of our long exposure at quarter-end.

The two special situation positions that we discussed last quarter each resolved, though we continue to hold positions in the long legs of each, as the special situation trades effectively provided advantageous entries into what I consider two great businesses.

I enjoy evaluating situations that require me as the analyst to do my own work. Spin-offs, IPOs (frequently the "broken" IPOs), post-bankruptcy, and similar situations frequently have little to no sell-side analyst research. There is no one there to hold anyone's hands. The lack of interest and institutional resources is compounded in small capitalization companies. Our two new top-five positions each fit this description. They are each quality companies, mostly ignored and uncovered, subject to forced or otherwise non-economic selling, trading at compelling valuations.

[1] Individual partner returns may vary based on fee structure and timing of investments. Please see disclaimer on page 6 for important information.

Whole Earth Brands (FREE) – The Price Asks the Question

I started my career at Credit Suisse First Boston in the equity research department (covering the glamorous sector of freight railroads). I was lucky to sit down the hall from Michael Mauboussin, whose work I have followed and admired in the almost twenty years since. Two years prior to my arrival at Credit Suisse, Mauboussin had published *Expectations Investing* with his frequent collaborator, Alfred Rappaport. The thesis of the book is that, as an alternative to attempting to value a company in the traditional manner utilizing a variety of inputs and forecasts, analysts can and should invert the process, and ask what expectations are embedded in a stock at its current price. I have heard this distilled to *the price asks the question*.

There is a large group of companies in the market today (many software as a service, or SAAS) that are trading for more than twenty times their annual revenues. One example is a company that is expected to generate approximately $3.5bn of revenue in 2021. It has a gross profit margin of just over 50% and is expected to generate between $300mm and $400mm of EBITDA next year. It is a great business, and is growing rapidly, but the company has a $120bn enterprise value and is trading at 35x sales, 360x EBITDA, and 420x earnings (all on calendar 2021 estimates). There is a certain set of expectations embedded within this valuation (around growth, margin, operating leverage, and – with Mauboussin on the mind – competitive advantage period,[2] etc). And in this example, those expectations are extremely high: continued rapid growth and ultimately something approaching total industry domination for decades.

This company's price is asking some pretty difficult questions. I prefer the prices of our stocks to ask easy questions, perhaps those even a kindergartener could answer.

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Whole Earth Brands (FREE) is a packaged food and ingredients company focused on the "healthier for you" and "free from" segments (primarily non-sugar sweeteners) and the licorice-based flavorings segment (whose end markets include tobacco, vitamins, and confectionary). FREE is pursuing a "buy and build" strategy under the chairmanship of Irwin Simon, who built natural food pioneer Hain Celestial (HAIN) from under $20mm of sales in 1994 to over $2bn of sales last year. FREE targets moderate organic growth and industry-leading margins derived from its asset light model. It has dominant market share in France and parts of Europe with its Canderel brand, leading market share in its licorice-based flavorings business, and strong growth brands in its Whole Earth and Pure Via natural non-sugar sweeteners (the former grew 70% y/y in 1H 2020).

These leading brands should generate just under $300mm of revenue, ~$65mm of EBITDA, and over $1/sh of cash earnings next year. Yet, at a market cap of $300mm and an enterprise value of $385mm, FREE is trading at 1.3x sales, 6x EBITDA, and 8x cash earnings. An undemanding set of expectations is embedded in this valuation. Again, the price asks the question. Is FREE a challenged, low-quality business in secular decline, as the market's valuation of it implies? Obviously, I believe the answer is no.

What might explain FREE's seemingly remarkable valuation? FREE came public via a SPAC, an avenue that, with good reason, is generally hated by the market (with a few notable high-flying exceptions). Further, prior to coming public, the businesses that comprise FREE – Merisant and Mafco – were owned by Ron Perelman. It is no secret that Perelman has been an aggressive seller of his assets – from artwork to yachts to companies – over the last few quarters as he seeks to de-lever. His fire sale is our opportunity to profit.

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[2] Mauboussin 1997

Merisant and Mafco reportedly had over $350mm of debt (over 5x leverage) under Perelman's ownership and Perelman's empire had significant additional leverage, so historically the majority of FREE's free cash flow was used to service that debt and pay out dividends to Perelman. Capital for integration, cost-cutting, brand-building, and growth was scarce. At 6x EBITDA, the market is pricing in decline, yet looking under the hood shows a business with secular tailwinds that is being set free from its debt shackles for the first time. Management will now be able to invest in the business to improve efficiency and drive growth. The fact that management has been buying shares in the open market suggests they are confident.

There are some parallels between the setup at FREE and that at our long-time holding Turning Point Brands (TPB) at the time of its IPO. TPB was also initially a "broken" IPO (although to be clear, there was nothing broken about the company), and was transitioning from meaningful leverage (5x+) to a less capital-constrained balance sheet, that would allow it to begin to invest for growth. TPB and FREE each incidentally own businesses that date back over 150 years. TPB's Zig Zag (rolling papers) and FREE's MacAndrews and Forbes (Mafco) were each founded in the 1850s, the latter by two Scots in Turkey to sell and distribute licorice root and licorice extract globally.

Packaged food and ingredient peers trade in a range of 8x - 18x+ EBITDA, with the most appropriate comps in the 9x - 13x range. If we apply the low end of this range to FREE, we would come up with a ~$14 stock (66% upside). At 11x EBITDA, FREE would trade for ~$18/sh (110% upside). Similarly, at 16x cash earnings, the stock would be a double.

As I see it, the biggest risk to FREE is that it rushes to do an outsized acquisition before the market has recognized the company's potential. As long as FREE is trading at a double-digit free cash flow yield, it is likely to have no better use of capital than buying back its own shares. M&A involves risk and uncertainty, and I believe FREE would be hard pressed to find a business as compelling as its own for anything approaching 6-7x EBITDA (even after assumed synergies, which don't always materialize as hoped). "Buy and build" strategies work best when companies make acquisitions at meaningful discounts to their own valuations. Over time, after FREE starts trading at a fair multiple, it will be able to kick start its acquisitive growth flywheel.

FREE seems to concur with this assessment. The company implemented a share repurchase program within months of coming public. The current authorization is for $20mm, or roughly six months of normalized free cash flow, which could reduce the share count by a meaningful ~7%. Three years at this pace – and this price – would of course reduce the share count by over 40%. And eight years, well…

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My kindergartener is starting to learn about the concept of multiplication. To make it concrete, we talk about *groups of*. "What is five groups of ten?" She knows that this is fifty. The price of Whole Earth Brands is asking questions that she can answer. "What is eight groups of one?" Or perhaps: "If I gave you $1 each year for the next eight years, how many dollars would you have?" Eight.

Okay, I rounded for my kindergartener. But if Whole Earth Brands can generate ~$1.10/yr in free cash flow (my estimate for 2021) for the next eight years (ignoring the organic growth and margin expansion that I think likely), it will have fully covered its current stock price/market cap. Investors could buy this business at today's price, recover their entire purchase price in eight years, and then get to own the business over the ensuing decades for free. For a business that has already been around for 170 years, this seems like a tantalizing proposition.

Pure Cycle (PCYO)

As a Colorado native, I'm certainly biased about the virtues of my home state. But the data seem to indicate that my bias is not completely misplaced. US News and World Report's list of top places to live in the US in 2020-21[3] begins with:

1. Boulder, CO
2. Denver, CO
3. Austin, TX
4. Colorado Springs, CO
5. Fort Collins, CO

According to the Denver Metro Association of Realtors,[4] September was the "toughest month to buy a house in Denver Metro's history," with just 5,301 total active listings, and 3,041 detached single family listings (almost half of the previous *low*). The median house stayed on the MLS for just six days. Inventory – especially at the entry level – is scarce, mortgage rates are low, and Denver's population is growing.

Given this incredibly bullish backdrop, could any stock exposed to this theme still have a reasonable valuation? Could a pure-play Denver real estate and water company be trading at an extreme low valuation below where it closed on March 23rd, the day the S&P 500 reached its Covid-panic lows, and down over 30% year-to-date?

Incredibly, the answer is yes.

Pure Cycle is a Denver area land developer and water utility. The company owns a nearly 5,000-single-family-lot-equivalent-development 25 minutes from downtown Denver that is delivering lots to a number of national homebuilders, as well as ~30k acre feet of water supplies and significant additional water infrastructure in the area. Its balance sheet is pristine, with a large net cash position and de minimis total liabilities.

I believe PCYO is a "fifty cent dollar," with approximately $10/sh of value in land and lots, and approximately $10/sh of value in water rights and infrastructure, against the current sub-$9/sh stock price. Importantly, the value of the "dollar" is growing as the company is commencing phase 2 of its real estate development and as more people move to the Denver area, proving out the scarcity value of entry-level homes and water rights in the region.

There is an element of special situation here. A former 25%-owner of PCYO has been exiting its position for the last year, which I believe has been weighing on shares. Once this seller is cleaned up, I believe the stock has 50% upside in the near term, and 100%+ upside over the next few years.

We have owned a number of real estate-related companies over the years (see our Q1 2016 letter, for example). What has tended to work for us are situations with the following attributes:

1) a large discount to liquidation value (preferably a "fifty cent dollar");
2) fair value (the "dollar") is growing; and
3) a catalyst to unlock value.

I believe Purce Cycle has all of these attributes.

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[3] Link
[4] Link

Clarus (CLAR)

Clarus continues to execute on its "buy and build" approach.

Clarus' Sierra Bullets division recently purchased Barnes Bullets from the bankruptcy estate of Remington Outdoor for $30.5mm. Barnes is likely on pace to generate over $25mm of revenue and $6mm of EBITDA this year.[5] On a pro forma run-rate basis (after synergies), it appears that Clarus may have purchased Barnes for a low single digit EBITDA multiple (3-4x).

I believe this was a fantastic deal that will be significantly value accretive for Clarus.

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Special Situations

We recently started building a position in a classic special situation set-up – a spinoff – that has the potential to become a core position. The company is a small cap consumer growth company that was spun out of a much larger parent, has a clean, net-cash balance sheet (but one must read the footnotes – the screeners won't pick up on this until next quarter), has had insider buying following the spin, and I believe has guided conservatively out of the gate. It is trading at a single digit multiple of cash flow.

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Conclusion

I continue to have the majority of my net worth invested in the partnership alongside of yours. Please don't hesitate to reach out if you have any questions about the partnership or any of our positions. Thank you for your continued trust and support.

Sincerely,

Dan Roller

[5] Barnes' trailing twelve months sales were $22mm, and industry trends have improved in recent months. I assume a similar margin structure to Sierra.

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In 3Q 2020, the total return of the S&P 500 was +8.9%, and the total return of the Russell 2000 was +4.9%. Year to date, the total return of the S&P 500 was +5.6% and the total return of the Russell 2000 was -8.7%. The S&P 500, Russell 2000, and Nasdaq 100 are indices of US equities. They are included for information purposes only and are not representative of the type of investments made by the fund. The fund's investments differ materially from these indices. The fund is concentrated in a small number of positions while the indices are diversified. The fund return data provided is unaudited and subject to revision.

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