# River Oaks Capital H1 2023 Report

https://www.riveroaks-capital.com

## Performance

| *Since Inception: 1/1/2020* | | | | |
|---|---|---|---|---|
| **S&P 500** | **YTD** | **1 year** | **3 Year** | **Since Inception** |
| S&P 500 TR* | 16.9% | 19.6% | 50.5% | 44.6% |
| **Benchmarks** | | | | |
| Russell 1000 TR | 16.7% | 19.4% | 48.5% | 43.2% |
| Russell 2000 TR | 8.1% | 12.3% | 36.1% | 18.6% |
| Russell Microcap TR | 2.3% | 6.6% | 29.9% | 15.9% |
| River Oaks Capital** | 10.3% | 11.0% | 66.9% | 44.4% |

**TR= Total Return (dividends reinvested)*

***Before Management fees*

## Our Companies

| Name | Market Cap | Strategy |
|---|---|---|
| Citizens Bank (CZBS) | $80m | Excessive Discount |
| Galaxy Gaming (GLXZ) | $60m | Wonderful Business |
| Boston Omaha (BOC) | $575m | Wonderful Business |
| Legacy Housing (LEGH) | $550m | Wonderful Business |
| Nicholas Financial (NICK) | $37m | Excessive Discount |
| Bankfirst Corp (BFCC) | $200m | Excessive Discount |
| Fitlife (FTLF) | $75m | Wonderful Business |
| America's Car Mart (CRMT) | $650m | Wonderful Business |
| R&R REIT (RRR.UN) | $30m | Excessive Discount |
| Greenfirst Forest Products (GFP) | $150m | Excessive Discount |
| Logan Ridge (LRFC) | $58m | Wonderful Business |
| M&F Bank (MFBP) | $35m | Excessive Discount |
| Endor AG (E2N) | $125m | Excessive Discount |
| Pharmchem (PCHM) | $13m | Excessive Discount |

**H1 2023 Letter**

*Here are the links to the past two letters : [H2 2022](); [H1 2022]()*

***"The stock market is a device to transfer money from the impatient to the patient"* - Warren Buffet**

As mentioned in prior letters, one of the most fertile grounds for finding opportunities in which people are "selling ownership for less than it is worth" is in small, underfollowed companies in the stock market. If you recall, in the last letter I condensed our investment strategy down to "we invest with a long-term mindset in underfollowed companies." The letter elaborated on the various reasons why small, underfollowed companies can become significantly more undervalued than larger, well-known companies – most notably because they are too obscure for sizeable investment funds to pay attention to.

What was not further addressed is how hard it can be to maintain a *long-term mindset* while investing in this corner of the market where very few shares trade each day on the stock exchange; these assets are often referred to as "illiquid."

Let's take, for example, one of our newer investments over the past six months – Fitlife Brands (FTLF). I'll further highlight our investment thesis for Fitlife Brands – a nutritional supplement producer – in a following section, but the important piece of information to know for this example is that only 300 people are shareholders in the company (which has a market cap of $75m).

Let's say that one of the 300 shareholders wakes up tomorrow and gets a call that the local pharmacy they work for has filed for bankruptcy and everyone has been let go. In order to temporarily make ends meet, this shareholder is forced to sell their $250k worth of Fitlife Brands stock immediately. Urgency causes them to sell irrespective of price – although they know that at Fitlife Brand's current price – $16.50 per share – it is quite undervalued.

Due to being a small, underfollowed company, Fitlife Brands has a minuscule average of ~$20-$30k worth of shares traded per day – indeed, it is a very illiquid stock. If this shareholder tries to sell $250k of Fitlife Brands stock right away, it will almost certainly cause an already undervalued Fitlife Brands to decrease 10-20+% instantly.

On the one hand, this can create an even better buying opportunity for those Fitlife Brands shareholders looking to increase their ownership. Conversely, it can be bewildering for Fitlife Brands shareholders who wake up to see the market price of their company decrease by 10-20+% overnight on no company news at all – solely because one shareholder needed money at once.

Unlike investing in Apple, 10-20+% changes in the share price of small, underfollowed companies – due solely to illiquidity – is quite common.

***"If you don't study any companies, you have the same success buying stocks as you do in a poker game if you bet without looking at your cards" – Peter Lynch***

It is possible that almost all the other 299 Fitlife Brands shareholders value the company at a reasonable valuation of $25+ per share and have no intention of selling before it reaches at least this price. But

when the price suddenly drops 10-20+% in one day, even those investors who were sure the company was worth $25 per share will start to wonder 'Am I missing something?'.

Unlike if UPS were to lose Amazon as a customer, when investing in small, underfollowed companies such as Fitlife Brands sometimes there is no quick way to find out if there is in fact a reason the company's price has dropped 10-20+% instantaneously.

The price may have plummeted because of an obscure piece of publicly available information that can't be readily found through mainstream sources – perhaps a strike at the company's plant in the middle of nowhere – or simply because one shareholder needed money right away due to a circumstance unrelated to the business.

That is why it is so important to put in the 'time requirement' – referenced in previous letters – of getting to deeply know the companies we own. Without a true understanding of the business, confidence in our thesis, and the ability to reach out to management and other fellow major shareholders, having a long-term mindset while investing in small, underfollowed companies would be near impossible.

The frequent 10-20+% price changes would have us constantly second guessing ourselves which would create an emotional rollercoaster ride that would make owning small, underfollowed companies for 3-5+ years – often the time period it may take for a company to reach fair value – too exhausting.

This exact situation has been happening at one of our largest holdings – Galaxy Gaming (GLXZ). There has been no material change in the company over the past six months – if anything it has become a stronger company – but Galaxy Gaming has declined to a significantly undervalued $2.50 per share (a $60m market cap).

There has been a large shareholder who presumably has been a forced seller – likely due to personal circumstances – and they have decided that $2.50 per share is the price at which they have the best chance of selling their entire ownership as quickly as possible. Due to the illiquidity of Galaxy Gaming shares, this has caused the company to remain significantly undervalued for reasons unconnected to company news over the past six months.

Alternatively, a year ago the share price of Galaxy Gaming went to over $5.00 per share as an investor rapidly bought over 5% of the illiquid shares in an attempt to get on the company's board.

Without me being able to visit with management multiple times in Las Vegas, speak with other major shareholders and have a solid understanding of the business, I would not have been able to maintain a long-term mindset through the 100+% swing in share price over these tumultuous 18 months (and yes, I've had to make more than my fair share of mistakes to realize this)!

In fact, we were instead able to use the irrational $2.50 per share price to increase our ownership in Galaxy Gaming.

Short-term minded investors who haven't put in the 'time requirement' would almost certainly have concluded that they were missing something when Galaxy Gaming dropped to $2.50 per share and would have most likely sold at the worst possible moment just because one major shareholder was a forced seller.

**“It’s not supposed to be easy. Anyone that finds it easy is stupid.” - Charlie Munger**

Even if a company is small, underfollowed and illiquid it does not by any means make it mispriced – if only it were that easy! It still requires a tremendous amount of digging and patience to find an undervalued company even in these areas of the market.

As famous investor Seth Klarman stated in an interview – ‘*There’s been a great misunderstanding in recent years that illiquidity (of stocks) delivers greater returns. I don’t think anything could be weirder than that idea. The reason you make money from illiquidity is when people that own an illiquid asset suddenly need to monetize it. That may cause it to trade at a discounted price’*

We are not looking to invest in small, underfollowed companies just because they are illiquid but rather because the illiquidity more frequently creates irrational prices – giving us more opportunities (such as recently at Galaxy Gaming) to achieve our fund’s goal of investing in wonderful businesses at a *significant discount to fair value*.

If you recall, when investing in a small, underfollowed company we go through the same checklist as we would if we were to buy ownership in the local restaurant around the corner. We look for a company that:

- Sells a wonderful product that will generate substantial cash for owners in years to come
- Treats their customers, employees and community admirably
- Is run by honest and able people that also have ownership in the business
- Does not take excessive risk
- Has a long-term plan for the business laid out
- Is selling ownership in their business at a significant discount to fair value

Undoubtedly, within the highly followed areas of the stock market – such as the S&P 500 – you can more readily find businesses that pass the first five bullet points of our checklist. But in small, underfollowed and illiquid areas of the stock market, we are able to more regularly find the rare, wonderful company that checks off the sixth bullet point – ‘selling ownership in their business at a significant discount to fair value.’

As outlined before, our ultimate goal is to have our fund invested in 10-15 of these wonderful businesses that check all six bullet points. But – as a reminder – due to the infrequency of wonderful businesses that sell at a significant discount to fair value, along the way we will buy ‘excessive discount’ companies which are so deeply undervalued – $0.50 or less on the dollar – that almost none of the first five bullets are needed as virtually any long-term outcome will generate an acceptable return. These opportunities are also more discoverable in small, underfollowed and illiquid areas of the stock market.

Over the past six months, in an attempt to find these wonderful businesses, I have traveled to:

- Clearwater, Florida
- Omaha
- Dallas (2x)

- Fort Worth
- Atlanta (2x)
- Columbia, MS
- Las Vegas
- Burkenroad Conference in New Orleans

Meetings via Zoom/Conference calls:

- Bavaria, Germany
- Mississauga, Canada
- Tinley Park, Illinois
- Ovilla, Texas
- Parker, Colorado
- Toronto, Canada
- Mexico City, Mexico
- New York City
- Charlotte, North Carolina
- Seattle

## ***Companies added in H1 2023***

**Nicholas Financial (NICK) -** was added to the fund in H1 2023 – and is now our fifth largest position. It was a sub-prime auto lender that is now being liquidated. The market cap is $37m.

I first heard about Nicholas Financial when we invested in **Boston Omaha (BOC)** in early 2022. The co-CEO of Boston Omaha, Adam Peterson, also runs an investment fund (Magnolia Fund) that owns ~33% of Nicholas Financial.

Additionally, Boston Omaha owns 15.6% of Crescent Bank, also a sub-prime auto lender that happens to be located in New Orleans and run by Gary Solomon. Adam Peterson is on the board.

This made me immediately put Nicholas Financial on the 'must follow' list as I knew Adam had insider knowledge on sub-prime auto lending from being on the board of Crescent Bank – meaning there was likely a logical reason he owns 33% of Nicholas Financial.

Nicholas Financial was started in 1984 with a different model than most sub-prime auto lenders. It was run as a decentralized company that had numerous individual branch locations – up to 60 at its peak – mainly throughout the eastern half of the U.S.

This differs from the traditional regional sub-prime lending approach that often just has one headquarter office where rapid lending decisions are made solely based on credit score.

Conversely, Nicholas Financial would make 'face to face' loans to borrowers who were planning to purchase a used car from a local dealership. Opposed to making a rapid lending decision only off of credit score, Nicholas Financial would interview individual borrowers and make a lending decision by

judging their trustworthiness and having a deep understanding behind the reasons for their financial status – not dissimilar to another company we own, **America's Car Mart (CRMT)**.

The way I view it is Nicholas Financial was set up similar to a community bank whereas most of its competitors are set up as regional and national banks.

Once the founder of Nicholas Financial left in 2014, the company went into a downward spiral until Adam Peterson took control of the board in 2017. Adam appointed a new CEO and tried to steer the company back to its profitable roots.

Despite the concentrated efforts of Adam and the Nicholas Financial team to right size the business, the ~$32m per year of costs required to run an existing network of 47 branches across the U.S. became too much of a burden.

By 2022, it seems that Nicholas Financial ran into a fork in the road where it either had to start growing by writing more aggressive loans to cover the ~$32m per year of costs or liquidate and receive cash for their undervalued existing loans.

Late last year, Adam and the board announced that Nicholas Financial would immediately go into liquidation mode. They sold their remaining branches, and the company outsourced the collection of their $130m in loans to a collection agency – Westlake Financial.

In March 2023 after the liquidation announcement and the share price dropping 40+%, I eagerly went to go visit the Nicholas Financial management team in Clearwater, Florida. Within five minutes, it was apparent to me that the company was ~70-100% undervalued. Due to multiple reasons – investor fatigue, under $40m market cap, and management's silence – investors seem unaware that a liquidation is occurring at Nicholas Financial and are still valuing the company as if it is a 47 branch sub-prime auto lender.

After speaking with management and board members multiple times, it feels safe to assume that the liquidation of their $130m in loans will take ~2 years. Even if we assume loan default rates similar to what was experienced in 2016 – one of the worst years in the history of subprime auto lending – Nicholas Financial would still end up with $60+m of cash from the liquidation – on a market cap of $37m.

Attached **here** is my write-up that goes through valuing the various scenarios over the two year liquidation, but suffice it to say that this is a "heads I win, tail I don't lose much" scenario spoken about in prior letters.

It is also worth noting that since earlier this year, Adam and other Nicholas Financial team members have continued buying shares at ~$6 per share, which is 15-20% above the price at which we are buying ownership in the company today.

Adam and his team are conservative, thoughtful and well-planned capital allocators that have a depth of prior experience that is rarely found in a <$40m market cap company.

Although it may not have been the original way Adam planned to realize the undervaluation of Nicholas Financial, he and his team have rapidly pivoted to a shareholder-friendly liquidation that should force the market to realize the mispricing of Nicholas Financial in the near future.

**Fitlife Brands (FLTF)** - was added to the fund in H1 2023 – and is now our seventh largest position. The company develops and markets nutritional supplements – protein powders, pre-workout, amino acids, weight loss products, etc. – under 12 different brand names and has a market cap of $75m.

Although Fitlife was started in the early 2000's, the story of the current business truly began in 2018 when current CEO Dayton Judd – who owns ~55+% of Fitlife – took control of the company.

I had heard about the exceptional job Dayton had done in turning around Fitlife, but it wasn't until I flew to Fort Worth to meet him in person that I was able to grasp his unique long-term plans and unwavering ability to execute on them.

When Dayton – who runs an investment fund called Sudbury Capital -– took control of Fitlife in 2018, the company was on the verge of bankruptcy due to both a poor acquisition by prior management and an over concentration of sales to GNC – the health and nutrition retailor. The company was losing money each quarter and its market cap had fallen to under $5m until Dayton ultimately stepped in and laid out specific plans to :

- Significantly cut costs
- Reduce debt
- Decrease dependence on GNC by building an e-commerce channel
- Diversify by acquiring new brands

Although this plan seems quite straightforward, Dayton's implementation shows why he is such an innovative capital allocator.

Upon taking over the company, Dayton made an unorthodox decision that instead of spending the historical norm of 20-30% of revenue on marketing – which a typical nutritional brand does – Fitlife would no longer try to compete head on with the marketing spend of the major brands in the industry – Muscle Milk, Vital Proteins, Cellucor, EAS, etc.

Instead, he decided to significantly reduce marketing spend – to 9% of sales – and become the lowest cost brands for all GNC franchisees.

An important factor in his strategy is that almost all Fitlife's sales to GNC are through GNC franchised stores. This means that the store is owned by a local entrepreneur who pays GNC a fee to use its brand name – meaning the store is not owned by the GNC corporate office.

As Fitlife became the lowest cost and highest gross margin brands for GNC franchisee owners, it in turn incentivized profit-driven GNC franchisee owners to push Fitlife products onto incoming customers.

Dayton has called this 'outsourcing' marketing costs to GNC franchisees. The strategy works exceptionally well because Fitlife has a bundle of brand names – NDS, iSatori, PMD, etc. – so the customer would never know that only Fitlife's brands are being suggested to them.

Through this unconventional strategy, Fitlife has reduced its operational costs from ~$8.0m per year before Dayton took over to ~$5m per year – a 60% decrease – while revenue continues to grow.

These savings of $3m+ per year provided Fitlife with enough cash to achieve the second step of its turnaround – reducing debt – as it was no longer in financial trouble by 2019.

Next, Dayton and his team were able to reduce dependence on GNC – Fitlife's $20m of revenue all came from GNC in 2018 – by creating an e-commerce channel. Fitlife has gone from virtually zero online sales when Dayton took over to now ~$10m in online sales by the end of 2023 – which is 30+% of last twelve months revenue.

At the beginning of this year, Fitlife acquired Mimi's Rock Corporation for ~$20m. This was a huge step in the last piece of Dayton's turnaround strategy as it both continued to reduce dependency on GNC and also added new brands to the business's portfolio.

All of Mimi's sales are through Amazon where the company has three successful brands – most notably Dr. Tobias, which is the number one selling fish oil brand.

Dayton was able to buy Mimi's for an incredibly attractive price – estimated 5x P/E ratio – because previous management had taken on too much debt and was forced into an immediate fire sale in late 2022.

Dayton was the only person who had done enough due diligence on Mimi's – Fitlife tried to buy the company in 2021 but the price was too high at that point – to feel comfortable quickly following through with the purchase.

The Mimi's acquisition now drastically diversifies Fitlife's revenue stream as only 50% of the firm's revenue will come from GNC. Additionally, I have little doubt that Dayton will be able to execute a similar cost cutting strategy at Mimi's as he did when he took over Fitlife.

Moreover, Fitlife has recently filed to be uplisted onto the NASDAQ exchange. This should draw more investor attention to the story of Dayton's excellent capital allocation ability and the undervaluation of Fitlife, which currently offers a 12-15% free cash flow to equity yield – 7-8 P/E ratio.

This is all a long-winded way of saying we should be very comfortable investing our money for years to come alongside Dayton who has turned Fitlife around from near bankruptcy in 2018 to a thriving business with the potential to generate $10+m of free cash flow over the next twelve months.

**R&R Real Estate Investment Trust (RRR.UN)** - was added to the fund in H1 2023 – and is our nineth largest position. The company owns 17 budget hotels – Red Roof Inns and Hometowne Studios – throughout the United States and has a $30m market cap.

R&R is almost certainly the most unique situation we have invested to date. The Canadian-listed real estate investment trust – REIT-– was formed by Majid Mangalji, a successful Canadian hotel entrepreneur.

Majid left Uganda in the 1970's due to the brutal conditions under Idi Admin and moved to Canada where he and his family bought one hotel upon arrival. Over the years, he bootstrapped his way to owning more and more hotels until, ultimately, he ended up becoming one of the most successful hotel operators in the world. He is now the CEO of Westmont, which owns and operates 500+ hotels across four continents with estimated annual revenues of over $700m.

In 2003, Majid and his team started their first REIT – Innvest – that was ultimately sold for $1b+ CAD in 2016.

In 2013, Majid launched R&R REIT as he wanted to create a Canadian tax shelter for many of his hotels located in the U.S. By Majid selling his hotel properties to R&R in exchange for equity, he has been able to defer tax payments on these hotels' income and capital gains.

By 2019, R&R had purchased 17 total hotels – primarily in the eastern half of the U.S. – from Majid and in exchange Majid and the rest of the R&R management team now own over 90% of R&R's equity.

If you have ever stayed at a Red Roof Inn or Hometowne Studios, you will know there is nothing too exciting about these hotels – they are no frills, budget brands. The reason that R&R is an attractive investment opportunity isn't because of the spectacular hotel brand but rather what was talked about on the first page of this letter – low liquidity and few investors following the company.

It was brought to my attention by a fellow investor that every time Majid has exchanged one of his hotels for shares in R&R, he has done so at $0.20 CAD per share of R&R's stock. This made no sense to me as the shares for R&R had never traded on the stock market at above $0.14 CAD per share.

Eagerly, I reached out to R&R management earlier this year to further investigate and found out that it really does make no sense why the shares of R&R have never traded above $0.14 CAD .

Because Majid and the R&R management team own a vast majority of the R&R equity, every time they sell one of their hotels to R&R in exchange for shares, they are not allowed to use the market price – currently ~$0.14 CAD per share – as a proxy for fair value of the R&R shares. Rather, they have to hire a third-party auditor to provide an independent, objective value for the R&R shares – irrespective of the current share price.

Considering that Majid and the R&R management team hire the third-party auditor – although they are technically independent – it is likely the auditor tries to generate a valuation for R&R shares as low as reasonably possible as to help benefit Majid in the exchange. The valuation the auditor has consistently come up with for a fair price of R&R shares in the exchange is $0.20 CAD – which is approximately book value.

Even the $0.20 CAD per share valuation is most likely too low for an estimate of fair value, as accounting book value almost always understates real estate assets during inflationary times. In fact, a publicly available asset appraisal was done in 2019 that valued R&R at $0.33 CAD per share.

So how it is possible that we are able to buy shares of R&R at an average of $0.14 CAD per share? It is almost certainly because of the low liquidity and underfollowed nature of the company. Even R&R management will indirectly say that this valuation makes no sense.

Only in small, underfollowed companies would we ever be ever able to buy shares in a company at 70+% below publicly appraised fair value and 40+% below where an independent auditor has valued the shares.

Even if we value R&R using more traditional real estate valuation metrics, we are able to buy ownership in the company at a very attractive 15+ cap rate and a 15-20+% free cash flow to equity yield – 5-7 P/E ratio.

After research and conversations with management, I think it is a fair assumption to value R&R at $0.25-0.33 CAD per share.

The next stage of growth for R&R is what I believe even fewer investors know about. With $10+m of cash on the balance sheet and $15+m of debt capacity, Majid and the R&R team have transitioned their strategy to now acquiring distressed hotels and no longer purchasing hotels previously owned by Majid. This pivot comes as the R&R management team sees significant financial strain emerging in the hotel industry as interest rates rise.

Ultimately, we are buying ownership in R&R at such an undervalued price that regardless of whether their new strategy is successful or not, we should have a favorable outcome over the long-term. However, if Majid and his team accomplish anything near their success at their first REIT – Innvest – our R&R ownership will be worth vastly more than our assumed fair value of $0.25-$0.33 CAD per share.

**Logan Ridge Finance Corporation (LRFC)** - was added to the fund in H1 2023 – and is now our eleventh largest position. It is a BDC – Business Development Company – which is a publicly traded company that provides financing to small and midsize private businesses using either debt or equity financing. This is a form of financing for those companies that outgrow their local bank but aren't big enough for Wall Street or are too risky for larger banks. Logan Ridge has a market cap of $58m.

Logan Ridge originally started under the name Capitala Finance Corporation which launched in 2013 but had entered a state of constant decline by 2017. Its net asset value – the value of all loans and cash minus debt – went from ~$83 per share to ~$40 per share by the end of 2020.

Ultimately, the nail in the coffin was in Q2 2020 when Capitala declared it would no longer be paying a dividend. BDC's are required by law to pay out a vast majority of its earnings in dividends. Once a BDC stops paying dividends, it is an immediate signal that its unprofitable and investors usually run for the door!

By July 2021, Capitala shareholders went activist and voted for a separate firm, BC Partners, to come in and takeover managing the company – it was renamed to Logan Ridge Financial Corporation and an entirely new management team was brought onboard.

BC Partners is a well-respected investment management firm who has recently implemented a roll-up strategy of taking over failed BDC's, implementing a turnaround strategy to bring them back to profitability and then cutting redundant overhead costs by merging them together into one larger BDC.

Since 2019, BC Partners has taken control of four other failed BDC's and eventually merged all four of them into a single, larger BDC called Portman Ridge (PTMN). As of June 2023, Portman Ridge is now valued at 88% of net asset value which has been an excellent outcome for all shareholders involved.

BC Partners' roll up of BDC's has been led by Ted Goldthorpe – also now the CEO of Logan Ridge – who I have gotten to know. He is an honest, well-established manager with a proven record for distressed investing and turning around BDC's .

After taking control of Logan Ridge, Ted and his team immediately implemented the playbook they used in their four prior BDC turnarounds:

- Sell off any equity financing within the portfolio and replacing it with senior secured debt financing

- Cut administrative costs
- Secure a permanent credit facility for borrowing money
- Grow net asset value by investing cash on the balance sheet back into debt financing
- Diversify the portfolio by not having an over concentration in any one company
- Reinstate the dividend

Starting at the beginning of this year, the turnaround of Logan Ridge seems to be taking full form as the company finally re-instated its dividend. It is now on track to pay a 4-5% dividend yield this year based on the current market cap of $58m.

The dividend creates an attractive downside protection opportunity for us as we are able to invest in a company that is still only priced at ~63% of net asset value while it is paying a 4-5% dividend yield that should soon increase to ~8+% as the turnaround is further implemented.

Due to the small size of Logan Ridge, it will almost certainly never be valued at 100% of net asset value because the fixed costs required for running a BDC are too large for Logan Ridge who only has ~$200m in assets.

In order for Ted and his team to achieve a 10+% dividend yield for Logan Ridge investors – which is typical for a healthy BDC – the next logical step is to cut costs by merging Logan Ridge into the larger Portman Ridge BDC.

In the past, when Portman Ridge has acquired the other BDC's that BC Partners has turned around, there has been a 20-40+% premium – and each transaction has been paid for using shares of Portman Ridge.

Regardless of what Ted and his team decide is the next best step for providing shareholder value, I see multiple ways we can make a 30-50% return in the near future and very few ways in which we wouldn't at least get the current market cap back.

**Updates from H2 2022 Letter**

**ECIP Community Banks: *Citizens Bank (CZBS), Bankfirst (BFCC), M&F Bank (MFBP*)**

At the end of 2022, we were invested in three community banks – Citizens Bank, Bankfirst, and M&F Bank – each of which had received unprecedented amounts of ECIP funding from the government earlier that year.

The significant macro-economic development over the past six months in the banking world has been the collapse of Silicon Valley Bank and First Republic Bank, among others. This temporarily spread fear to regional and community bank investors that deposits would be rapidly taken out of smaller banks and put into the larger "systemically important" banks – such as JP Morgan Chase, Bank of America, etc. For various reasons, fortunately this has so far not been the case at any of our three community banks as deposits at each have remained stable.

Additionally, investors were concerned about banks that have high-rise office building loans on their balance sheet – the worry being low occupancy rates following the post-Covid "work from home" trend. None of the community banks we own have any significant commercial real estate loans of this kind and

almost all major office building loans are issued by regional and national banks, as well as large investment funds.

***Citizens Bank (CZBS)*** is a community bank located in Atlanta, Georgia. It is the largest position in our fund and now has a $80m market cap.

In May, I went to Atlanta for the Citizens Bank annual shareholders meeting where I was able to spend more time with CEO Cynthia Day, Chairman of the Board Ray Robinson, and the rest of the Citizens team.

I left the meeting feeling reassured by their vision and the future capital allocation plans they laid out. They have historically been a conservative and cautious management team and reiterated that despite having over $100m in cash at the holding company – from ECIP funds and preferred equity from major banks – they will continue to focus on profitability over aggressive growth.

Developments at Citizens Bank over the past six months include: declaring a $0.75 per share dividend, buying back ~5% of its shares, and continuing to gain momentum in its strategic lending relationships as the company brought on the NFL as a client (*see here*).

Although the share price has increased 25+% since the beginning of the year, Citizens Bank is still valued at a ~20+% free cash flow to equity yield – 5 P/E ratio – and has more than its entire market cap in cash at the holding company. Management is ready to deploy that capital toward business growth, acquisitions, or dividends/share buybacks.

Using reasonable valuation metrics, Citizens Bank still appears to be 75-100% undervalued and remains the most excessive discount we have found so far.

***Bankfirst (BFCC)*** is a community bank located in Columbus, Mississippi. It is the sixth largest position in our fund and now has a market cap of $200m.

In January, I visited Bankfirst CEO Moak Griffin and CFO Luke Yeatman at the company's headquarters in Columbus, Mississippi. I was able to further understand the thought process behind Moak and Luke's top-notch capital allocation over the past decade and their plans to grow the business from $2.7b in assets to $5.0b over the next few years .

The final of the company's three acquisitions using ECIP funds – Mechanics Bank – closed at the beginning of this year and has slowly been reflected in the financials; earnings and book value continue to grow compared to this time last year.

However, the most exciting news for Bankfirst since the start of the year has come from yet another capital contribution from the government. As mentioned in previous letters, Bankfirst is a CDFI – Community Development Financial Institution – which means they are qualified to receive financial grants from the government from time to time. In April, the government granted Bankfirst ~$11m which is 5.5% of the company's market cap (*note: Citizens Bank also received a grant but only for $500k*).

Worth noting, a unique attribute of Bankfirst is that almost all of its borrowers are located in rural areas whose residents have historically preferred to borrow on fixed interest rates versus variable interest rates. As such, ~80% of Bankfirst's loans are fixed interest rates.

As interest rates have rapidly risen over the past year, Bankfirst's earnings have increased more slowly than metropolitan and larger banks – who can have 50+% of loans in variable interest rates. This makes little difference for those long-term minded investors but can often confuse those investors who are hyper focused on each quarterly earnings report .

Despite Bankfirst receiving 5.5% of its market cap in a government grant (alongside earnings and book value continuing to grow compared to last year), Bankfirst's stock has actually decreased by ~15% since the beginning of the year. This is most likely due to the macroeconomic fear that was spread during the bank failures, alongside the misunderstanding of the firm's fixed interest rate earnings. Or perhaps, just simply due to the illiquidity of the stock!

The valuation of Bankfirst made little sense six months ago, but now it has become irrational. At a market cap of $200m, it is valued at a 15-20+% free cash flow yield – 5-7 P/E ratio – about 60+% below what I would consider a *conservative* fair value.

And this value doesn't even take into account the fact that Moak, Luke and the first-class Bankfirst team plan to continue to innovatively take advantage of an inefficient southeast banking market.

As they grow the bank to $5.0 billion in assets, they will also uplist on the NASDAQ exchange in the next few years. We are very fortunate to have Moak, Luke and team investing our capital for us.

***M&F Bank (MFBP)*** is a community bank located in Durham, North Carolina. It is our twelfth largest position and now has a market cap of $35m.

Late last year, I had the pleasure to visit with the M&F Bank team in Durham, North Carolina, which is the second oldest minority-owned bank in the U.S. I left the meeting impressed with the management team, but it wasn't until I became more familiar with the community banking industry that I further discovered the stellar reputation that CEO James Sills has amongst his peers.

M&F Bank is the smallest of the three ECIP banks we own and the biggest question remaining is how will it use its $80m of ECIP capital to grow assets; with under $500m in assets, the company needs to grow to adequately cover the necessary fixed costs required to run a bank.

James and the M&F team have outlined a plan to organically expand to new markets and populated areas within North Carolina. This plan will hopefully allow M&F Bank to grow large enough to reach an adequate size. If not, it seems likely James and his team will ultimately find a shareholder friendly way to allocate the $80+m of excess cash.

Over the past six months, M&F Bank also received a CDFI grant of $2.5m – ~5% of their market cap – as well as brought on the NFL as a client.

Despite mostly positive developments since the beginning of the year, M&F Bank's stock remained flat. It continues to be valued at a 15-20% free cash flow yield – 5-7 P/E ratio – while still having $80+m in cash – over 2x its market cap – on the balance sheet. M&F Bank remains 75-100+% undervalued using reasonable assumptions.

**Galaxy Gaming (GLXZ)** licenses proprietary table games for casinos – most notably '21+3'. It is our second largest position and now has a market cap of $60m.

Over the last six months, Galaxy has had nearly all positive business developments, but as mentioned in the beginning of the letter, the price remains in the $2.50 per share range, likely due to a large seller.

In April, I traveled to Las Vegas for the Planet Microcap conference, where I got to spend more time with Galaxy CEO Todd Cravens. After I caught up with Todd, he presented Galaxy to a room full of potential investors. I thought Todd gave a very impressive presentation that was a straightforward and candid assessment of the pros and cons of Galaxy's current status.

Some recent positive developments for Galaxy include: continuing to acquire distribution rights for notable casino table games such as EZ Baccarat, hiring key employees to continue building up Galaxy's 'bench strength', implementing a new top-of-the-line operating system, and most notably, signing a 10-year agreement with Evolution Gaming – by far the company's largest iGaming customer.

On the other hand, the largest financial overhang for Galaxy is still its debt burden. As discussed in the previous letter, Galaxy has ~$54m of debt outstanding due to buying out its founder in 2021.

This debt is charged a variable interest rate, which has increased to ~13%, as interest rates have rapidly risen – meaning almost all of the company's free cash flow is going towards paying interest and the required quarterly debt repayments.

The big question from now until the end of the year is "will Galaxy be able to refinance their debt with a more traditional bank?" That scenario would likely see ~4% lower interest rates, which would save Galaxy $2+m per year.

Worth noting again is that Galaxy has ~$16m of cash on the balance sheet which provides a significant cushion against interest rate uncertainty over the short term.

As Galaxy continues to grow revenue at 12-15+% per year and the debt burden begins to lessen, it should be back on track – over the next year or two – to generate $6-8m of free cash flow to equity – 8-10 P/E ratio. Additionally, if iGaming – online casino games such as blackjack – continues to legalize throughout the U.S, Galaxy will be worth multiples of its current market cap in the future.

**Boston Omaha (BOC)** is a holding company that divides itself into four main segments: Billboard, Insurance, Broadband and Asset Management. It is our third largest position and now has a market cap of $575m.

This April, I went to the Boston Omaha shareholders meeting in Omaha and was able to re-connect with co-CEO's Adam Peterson and Alex Rozek. I was also introduced to Boston Omaha board members Jeff Royal and Brendan Keating.

The more I get to know the Boston Omaha team, the more comfort I feel in their ability to allocate capital for decades to come – both Adam and Alex are in their early 40's and the surrounding team is within the same age range.

The Boston Omaha team has proven to be astute capital allocators who continue to methodically execute their plan they laid out when first starting Boston Omaha in 2015. I highly recommend reading their annual letters (*attached here*) to see how thoroughly planned out their strategy has been since day one.

Although the backbone of Boston Omaha is still billboards – it is the sixth largest billboard company in the U.S – almost all of its $25+m of cash generated over the past year has been reinvested back into the broadband division to grow its niche fiber internet business in rural and newly built neighborhoods.

In fact, over the first three months of the year, Boston Omaha sold $28m worth of shares in the open market – at around ~$25 per share – to raise money to continue expanding its fiber internet buildout – the cutting-edge technology that is replacing cable internet.

Adam and Alex stated they are almost always against selling shares. However, with most of their broadband internet competitors stalled due to high debt costs, they took advantage of the opportunity to raise money through equity. This has allowed them to get financially ahead of competition in a rapidly moving fiber internet expansion across the U.S – they estimate all of the fiber internet in the U.S will be built over the next 6-7 years.

Additionally, Boston Omaha has been rapidly growing the asset management side of the business. So far, launching two real estate funds that are financed by both Boston Omaha as well as outside investors. Initial conversations are being had about raising a third fund for investing in fiber internet.

This year, board member Brendan Keating was hired full time to be the co-manager of Boston Omaha's asset management business.

Currently, Boston Omaha is valued at book value or a 6-8% free cash flow to equity yield – 12-16 P/E ratio. Although this valuation may not seem unreasonable at first glance, Boston Omaha is still in the growth stage of its business where it is heavily investing into companies that require significant upfront capital – notably billboards, broadband and Sky Harbour. As these businesses mature, the free cash flow to equity should progressively increase without having to invest additional capital.

Re-stating the H2 2022 letter, Boston Omaha is a "close your eyes and in multiple years or decades from now it will be worth more" type of investment. Being able to invest at book value alongside two early 40's, savvy, long-term orientated capital allocators who should have decades of success ahead of them is an opportunity we will gladly continue to invest in for years to come.

**Legacy Housing (LEGH)** builds and finances manufactured homes. It is our fourth largest position and now has a market cap of $550m.

Legacy Housing today compared to a year ago is in a completely different place. If you recall, a year ago the company was going through accounting problems and had a severely depressed valuation – $350m market cap.

Since then, Legacy Housing has hired a new accounting firm, a new CEO, and has started to rapidly hire qualified team members. They have methodically become a professionalized business since we invested in them 1.5 years ago.

I visited with new CEO Duncan Bates in Dallas a few months ago and it is impressive to see how much he has developed as a CEO in just over a year. Make no mistake, Legacy's big decisions are still largely made with the input of the company's two co-founders Curt Hodgson and Kenny Shipley. Yet, Duncan has become a huge asset by seamlessly running the day-to-day business and allowing Curt and Kenny once again to focus on what they do best: using their unrivaled entrepreneurial genes to grow Legacy Housing and consistently remain one step ahead of their competitors.

Legacy Housing's share price has increased by 60+% over the past year and is slowly approaching a reasonable valuation – ~10% free cash flow to equity yield which is a 10 P/E ratio.

That being said, Curt and Kenny plan on innovating their business once again as the next stage of growth will come from developing their own manufacturing housing parks on the one thousand acres of land they own around Austin, Dallas and San Antonio.

This should provide significant growth, to both the manufacturing and lending side of the business, that we did not anticipate when we first bought ownership in the company – one of the many bonuses of investing alongside two die hard entrepreneurs.

**America's Car Mart (CRMT)** is a deep sub-prime auto lender and car dealership. It is our eighth largest position and now has a market cap of $650m.

Just as small, underfollowed companies can rapidly become undervalued based on no new company news, they can also drastically rise in price for seemingly no reason.

As mentioned previously, when I visited CEO Jeff Williams and CFO Vicky Judy last year in Rogers, Arkansas, one of the quotes that stuck with me was Jeff saying, "he doesn't see much of an advantage in being a public company as the stock is very volatile with many short-term minded shareholders, whereas our advantage lies in being able to think 5-10 years out."

Not only did this statement adequately outline the patient, long-term mindset that the America's Car Mart team has had for decades, but we have also now witnessed the baffling volatility of their stock price that Jeff alluded to.

When we bought America's Car Mart less than a year ago, they were considerably undervalued at 85% of book value – 15% below where the company would most likely be sold in a fire sale scenario – to now over 130% of book value. The company's stock price hastily went from $65 to over $100 – and continues to increase throughout July – with no new major developments.

There just seems to be no rhyme or reason why America's Car Mart stock price has been so volatile over the past year. Nevertheless, they continue to be a slow and steady business that consistently delivers excellent return on capital for us shareholders.

The company has now grown to 155 dealership & lending locations throughout mainly the southeastern part of the U.S. In addition, it continues to increase average cars sold per dealership to now 34 cars per month – one of Jeff's main short-term goals is to increase this metric even further to 40 cars per month.

America's Car Mart's dominance as the largest deep sub-prime auto lender and dealership should continue to expand as used car prices decrease and interest rates remain high. This will most likely put a financial strain on its smaller, marginal competitors, allowing America's Car Mart to increase its market share at current locations as well as acquire competitors to enter into new markets.

We are lucky to be invested alongside Jeff and Vickie as they are unwaveringly focused on achieving their 5-10+ year growth plan.

**Greenfirst Forest Products (GFP)** owns and operates four lumber mills in the Ontario providence of Canada. It is our tenth largest position and now has a market cap of $150m.

Over the past six months, Greenfirst has had the same good news and bad news as it did late last year.

The good news is still the capital allocation at Greenfirst under major shareholder and CEO – Paul Rivett – remains brilliant as over the past six months they have:

- Completed the sale of their two Quebec lumber mills for ~$67m
- Sold 30 acres of land in Kenora, Canada for $8m
- Paid down $20m+ in debt
- Reduced the duties paid on U.S exports from 20.23% to 7.99%
- Continue to invest capital into increasing productivity at their four lumber mills
- Cut corporate overhead costs

The bad news is that lumber prices still remain in the $500-$600 USD range – just slightly above breakeven for Greenfirst's lumber mills.

The market cap implies a valuation for its four lumber mills below $125-$150 MMfbm – capacity measurement for lumber mills – once you subtract out the other assets on Greenfirst's balance sheet such as inventory, duties receivable, land, and the paper mill.

This valuation makes little sense as it is 30-50+% below where lumber mills of much lesser quality have been selling for in the private market.

As we already know, Intefor – a major Canadian lumber company – bought 16% of Greenfirst shares over a year ago at 70+% above today's price. Intefor is a natural acquirer of Greenfirst and given its previous purchases of entire lumber companies it seems probable the firm would be willing to buy all of the Greenfirst shares at a significant premium to the current market cap.

In short, the downside protection we have at Greenfirst is significant. However, it may take a while for Greenfirst to be properly valued as lumber prices remain in the breakeven or below range. While we wait, Paul and his shrewd, fast-paced management team will continue to aggressively sell non-core assets and in the near future should start returning capital to shareholders.

**All Companies below 3% of our fund**

The remaining two companies are below 3% of the fund: **Endor AG and Pharmchem.** As usual, if these companies' positions grow in size, I will provide a detailed write-up. If you are interested in learning more about these companies now, please feel free to give me a call or I can e-mail you a write-up.

**Companies sold over the past six months**

**Sky Harbour (SKYH)** as the price increased over 150+% since the beginning of the year.

**FG Holdings (FGH)** as we used the sale proceeds to increase our ownership in *Greenfirst Forest Products (GFP)* which FG Holding's owns 8.6% of.

**Becle (Cuervo)** as we used the proceeds to invest in smaller sized companies as the risk/reward investment opportunities ,in smaller companies, have become increasingly more attractive over the past six months.

## My main mistake over the past six months

*Sky Harbour*

If you recall, last year we invested in **Sky Harbour (SKYH)** which builds and leases private aircraft hangars located at airports throughout the U.S.

Throughout 2022, I met with management and other Sky Harbour team members multiple times as well as visited their private hangars just outside of Houston and Dallas.

When we started buying ownership in Sky Harbour, it was valued at $3.50 per share ($200m market cap). Undoubtedly, there were some risks involved as Sky Harbour needs to increase their six airport hangar locations to twenty locations in order to reach an appropriate scale to cover the expenses of the business. Considering this, I decided to make Sky Harbour 4-5% of our fund.

A few months after we bought our ownership in Sky Harbour, the stock price declined ~40% to $2.50 per share ($140m market cap). By now, I had done an immense amount of research on the company – probably the most due diligence on any business to date – and had again met with management following the stock price decline. Despite this, I didn't take my own advice on page one of this letter; I didn't increase our ownership despite a 40% decline in price on no new company news.

I should have increased our ownership to 10+% of the fund at this point. At a $140m market cap, Sky Harbour was valued well below where they could liquidate their six airplane hangar locations and ground leases. It was an incredible risk/reward opportunity!

Due to my error, we missed out on having a phenomenal H1 2023 as the price of Sky Harbour went to $8+ per share ($450m market cap) when they announced a few positive developments in the beginning of this year.

The mistake wasn't because the price rapidly increased to $8+ per share. It was due to the fact that I hesitated from buying significantly more ownership – at a 40% cheaper price – despite having done in-depth research, spoken to management and knowing the decrease in share price was only because of illiquidity.

As a result of my error, we missed out on the possibility of buying more of a 'wonderful company' at 'excessive discount' valuations. That opportunity rarely occurs!