Greystone Capital Management
Concentrated Value Investing

Q1 / May 2024

Dear Clients and Friends,

During the first quarter of 2024, returns for separate accounts managed by Greystone Capital ranged from -1.2% to +2.0%. The median account return was -0.1%, net of fees. First quarter results compare unfavorably to the S&P 500 and Russell 2000 returns of +10.6% and +5.2% during the quarter. Because client portfolios are invested in a concentrated way consisting of small companies mostly outside of the major indices, our returns should typically vary from the returns generated from those indices.

We finished the quarter roughly flat, despite two of our top five positions in Limbach and Bel Fuse trading down -25% during the quarter, offset by strong performance from Sylogist, Medical Facilities Corp., and our newest position, Innovative Food Holdings, which is discussed below.

Good or bad, I always caution reading too deeply into any 3, 6, or 12-month period, and that caution should still be heeded. I covered a lot in my Q4 letter written just a few months ago, and that commentary is still applicable. I continue to find interesting investment ideas to research, two of which made their way into your portfolios this quarter.

Importantly, for our holdings that detracted from performance this quarter, the investment theses remain very much intact, despite short-term worries leading to over-extrapolated share price declines. In each case I added to our positions. Again, it's my preference not to place too much weight on short-term results, as share prices will continue to align with business performance over time. I understand that in the short term, large moves to the downside can be painful. Equally painful is the market ignoring or misinterpreting strong operating performance. We've had our share of both. But as Warren Buffett tends to remind us:

> *"The stock market is a device for transferring money from the impatient to the patient."*

We sit in the latter camp, which is not a popular one. Increased allocations to multi-manager firms or 'pod shops' means that a large group of equity holders operate with principles and strategies very different from ours*. Strict risk controls and near zero tolerance for underperformance have a drastic effect on holding periods for these managers. Due to the amount of assets being fed to these firms, the views of which are the opposite of long term, we must sit through the quarterly game of investors unnecessarily punishing or rewarding earnings beats and misses, and sometimes deal with the resultant share price moves. For the remaining market participants, the recipe for success lately has been to own the largest businesses that exist, and in most cases avoid, or even sell short the small stuff. Add in the convergence of economic, political, and technological transformation taking place, and there is plenty to react to on a daily basis.

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*Although multi-managers comprise 8% of total hedge fund AUM, their hold on US equities has grown to 27%, up from 14% since 2014, mostly facilitated by leverage.

This creates a lot of noise, most of which doesn't deserve our attention. Even if the near term seems murky, the quarterly trading game is not one I am equipped to play, nor do I want to. If you'd like to get a better sense of how your portfolio is truly performing or is likely to perform in the future, pay attention to the operating metrics and KPIs of our companies over a multi-year period. In other words, the things that matter. Are revenues growing? Is the cost structure stable or declining? Are margins increasing? Is cash being invested wisely, or returned wisely? These are the things we are betting on, and the things on which I've encouraged clients to focus. But it requires patience, not the viewing of business ownership through daily mark to market activity.

On a positive note, April is off to a good start for us despite small cap and microcap indices giving back nearly all their year-to-date gains. Markets once again are having a difficult time digesting inflation news and the idea that near-term rate cuts will likely be pushed back further than anticipated. Despite the constant and sometimes severe ups and downs, we are being granted the psychological catalysts needed to find and purchase very good investment opportunities that will help drive our future returns.

During periods of outperformance or short-term underperformance, my investment worldview remains unchanged. As does my personal investment in the firm. Our interests are aligned.

Portfolio Commentary

Outside of **Innovative Food Holdings**, we entered into another new position in **NN, Inc.** discussed below, representing the type of company we hope to be invested in for a long time.

Our current positioning remains favorable as we own companies with a good combination of growth and value along with businesses that possess better characteristics than what's found in broad indices, at prices below what could be considered reasonable. Only three of our businesses have meaningful net debt positions, appropriate for their business predictability, and have been maniacally focused on bringing leverage down. The remaining have sizeable net cash positions, strong capital allocators at the helm, and growing businesses in which to reinvest. Most of our companies are also engaged in meaningful share repurchase programs at favorable valuations. We will experience the occasional bump in the road, but our long-term prospects remain very good.

New Positions

"I like to do well. So, if I'm handed something with absolute proof that I will fail, I will reverse course." -- Conan O'Brien

Management changes are an interesting subset of corporate news I like to follow. When it comes to microcaps, my ears perk up when a new CEO announcement involves someone who was a former executive at a much larger business. It's interesting that someone would choose to leave a stable, likely high-paying job for the uncertainty of managing a business that potentially few have ever heard of. It's also likely that considerable thought went into the decision given the risks involved.

During my time in the sports world, I witnessed team executives, scouts and entire fan-bases take for granted a traded NBA player showing up to his new team and performing well, sometimes *that same night*, despite being immediately uprooted from their home, from their teammates, from their friends and sometimes family. It's incredibly hard to do, and the only reason it works is because in those scenarios, athletes don't have a choice. For CEOs, *choosing* to move geographies, build relationships with co-workers from the ground up, pull kids out of school, or convince a spouse you're making a good decision are also incredibly difficult things to do. To do them willingly is not something we should take for granted.

So, considering the potential pitfalls and possibility of failure, why would someone leave a stable job and family life, risk their spouse's disapproval, or alter their future to dive into a new, risky, unknown thing? One argument is that people do dumb things all the time. We have to account for that. But the rational, more likely argument is that *they think they can succeed*. I love a CEO who likes to compete, but the smartest ones would rather step over one-foot bars, not seven-foot ones.

Reading between the lines, identifying low-hanging fruit likely played a part in deciding to take on the roles discussed below. The other parts involve incentives and people, likely the two strongest forces in the investment world. Our new CEO's have two things in common, they are highly incentivized to succeed, and they brought their own people with them to these new opportunities. Strong monetary incentives based on the right metrics along with having others depend on you, brings with it the weight of expectations. A good setup to get behind is when a management team has a lot to gain, *and* a lot to lose. This isn't always a panacea for an ailing business, but it's a great first step.

A great second step is to stop doing dumb things.

In keeping with our theme of investing in companies that cease doing dumb things, two new positions that made their way into the portfolio this quarter include **Innovative Food Holdings** and **NN, Inc.** Each business possesses the criteria of being a better business than currently being given credit for, have undergone significant changes in the C-Suite, and have many common-sense items to address that will help reveal each company's core business quality over time. In other words, plenty of one-foot bars.

Below I highlight each investment and look forward to disclosing more in future letters.

Innovative Food Holdings (IVFH)

Innovative Food Holdings is a specialty food distributor with a niche service offering and a history of strong organic growth. The company distributes over 7,000 perishable and specialty food and food related products, with expertise in selection, sourcing, and logistics. The business was founded and run for nearly twenty years by the former CEO who was both overpaid and had a history of chasing pet projects to the company's detriment. Despite following IVFH for years and liking the core business, the company was un-investable under the prior management team. That is no longer the case.

With a highly competent and experienced management team now in place, along with an aligned and incentivized Board, shareholders finally own a food distribution business that will focus on its core customer and has the opportunity for revenue growth and margin expansion. However, as the result of questionable strategic decisions, the past few years of financials reveal a business that is under-earning, with true earnings power being masked by an unnecessarily high-cost structure due to an unprofitable e-commerce segment that is in the process of being wound down.

Innovative Foods has three core offerings: a direct-to-chef specialty food service platform, an asset-light drop shipping distribution business where IVFH partners with broadline distributors such as US Foods to drop ship directly to end customers, and a specialty food distribution business that serves professional chefs in the Chicago area through their subsidiary, Artisan Foods. Food distributed by IVFH ranges from familiar to completely esoteric, where they've carved out a niche for themselves due to their relationships with hundreds of small food producers, including small farms, boats, and ranches. Specialty food distributors, and IVFH in particular, serve a critical need in the food distribution ecosystem by providing an important add-on offering for broadline food distributors, sourcing quality in-demand fresh foods for professional chefs, and providing capabilities for broadline distributors to plug IVFH's offerings directly into their ordering and billing systems.

Companies like IVFH and other regional specialty food distributors have often been ignored by competition given the difficulty in building out these capabilities, as it doesn't make sense from a cost or profitability standpoint for a US Foods or United Natural Foods to develop a specialty offering. As a result of this niche along with higher priced specialty items, IVFH has historically posted strong organic growth figures along with gross margins well in excess of broadline distributors. Given the asset lite nature of this business along with good incremental margins, the cash flow profile for food distribution is also strong.

Unfortunately, despite the profitable food distribution business growing 20% per year from 2015 until 2020, prior management started spending more time on a direct-to-consumer e-commerce offering that was low margin and expensive to scale. This dragged down the profitability of the entire business due to elevated customer acquisition costs and bloated SG&A.

Following years of disappointment and a business under-earning on its potential, members of the Board were successful in replacing the former CEO with new CEO Bill Bennett, an industry veteran who spent time with both Wal-Mart and more recently Kroger, where he oversaw their $10 billion e-commerce business. Once at IVFH, Bill's first tasks were to prioritize cash flow and reduce costs, by examining every single dollar that went out the door, including what IVFH pays to landscape the small patch of grass outside of headquarters. This is my kind of CEO.

As you'll see with NN Inc., it's remarkable what Bill and the team have achieved since their hiring, winding down unprofitable e-commerce operations, divesting non-core assets, reducing SG&A, and securing additional broadline distributor relationships for the Professional Chef business. However, we are still in the first inning of management's strategic plan to stabilize the business, lay the foundation for growth, and then build and scale. Management is incentivized to do two things, above all else: increase profitability and deliver strong shareholder returns. If successful, management will own a large chunk of the business through their compensation package, and we are betting on their success. We didn't pay up for it either.

Although there are a lot of moving parts, IVFH finished FY23 having generated $2.5mm in EBITDA, which is likely a trough figure. Low hanging fruit can double this number in the near term before any growth initiatives take place, and there is a mid-term goal to increase the top line to $100mm in revenues with a 10% EBITDA margin profile. While not quite there yet, as non-core assets continue to get sold, IVFH will be a $50mm market cap business with around $10-12mm in net cash on the balance sheet, a sustainable $5-6mm EBITDA profile, limited capex and high returns on capital. This is all before any new business growth.

There are levers to pull to help uncover latent earnings power, and I'm betting on this management team to execute on the opportunity. A renewed focus, and various avenues for growth also means that the company can build scale in food distribution for the first time in years. If the core business returns to 20% annual growth, we will win big. Further optionality exists with IVFH being able to develop a platform for specialty food M&A, for which the industry is rife with such activity. Private equity is leaning hard into specialty food distribution M&A, and the fragmented industry provides opportunities to grow products, geographies, and customers. IVFH could find itself on the receiving end of a takeout offer as well.

There will be bumps in the road on our way to success, but I'm excited to see what Bill and his team can accomplish during the next few years.

NN, Inc. (NNBR)

For readers in the habit of using quantitative screens to identify investment ideas, NN will likely cause you to turn the other cheek. At first glance, this business does not look pretty. Under the hood, there is a lot to like. The fact patterns here along with management efforts are very similar to our investment in Bel Fuse. Like Bel Fuse, NNBR possesses strong technical expertise, a large manufacturing footprint, and long-dated customer relationships. Also, like Bel Fuse, NN was historically mismanaged, which shows up in the areas of pricing, manufacturing overhead and new business wins.

NN, Inc. is a precision parts manufacturer that specializes in the development of plastic and metal components for various end markets. The company operates through two segments, **Mobile Solutions** and **Power Solutions**. Mobile Solutions manufactures parts primarily for the automotive market in power steering, braking, and fuel systems, while Power Solutions makes parts for general industrial, electronics, and medical markets. Specifically, NNBR manufactures parts that help other machinery spin, turn, and rotate. This other machinery is made up of everything from power steering systems to surgical devices to aerospace components. The company has a history dating back to the 1980's as a manufacturer of metal balls and rollers for the oil and gas industry, and today their precision capabilities and blue-chip customer base means they manufacture a wide variety of SKUs leading to a stable base of $500mm in revenues.

The performance and durability required of NNBR's parts means that they have a high cost of failure, making them critical components despite their low cost to end customers. This has led to long-standing relationships with their customers, along with many of these components being sole source, making NNBR's competitive position quite strong. This helps partially explain how, despite NN losing its way recently, the customer base has held up well, despite a history of poor acquisitions, too much leverage and an incredibly weak culture.

Thankfully, our involvement is recent, following multiple positive changes that the market has yet to price in, despite the 'why now' part of the investment thesis being more evident today than at any point in the past few years. As management continues to execute, I believe NNBR is rapidly approaching a more normalized cash flow profile that will reveal the future is going to be much different than the past. As you've likely seen with good businesses that besmirch their public market reputation, the prior management team took on significant leverage to make a string of bad acquisitions that didn't contribute meaningfully to profitability nor provide any cost savings or manufacturing synergies. Companies can sometimes hide behind bad deals, but when COVID hit, NN was forced to take drastic action in the form of unfavorable capital raises along with the sale of one of their other business segments in order to pay down debt.

Today is a new day at NN as there is an incredibly high-quality management team and Board in place, spearheaded by two activist funds, also the largest shareholders of the business. Current CEO Harold Bevis is an industry veteran who has been there, done that in previous roles, having spent the last twelve years at two different public companies, Xerium (XRM) and Commercial Vehicle Group (CVGI), both of which left shareholders much better off than before he arrived. In line with my comments above about people and incentives, Harold recruited some old team members to join him at NN, where each have the opportunity to earn many multiples of their base salaries if successful. In fact, Harold dumped his prior role at CVGI to take the CEO job at NN, which should bode well for us as one source described Harold as someone who will 'run you right over' if you get in his way.

Since their hiring, management has laid out several key strategic pillars on which they will focus and have already made remarkable progress in a short period of time. These pillars include strengthening the leadership team, addressing unprofitable business, expanding margins, delivering consistent free cash flow, and increasing new business wins. While that sounds like a tall order, most of these initiatives only require adopting common sense operational tactics. Importantly, there is valuation upside even before new business wins take place or top line growth resumes. In other words, there is plenty of low-hanging fruit to lower costs and expand margins, the bulk of which is being undertaken as I write this letter. Some of these items include addressing unprofitable business, implementing better pricing practices, and instituting a more centralized system to purchase raw materials. If I am correct about the cost improvements for each one of these items, the permanent flow through to EBITDA would be tremendous.

While there is execution risk, and NNBR is still a show me story, I'm confident that in the near-term that management's efforts will start to show up in the company's financials and reveal NNBR to have much greater earnings power than is currently being demonstrated.

Management has guided to $47-55mm of EBITDA for FY24, and there is likely a significant amount of upside to that figure as early as this year. Then, as new business wins contribute to improved top line growth, operating leverage should also kick in, presenting the opportunity for increased free cash flow conversion over time. This should help change the perception of NNBR, which will be very powerful for our returns.

We have David Polansky of Immersion Partners to thank for helping outline the strength of the opportunity.

Broad Market Commentary

Please refer to the first section of this letter for my market commentary, included in my initial thoughts.

Recent Developments

Greystone added one new client during the quarter with the goal of continuing to add like-minded and patient investors to the firm. On a weekly basis, I continue to have meaningful conversations with thoughtful high net worth, family office and institutional investors. Referrals continue to be welcome and if you know anyone that might be a good fit for the firm, please feel free to pass along my information. Thank you as always for allowing me to manage your hard-earned savings. I am incredibly appreciative.

Please feel free to reach out anytime. Thank you for reading.

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