Greystone Capital Management
Concentrated Value Investing

Q1 / May 2025

Dear Clients and Friends,

During the first quarter of 2025, the median account return for separate accounts managed by Greystone Capital was -7.9%, net of fees. First quarter results compare unfavorably and favorably to the S&P 500 and Russell 2000 returns of -4.2% and -9.5% 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.

Given our Q4 2024 letter was published in late January and our Annual Partner's Meeting was held on March 5th, this letter will be shorter than previous quarterly updates. During the annual meeting, I shared my thoughts on the broad market and future outlook, while covering the portfolio in depth. If you did not receive the link, please reach out. If you haven't watched the recording, I recommend you do, as I reiterate how we operate and invest through all environments, including those with uncertainty, pointing to the non-negotiable aspects of our process, while emphasizing my preference for thinking long-term and not over-analyzing short term results.

During Q1 we witnessed a broad market decline which was exacerbated in early April due to punitive tariff measures announced against our global trade partners, stoking geopolitical and recession fears. We were not spared, as several of our large positions declined significantly from February to late March, despite continued strong business progress, and in some cases, record FY24 performance. This is to be expected. Periods of fear and uncertainty drive all correlations to 1.0, and recent short-term volatility has been swift and aggressive. Due to the back-and-forth nature of policy, and the short time frame since implementation of tariffs, I deem it best to give adequate time before providing any commentary.

As stated, we ended the quarter down -7.9%. Certainly not ideal but hardly cause for panic. For us, two things happen during periods of uncertainty and volatility. The companies we like in your portfolio get cheaper, and companies on my watchlist do the same. We will be given the chance to add to our current holdings as well as upgrade the quality of the portfolio as opportunities present themselves. We took advantage of one such opportunity during the quarter, buying shares of **KITS Eyecare**, the details of which are appended to the end of this letter.

There was a point in early April where it seemed likely we were headed for a steep market decline along with the possibility of a recession. Despite some stabilization, both outcomes remain on the table as markets and the world digest commentary and policy changes from the White House during the next few months. What happens next is unknowable, but if this decade is intent on turning your portfolio manager into a seasoned bear market investor, our process was developed precisely to handle periods such as this one.

Our advantage is feeling comfortable investing *through* disruption, volatility and the many ups and downs that we will likely face over a long enough investment timeframe, armed with the knowledge that falling stock prices combined with good business results means strong future returns. Periods of heightened uncertainty call for restraint, not reaction. Rather than chase headlines or shift course hastily, we'll stay anchored to a proven philosophy in place since inception – echoing [Jack Bogle's timeless reminder]: *"Don't just do something. Stand there!"*

Ours is a patient, long-term strategy, which is why regardless of what the short term brings, we remain invested alongside each other, firmly aligning interests.

Portfolio Commentary

The inconsistency, randomness and unpredictable messaging around potential new trade rules creates an environment for businesses where planning strategically, hiring, investing, and growing, becomes nearly impossible. Assuming the administration ploughs forward on the current path, investors and companies alike will be faced with many tough questions.

The overarching question for us, however, is will the earnings of our businesses be higher or lower in 3-5 years or more? Assuming the answer is higher, and assuming we didn't overpay for this stream of earnings, we will do well, despite the ups and downs we experience along the way. From my perspective, tariffs, a recession or the shifting of global trade will not *directly* knock our companies off their paths. *Indirectly*, there are likely to be ripple effects that will reveal themselves over time, similar to the pandemic.

Come what may, it's worth noting that during the past few years, we have placed significant emphasis on business *quality*, investing in strong competitive positions, high quality management teams, rock solid balance sheets and substantial durability. A large portion of our companies have decades-long operating histories, strong track records of free cash flow generation, clean balance sheets and the ability to withstand and even improve during adverse economic conditions. These are favorable attributes that will help them – and us – cut through the noise and navigate periods of uncertainty, knowing that collectively, thousands of people go to work each day to make our companies better.

Additionally, due to the sales of **Franklin Covey** and **Xponential Fitness** during the quarter, we are holding a larger than normal cash position, which I am not in a hurry to deploy. That could shift on a moment's notice, but for now, I'm adding to things that are working and studying new companies and industries. As always, I will make changes as necessary but remain optimistic about our positioning. Below, I briefly discuss some of our companies and their direct exposure to tariff-related cost increases.

Sold Positions

Franklin Covey (FC)

During the quarter, we sold our position in Franklin Covey. Although we are long-term investors, the uncertainty of the near-term environment may prove to be a large headwind for the business, and my prior estimates of cash flows have been very wrong up to this point. I was also blindsided by the company's recently reduced guidance (for the second time) for FY25, which along with some other management blunders that has caused me to lose some faith. My loss of confidence combined with better current opportunities were the primary reasons behind the decision to part ways.

Xponential Fitness (XPOF)

Xponential Fitness was a new position for us that I started buying in late February and spoke briefly about during our annual meeting. I won't rehash the details, but based on our work, I was under the impression that the company's past issues were in the rearview mirror, and with a new management team in place, the future seemed bright. We bought our shares at a wide discount to other franchise businesses, despite the high-quality business and growth prospects.

Shortly after our initial purchases, we were sucker-punched by an incredibly weak Q4 / FY24 report where XPOF announced reduced same store sales growth, a restatement of their 2023 financials, lowered guidance, and issued an outlook for studio closures and new studio openings that in no way resembled the growth path being discussed just a few months prior. To be fair, the accounting issues were benign, but open the door to more problems down the road and introduce the possibility that management knew of these issues for some time. I believe investors have been misled and as a result we sold our shares. This was an unforced error on my part that could have been avoided with patience.

Other Updates

Bel Fuse, Leon's Furniture, and **Natural Resource Partners** are the only companies in your portfolio that have direct exposure to tariffs.

During FY24, **Natural Resource Partners** generated $250mm in free cash flow, despite met and thermal coal prices significantly lower than those of the past few years. This is the beauty of the royalty business model, with no ongoing capital requirements and minimal operating expenses. To be clear, free cash flow generated during 2025 will be lower than 2024, but within the next year or so, NRP will have the flexibility to both repurchase units and significantly increase their distributions to unitholders, amounting to a 15-20% yield on the current price. A shutdown of China as a coal export market for the US would not be good for either country, especially as the current administration aims to reinvigorate the coal industry. As a result, it's likely that cooler heads prevail. If not, NRP is nowhere near priced for perfection as intrinsic value lies between $200-250/share versus the current price of $100/share.

For **Leon's Furniture**, only a small portion of their business will be directly affected by tariffs. As a Canadian based retailer, Leon's sources goods from countries outside of the US but does derive a small portion of revenues from the US (sub-10%). In addition, they are the largest importer in the country of containers from China, giving them tremendous negotiating leverage and the ability to weather any supply chain storms, as evidenced by their margin profile during and post-COVID when container rates skyrocketed by 5x. This is not a luxury their competitors have, and I would expect Leon's to take incremental market share in an adverse economic scenario, with the window for M&A also opening. Despite Leon's strong performance through all cycles, I believe shares remain priced as if bad news is on the horizon. I peg intrinsic value at CAD $50-60/share versus today's price of CAD $22/share.

Within **Bel Fuse's** operating footprint, around 13% of total revenues are directly exposed to tariffs via China and Mexico. Bel has shown the ability to pass cost increases through to customers, which they anticipate will continue, with minimal impact to Bel's financials. Localized manufacturing will also help offset any further impact. During the past few years, management has proven adept at navigating both internal business issues along with the difficult post-COVID economic environment that has plagued a few of their business segments.

A recession would not be ideal for Bel Fuse, and following the acquisition of Enercon, they are leveraged 2.8x. however, management has always shown conservatism and Bel has a cash generative business model that provides a decent margin of safety. My estimate of intrinsic value is between $120-135/share, versus a current price of $67/share.

Recent Developments

During the quarter, we onboarded several new clients who represent exactly the type of partners we want to be invested alongside for the long term. As always, referrals are welcome.

In March, I was invited on the Capital Compounder's Podcast with Robin Speziale, where we talk my background, Greystone's investment process and dive into some of our portfolio companies. I was also a guest on The Investor's Podcast with Kyle Grieve, where we talked about my time working in sports and various aspects of my investment process. I've been listening to The Investor's Podcast for over 10 years and always learn a lot, so it was fun to finally be a guest.

This is an interesting time in both markets and history through which I am excited to be learning and investing. Thank you as always for the opportunity 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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Appendix: KITS Eyecare (KITS.TO)

During the quarter we entered into a new position in KITS Eyecare, an e-commerce optical retailer which I've followed since their IPO in 2021. The investment thesis for KITS is simple; earnings power should grow significantly during the next 3-5 years. The company is operating a disruptive, low-cost business model, currently at an inflection point, growing 30-35% organically in a huge category with a large TAM, has strong operating leverage, positive cash flow, excellent management, and a net cash balance sheet. We paid less than 18x EBITDA for the above attributes, which I believe will look very cheap in the coming years.

Like most of the companies in your portfolio, the best starting point for understanding the attractiveness of our investment is with the management team, particularly KITS Founder, Chairman and CEO Roger Hardy. Roger built a very similar business in the early 2000s called Coastal Contacts, which was ultimately sold to Essilor Luxottica for $430mm in 2014. Coastal was an early pioneer of e-commerce eyecare which helped reveal a strong product market fit that Roger and his co-founders set out to improve upon with KITS. I like to screen for CEOs on their 'second act', where past learnings, mistakes and successes can be applied for our benefit. Roger, COO Joe Thompson and the team check many of our boxes, not only as owner-operators but as a group spearheading a strong corporate and financial culture that would be very difficult to replicate. As you'll see below, KITS is unlike most businesses in the optical industry, where a focus on the customer typically comes second (or third), not first.

Along with the favorable culture, KITS management team has engineered this business in a differentiated way as compared to most optical retailers, and in just seven years, have built a better mousetrap for e-commerce eyecare, lending itself to recurring revenue, a strong moat, a significant growth runway, and more. KITS competitive advantages should widen over time.

KITS is an e-commerce retailer of contacts, glasses and accessories. The company offers a wide selection of contacts and prescription eyewear with low prices and fast shipping, along with online vision tests and prescription renewals, enabling a superior value proposition for customers versus legacy retailers. This value proposition is made possible in part by KITS ability to take cost out of the value chain by owning their own automated optical labs and selling direct to consumer. Years of investment have enabled KITS to manufacture eyeglasses in-house (as opposed to the traditional model of outsourcing to a third party), made to order in as fast as 30 minutes, while controlling quality and cost, allowing KITS to eschew traditional markups for frames and lenses typically seen throughout the industry.

Despite the low price point, you won't find KITS glasses at the checkout line at the drug store. KITS quality and selection are no different than what customers would find at their optometrist office, or similar e-commerce incumbent Warby Parker, not skimping on materials and using prescription polycarbonate lenses, acetate frames, European sourced hinges, and modern designs. Customers can purchase a pair of prescription glasses for as low as $28 and receive them within 1-3 business days, leading to high customer satisfaction and repeat visits. KITS convenient, scalable and limited inventory model has been perfected during the past 7 years, and exceeds all legacy players, who burden customers with long wait times, mandatory eye exams, 1–2-week shipping, and unnecessarily high prices, in some cases between $300-$1,000 dollars for a single pair.

In the optical industry, the sale of eyeglasses and lenses specifically drives the majority of industry profits. Despite the apparent simplicity, eyeglasses are complex pieces of technology that require advanced machinery and expertise to manufacture. For most brands, a lack of expertise in manufacturing requires the outsourcing of production to a concentrated group of suppliers, meaning manufacturers can charge significantly higher prices than their costs would suggest is necessary. Industry giant, EssilorLuxottica controls nearly 50% of the industry by owning many parts of the value chain, including retailers, e-commerce players and manufacturing in the form of optical labs. Because of this ownership position built decades ago, Essilor has typically been able to extract rent seeking prices for eyeglasses, despite their low cost of production, given opaque industry pricing and control of the supply chain.

As a result, the historical price to value equation has been to the detriment of the consumer. This would make any industry ripe for disruption with optical care being no different. Decades ago, KITS management saw an opportunity to 'make eyecare easy' via a large gap in the market among younger consumers that were both comfortable shopping online for eyecare and would prefer a better consumer experience and more affordable price point, without skimping on quality. In other words, competitor's margins were KITS opportunity.

The KITS model works in large part by choosing to make their own products, building quality relationships with suppliers, refusing to build a brick-and-mortar presence, avoiding traditional and costly marketing channels, and keeping prices low. As mentioned, KITS can manufacture a pair of prescription glasses within 30 minutes and have them out the door to a customer that same day. The cost savings that stem from this model are passed along to customers, resulting in a better customer experience via low prices and fast shipping. Although KITS gross margins lag below peers such as Essilor (65%) and Warby Parker (54%), the model requires much lower fulfillment, marketing and G&A expenses.

This is a structural moat that would be difficult to breach as it would require a complete overhaul of competitors' cost structure and operating footprint along with a willingness to accept lower prices. The model has been attempted by others with limited success. Early e-commerce players such as Warby Parker focused on selling glasses *first* by cutting out the middleman (brick and mortar) and offering lower prices. However, selling eyeglasses first is a difficult undertaking given the lack of repeat purchases, upfront cost of acquiring customers and the challenge of retaining them. This path requires significant marketing spend and scale before dollars start rolling in, which is why most e-commerce players have yet to find the formula for profitability.

KITS bucked this trend in a major way by selling contacts *first*. Despite the unattractive financial profile as a commoditized, lower-margin product, this was a great chess move, as contacts drive recurring purchases, meaning these early efforts resulted in customer stickiness and repeat business. Today, nearly 70% of KITS revenue comes from repeat customers, providing the perfect segway to sell eyeglasses, which is a segment of KITS business growing 40% per year.

Furthermore, KITS in-house automated manufacturing capabilities took years to build and cost tens of millions of dollars, with the only capital raise to date coming from their 2021 IPO. This is not a business or industry you can attack by throwing money around. Despite a first-mover advantage, and raising hundreds of millions in venture capital, Warby Parker has lost money every year since going public.

Aiding KITS execution is the $70B US optical industry, a recession resistant space which has exhibited consistent, stable growth across most economic cycles. The category is also shifting online. Since 2005, online penetration for contacts has grown from 5% to 40%, while sales of eyeglasses grew from 1% to 18%. This shift accelerated rapidly post-COVID, as the online mix for glasses was 6-8% pre-pandemic, and sits above 18% today, while 15% of contacts purchases were made online pre-COVID, increasing to over 40% today. Given global growth in myopia, further online penetration, younger consumer trends and increasing brand awareness, KITS has an enormous runway for growth.

Given the above, it's no surprise that KITS has grown tremendously since its founding. Sales have grown at an average rate of 35% since 2019, with no signs of slowing down. In fact, I believe the business is at an inflection point, both company specific and industry wide, allowing growth to persist for the next decade plus. Importantly, this growth has not come at the expense of profitability, with EBITDA margins for FY25 estimated to be in the 6-8% range and growing. Free cash flow margins will remain close to that, as KITS has no debt and limited capex requirements.

KITS currently trades for 1.5x sales and 22x my estimate for FY25 EBITDA. Although this does not screen headline cheap, unit economics for eyeglasses are phenomenal. I estimate that KITS has an industry-leading CAC/LTV, by acquiring customers for around $25 who then go on to spend an incremental hundreds of dollars on KITS.com within 6-12 months. Additionally, there are opportunities to improve on nearly every line item of the P&L, and this model should show strong operating leverage over time. Despite *nine straight quarters of 30% or more revenue growth*, KITS fulfillment costs, G&A, and sales and marketing have all trended *downward* as a percentage of revenue. Furthermore, this is not a post-COVID explosion in the category, as much of this growth is from incremental spending from repeat customers, while new customer growth has been modest at 7-8% per year. Therefore, I do not believe KITS is experiencing abnormal growth trends.

Over time, KITS can capture an ever-bigger share of the industry by following a repeatable and effective playbook. Management believes the business can scale to CAD $250mm in revenues within 2 years, up from CAD $159mm at the end of 2024. Within five years, KITS is aiming for CAD $500mm in sales, at which point 10-15% EBITDA margins are within reach. At that scale, assuming the low-end margin range and no change in multiple, KITS stock would be worth CAD $35/share versus our average cost of around CAD $9/share. Importantly, these targets are not formal guidance, and in my view are conservative. Despite their progress, KITS brand awareness remains low, which provides further room for upside.

Should I be wrong about my assumptions, I trust management, as owners, to steer the business in the right direction. An unprofitable, slower-growing Coastal was sold for 2x revenues in 2014, and I believe it's only a matter of time before KITS receives some offers from a larger optical industry player. Let's hope it's further down the road this time.

Disclaimer: *Past performance is no guarantee of future results. Investing involves risks which clients should be prepared to bear, including but not limited to partial or complete loss of principal originally invested. Investing in small and microcap companies can result in additional volatility and higher risk due to comparatively low market capitalization, more sensitivity to economic and market conditions, and more limited managerial and financial resources. In addition, small companies typically trade in lower volume, making them more difficult to purchase or sell at the desired time and price or in the desired amount. Please refer to Form ADV Part 2 brochure for more information about Greystone Capital Management and its personnel.*