Greystone Capital Management
Concentrated Value Investing

Q3 / October 2023

Dear Clients and Friends,

During the third quarter of 2023, the median account return for separate accounts managed by Greystone Capital was -11.4%, net of fees. Third quarter results compare unfavorably to the S&P 500 and Russell 2000 returns of -3.2% and -5.1%. 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.

This is a longer than usual update for Q3. Given our performance this quarter along with negative sentiment within our universe (we are one *'The Death of Small Caps'* article away from being able to call a bottom), I felt it was necessary to provide my take on the current investment environment as well as do some cheerleading for our asset class. The prevailing mood is myopic and fails to highlight the many opportunities that are currently available, some of which have become new investments for us. Looking out over a multi-year timeframe, I am as excited about our portfolio as I've been since the depths of COVID.

Negative performance this quarter was largely the result of our investment in Polished.com, discussed below, as well as three of our top five positions each drawing down between 15-25% during the past two months. My Q4 letter is typically when I discuss our top five positions in depth. I will save that discussion for a few months from now. Apart from Polished and some transitory headwinds for RCI Hospitality, most of the share price declines within your portfolio can be attributed to the continued small company drawdown, as business execution across the rest of the portfolio continues to be excellent.

With that said, the market seems like a scary place right now. We are operating in an environment rife with uncertainty, complete with a looming potential recession, geopolitical strife, and persistently high inflation. Today's set of problems is unique to this period, but ever-present macro concerns are nothing new. Among them, the direction of interest rates is taking center stage, where the equation of higher rates equals lower stock prices has historical precedent. If 'higher for longer' is here to stay, small cap and microcap stocks may continue their decline. As the market tries to digest the present uncertainty (what will the Fed do!?), the typical response has been to over-extrapolate. When it comes to small companies, we are right on cue.

Make no mistake, small-caps and micro-caps are in a bear market. Despite the iShares Micro-Cap ETF (IWC) being down -10% on the year, the average stock in the index has drawn down -43% from its 52-week high, versus -19.1% for the average stock in the S&P 500. Zooming out further, the drawdowns are even more severe relative to post-COVID highs.* The Russell 2000 has not fared better, with valuations remaining close to 20-year lows relative to large caps at the end of September.

As a *person* with significant personal and family capital invested in Greystone, and more than one dependent, I would be lying if I said I enjoyed periods like this one. As an *investor*, I am fired up. Every bear market has one thing in common. Times like these are often the most rewarding times to be invested in select companies for the long term. This one is no different. Quality businesses are being sold off left and right, and the opportunity set is growing. Additionally, there is a restorative element to removing

***Source: Bespoke Investment Research**

cheap costs of capital from the system, where fraud, speculation, value destroying business models and infinite multiples of revenue became the norm for some time. Today, cash flows matter. Non-stretched balance sheets matter. Valuations matter. This environment has set the stage for active managers to earn their paychecks.

Nevertheless, recent performance headwinds deserve explanation.

First, given our focus on small companies, we are affected disproportionately during market drawdowns. Second, we don't always own optically cheap or structurally attractive investments. With all of our investments, I spend time thinking about the long-term trajectory of the business along with peeling back the onion to understand the true earnings power of each company. This is not something the current market environment promotes. This has been a headwind for us. I'm ok with that because there is value in purchasing companies whose earnings power is not yet obvious. That is how mispricings are found.

However, this can *take time* to play out, which has also been a headwind for us, as today's market doesn't have time. The focus on macro issues or next quarter's results has never been greater. But business execution is gradual, meaning the progress a company is making may not show up in the numbers right away. There will also be bumps in the road. When you're dealing with momentum, short term price concerns, and leverage, *not showing up in the numbers right away* is unacceptable. *Bumps in the road* are unacceptable.

The good news is that the market mechanism that appropriately values companies that consistently grow their revenues and earnings per share is not broken. Eventually macro fears will abate. High interest rates don't change the fact that building owners still need to maintain their critical systems. Geopolitical concerns don't affect statutorily mandated fire safety protection services. Government organizations will still require software to run their operations effectively during a recession, and electrical components that power large systems will still be in demand with persistent inflation. Our companies are taking the necessary steps to increase their earnings power, even in the face of tough economic circumstances, while our management partners are taking advantage of declining stock prices by repurchasing shares. Time is on our side, as is history.

Examining the long-term chart of any relevant market index would reveal that most significant macro events are barely noticeable along the market's consistent, upward trajectory. If we can remain patient, I believe we will be rewarded. As always, we remain invested alongside each other and thus firmly aligned.

Portfolio Commentary

Activity this quarter consisted of purchasing boring, cash flowing business at cheap prices. My favorite kind. Within our portfolio, I can point to multiple businesses with double digit free cash flow yields and growing, with others well on their way. Although it's been difficult to watch some of our positions being sold off along with the broader market, especially in the face of strong business execution, I welcome the opportunity to add to our current holdings as well as make attractive new investments. I've also made the necessary adjustments in areas of the portfolio where we are experiencing headwinds.

We entered into four new positions and exited our holdings in Polished.com and IDT Corp. for the reasons discussed below. I also trimmed our position in Basic-Fit, purely for opportunity cost and risk management reasons, as it was one of our largest holdings, along with one of our largest detractors to performance.

Given the current opportunity set, it no longer made sense to own such a large weighting. There are aspects of BFIT that remain unappreciated by the market. I think this will be corrected over time.

Below you'll find commentary surrounding exited positions, along with three new investments that were made during the quarter.

Sold Positions

Polished.com (POL)

We sold out of our position in Polished.com this quarter, closing the chapter on an incredibly unsuccessful investment. Following the year-long period during which the company attempted to get current on their financial filings dating back to Q2 2022, the company finally released their financial statements only to reveal an over-levered, significantly declining business that had been mismanaged all the way back to our initial investment.

I am more than glad to be moving on from this business. There are significant lessons to be taken from investment mistakes, which unfortunately, can be great teachers. The mark of a good portfolio manager is one who learns from mistakes, and ceases making the same ones repeatedly. I will do my best to avoid a similar fate going forward. For the sake of brevity, I've emailed clients separately my thoughts regarding our position.

IDT Corp. (IDT)

Another one of our biggest detractors during the past year was IDT Corp. Despite very strong business execution during our ownership, IDT found itself amidst a legal battle with Straight Path Communications, surrounding prior business dealings for which Straight Path was seeking damages in excess of $1 billion. Given the developments with Polished, it made sense to de-risk the portfolio from any binary events, and without being able to mitigate a disastrous legal outcome, it made sense to exit the position.

New Positions

Bel Fuse Inc. (BELFB)

Market drawdowns provide good opportunities to buy shares in growing, cash generative, well-managed businesses at cheap prices. Our newest investment in Bel Fuse is no exception. Bel Fuse is a 75-year-old manufacturer of electronic components that designs products fit for use in telecom, aerospace, transportation, and consumer electronics end markets. For those with a non-technical background like your portfolio manager, Bel Fuse makes a lot of little pieces that go into bigger electrical systems. These little pieces are often very necessary for Bel Fuse's customers as they help electrical systems function or prevent them from malfunctioning. Bel Fuse operates through three segments, Power Solutions, Connectivity Solutions, and Magnetic Solutions where they provide a broad array of SKUs with a wide range of applications. The company sells its products directly through various brands as well as through distributors where they have favorable end market exposure among industrial, automotive, aerospace and network technology customers.

When thinking about electronic components, the word commoditized might come to mind. At first glance, Bel Fuse seemed to fit that description given their large SKU count, low organic growth, and margins below peers. However, a deeper look into the business and industry dynamics revealed that BELFB has positioned themselves nicely between product design, implementation, and distribution, garnering a strong reputation for quality, which has led to trust and repeat business among their customers. I haven't discussed Bel Fuse products in depth, but Bel Fuse products *need to* work, often for safety reasons. Circuit protectors, cables that are needed to work in harsh environments, and fuel gauge monitors for military aircraft are all examples of products that may not cost much, but where there is a high cost of failure.

That last point is important because it means that during their long operating history, Bel Fuse has developed sticky relationships with their customers, leading to input on the actual design and product specificity of some of their SKUs, which in turn protects them from competition on pricing and distribution. This can also lead to annuitized relationships with customers giving BELFB the ability to take some price over time. Evidence of industry success can be gleaned from Bel Fuse's peers such as TE Connectivity, Amphenol and Littelfuse, all of whom can be considered compounders, earning significant shareholder returns during the past decade with organic growth, exposure to favorable end markets and being integrated with their customers.

Bel Fuse is in a similar spot today, and I believe it is mispriced. Typically, businesses with 75 years of history, especially ones that are still standing, offer elements of a moat and staying power. That applies here, although changes had to be made. Prior operating history would reveal that the company lost its way for a period of time under family ownership, failing to grow organically, lacking efficiency, and losing sight of margin goals and product management. During the past few years, this has changed dramatically, and evidence of the company's strong competitive position has begun to shine through.

Although Bel Fuse is a family owned and controlled business, current operations are being spearheaded by new CFO Farouq Tuweiq, the first CFO in company history, and first non-internal hire in decades. Hired in 2021, Farouq has an industrial electronics background and has done a remarkable job of turning the business around by implementing operating efficiencies, overhauling the company's pricing strategy, and re-tooling the sales force to better align incentives throughout the organization. As a result, financial performance has improved drastically with gross margins up 1000 bps since Farouq's hiring, and EBITDA margins up more than 3x from when Farouq joined to today. Importantly, margins remain comfortably below peers, leaving room for additional upside over time with selective pricing, better fulfillment, and new product development.

What started as a self-help story has now evolved into a business acceleration story, with notable operating momentum in each of the company's segments, and the ability to increase both margins and cash flow into the foreseeable future. Adding to my excitement is the fact that Bel Fuse has yet to reach a point where each of their business segments are firing together. There are several reasons for this including supply chain issues, lack of component availability and some cyclicality, but as BELFB continues to prioritize organic growth and margins, they will drive positive results over time. Furthermore, with operational improvements out of the way, Bel will have a clean net cash balance sheet very soon, where positive capital allocation can help drive additional upside.

We were able to purchase our shares at a mid-single digit multiple of EBITDA, a low absolute valuation, and below peers, indicating there is room for multiple expansion. Insiders agree, having been purchasing stock since 2021, with Farouq's most recent buying spree taking place last month. This is one of those investment opportunities that I can't help but get excited about and can't wait to see what Farouq and the team can accomplish. I look forward to sharing more details about Bel Fuse in future letters.

Medical Facilities Corp. (MFCSF)

Medical Facilities Corp. found its way into the portfolio this quarter as an under-the-radar microcap that owns minority interests in a group of surgical hospitals in various geographies. The company's four core facilities are located in South Dakota, Oklahoma and Arkansas and provide services ranging from orthopedics to spinal care to various inpatient and outpatient procedures. Medical Facilities partners with physicians for ownership of these hospitals, and operates the facilities from an administrative, billing and back-office standpoint, while generating revenue by collecting a facility fee for their services. This model is a beneficial partnership for both the company and its physician owners, as doctors are free to provide medical care while MFC takes care of management of the facilities.

I wouldn't typically be interested in this business or industry, as there is no shortage of bad examples of private equity surgical hospital rollups where scaled players who took on too much debt collapsed under the weight of a high fixed cost model. MFC is not a rollup, and when run well, surgical hospitals are licenses to print money. Furthermore, there are elements of this story that I believe have allowed us to purchase shares at bargain basement prices. Following years of mismanagement, recent activist involvement led to a management and board change, strategy shift, dividend cut, and operational improvements that were executed with the sole focus of driving shareholder value. The dividend cut and strategy shift caused the stock to sell off, which hasn't quite recovered despite the positive improvements that have taken place.

Furthermore, MFC has some of the best performing hospitals in their geographies, carry less leverage than their peers, and have been in operation between 20-40 years, earning very high-quality scores among patients and staff. MFC will also benefit from favorable trends in the US healthcare market including an aging population and strong demand for orthopedic services moving forward. Despite this being a competitive space, MFC has some aspects of a soft moat, that have allowed the facilities to grow their patient volumes and revenues at mid-single digit rates for the past decade plus.

These include:

- High levels of patient satisfaction are driven by convenience, high standards of care and a less bureaucratic environment than a traditional hospital. This allows for more convenient intake and discharge as well as better scheduling availability
- Physicians practicing at MFC facilities can drive their procedure volumes higher than a traditional hospital setting, thereby increasing earnings potential which leads to surgeon loyalty over time
- The scale of each facility means that MFC can offer a wider range of procedures and patient choice, providing an equal alternative to a traditional hospital
- Given the choices available, MFC can lead with billing transparency and avoid surprise medical bills for hospital visits

I like our chances to do well here as the mandate for management is simple. Manage the hospitals efficiently, sell off non-core assets, and return capital to shareholders. MFC has been executing on all three initiatives, by divesting five of six non-core Ambulatory Surgery Centers, restoring hospital level margins, and returning a significant amount of capital by repurchasing nearly 20% of shares outstanding last year alone. It is likely the business will continue to divest both non-core assets and potentially surgical hospital assets over time.

Selling into strength will benefit MFC. Significant consolidation is taking place across the industry, with the last 12-18 months representing one of the most active periods for M&A in industry history. The rise of physician owned hospitals, outpatient care, the need for market share gains and significant scale mean that MFCs assets are very attractive and could fetch strong valuations in a sale scenario. The closest public company comps, as well as every relevant M&A transaction I could find point to a sale scenario being one path to strong returns. Absent that, mid-single digit top line growth, even on a slightly elevated cost base, means that MFC should be able to generate $1.5 - $2.0 dollars in FCF/share within the next few years. The current share price is $6.75 USD. With the continued divesting of assets, more share buybacks, and potential margin expansion, our upside could approach 100% over time.

Seneca Foods Corp. (SENEA)

Moving on to our new position in Seneca Foods, I may have just one-upped even our most boring investments by way of owning this microcap canned vegetable producer, the largest in the US. As a company trading below the value of its net current assets, along with real estate held on the balance sheet that could exceed the entire market cap of the business, Seneca Foods is a throwback to the Graham and Dodd style of buying companies below their net current asset value. However, unlike most Graham and Dodd 'cigar butt' investments, Seneca Foods has an actual operating business. One that is not in decline. In fact, the industry in which Seneca Foods operates has changed in such a way that stable market share and the resulting higher earnings should be the norm moving forward.

Furthermore, there are clear cut reasons why the stock is mispriced. First, Seneca was booted from the S&P 600 index earlier this year, which resulted in forced selling, driving the share price down around 30% despite no significant changes to the business. Second, Seneca doesn't screen particularly well. The company has both a large debt load (due to inventory purchase requirements) and understated earnings given their inventory accounting methodology. If investors don't make the necessary earnings adjustments, GAAP earnings look non-existent. Third, management runs their business like a private company, with no IR strategy, no earnings calls, and no investor outreach (it took jumping through a few hoops to get management on the phone).

The canned vegetable business is tough and has historically been a battle for market share among a few large competitors, resulting in price wars driven by tough periods of seasonality and ever-changing cost structures. Following the exit of Del Monte Foods from the private label canned vegetable business, Seneca and smaller private competitor Lakeside Foods now control around 85% of the market, which will aid in the investment case moving forward, given Seneca's substantial capacity versus their peers. Rather than pricing wars this time around, Seneca has been (and will be) able to pass along price increases to their customers, which will prove vital given the COVID-related increases in nearly all of their input costs. The importance of these factors can't be overstated, as reduced industry supply and a more rational competitive environment means that these changes are more durable than Seneca is being given credit for.

Outside of the index removal, which proved a timely buying opportunity, a great time to purchase businesses in commoditized, highly competitive industries where they are fighting for market share is when the industry structure changes. There's a fairly well known investor who has also been successful investing against the backdrop of positive industry changes.

We were able to purchase our shares at a mid-single digit multiple of earnings, and our downside is well protected, which means we can be patient as the company works through their current volumes, moves through their inventory, pays down debt and continues to generate strong earnings. We've done well since our initial purchase, but I think the share price should continue to trickle upwards, where I peg fair value to be significantly higher than today's price.

Broad Market Commentary

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

Recent Developments

During the quarter, I had the opportunity to attend the Microcapclub Leadership Summit in Chicago, where I sat with Sylogist CEO Bill Wood for a presentation and fireside chat. Bill did an excellent job outlining the Sylogist story while I just tried to keep up by asking thoughtful questions. I remain very excited about what this business can accomplish over time. Please feel free to give it a watch or listen.

I'm also excited to announce that I recently hired an intern, our first one, who started working on projects during the quarter. His name is Nihir Addla, and he's an NYU student who reached out to me and sent some very high-quality work samples prior to his onboarding. Nihir is way ahead of where I was at his age, which makes it no surprise that in a short period of time, he's already proved a valuable resource to the firm. I've enjoyed getting to know him as a person and he's been a welcome addition thus far.

Thank you as always for the opportunity to manage your hard-earned savings. I look forward to touching base in a few months and please feel free to reach out anytime.

Thank you for reading.

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