Merion Road Capital Management
2017 Year End Letter

"There are no facts, only interpretations."
- Friedrich Nietzsche

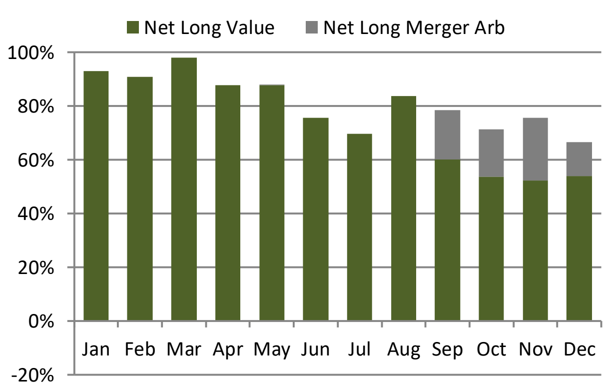
Dear Friends,

Welcome to my inaugural year-end letter. I intend to focus more on individual stocks and less on market prognostication, as the former is my core competency and where I hope to differentiate myself. That being said, some brief commentary on the market is in order.

During 2017 the SPY (S&P 500) and IWM (Russell 2000) rose 21.7% and 14.6%, respectively, despite a laundry list of geopolitical risks that could have derailed equities at any moment. Throughout the year many investors and commentators remained on the sideline, waiting for a correction, in what has been commonly referred to as "the most hated bull market." It would be naïve to assume that low interest rates and excessive optimism are the sole reason for recent gains. Fundamentals improved as exhibited by corporate earnings, industrial activity, business sentiment, and employment. Lower corporate taxes in 2018 bode well for equities as a whole while U.S. protectionist measures are poised to benefit certain industries at the expense of others.

Heading into 2018 one of investor's biggest concerns is the fed's well telegraphed plan to continue to increase the federal funds rate, with current probabilities forecasting 2-3 increases over the course of the year. We believe that inflation will be a necessary precursor for the fed to meet the higher end or to surpass these expectations. Inflation can be a strong tailwind for companies that have the power to frequently adjust prices and, therefore, we are less concerned about rising rates than others (with regards to equities). It is hard to predict what will happen to inflation as upward pressures, such as low unemployment and interest rates, combat the deflationary forces of technological improvement and an aging population.

The following chart provides a high-level insight into our expectations of the broad market performance. It shows net exposure as a percentage of net asset value for our long-short fund. While we began the year >90%, we gradually reduced our market exposure and ended 2017 at 66%. This reduction is even starker when excluding merger arbitrage positions that have significantly lower correlation to the broad market. Though we anticipate that equities will move higher through 2018, we are clearly more skeptical than we were at the beginning of last year.



On a personal note I have decided to launch my own investment firm. The firm will offer two products, a long only fund and a long short fund, structured as separately managed accounts. We welcomed our first outside investors this year and are thankful for their trust and support. If you are interested in investing, please contact me for more information.

We are extremely pleased with our performance during 2017 and know it will be difficult to sustain such levels going forward. Nonetheless, we work tirelessly to monitor existing positions and find new opportunities, hoping to generate an attractive risk-adjusted return for our investors.

Since our long only product has less than 1 month of performance, I limit the following section to our long short fund. In future years I will do the same for the long only fund as well.

I hope everyone has a healthy and happy 2018!

Aaron Sallen

LONG-SHORT: LARGEST POSITIVE PERFORMANCE CONTRIBUTION

Ash Grove Cement (ASHG): +13.0% contribution

ASHG is a sleepy, illiquid, family controlled business that happens to be the fifth largest cement manufacturer in the United States. The cement industry has many positive attributes that lead investors to ascribe a large valuation multiple to their earnings. Notably, high transportation costs make it economically prohibitive from driving cement long distances, giving manufacturers a regional monopoly and pricing power. At the time of our investment, cement manufacturers also benefited from positive tailwinds. Despite the extended economic recovery, cement "consumption" per capita was only .299 tons in 2016 vs. a 25yr average of .333 tons. Increases in demand are not necessarily met with new supply as NIMBY (Not in My Back Yard) regulations make it difficult to construct new facilities.

At the time of our investment ASHG had ~40% of its market cap in net cash and investments, and was trading at <3.5x EBITDA and almost a 20% cash flow yield (when excluding the cash on the balance sheet). This compares incredibly favorably to most competitors that have valuation multiples generally > 10x EBITDA. MRCM understood that the valuation disconnect was largely due to non-fundamental reasons, including: A) OTC listing and a lack of liquidity B) no public financial reports, instead only providing reports to proven shareholders C) screening poorly and D) no research coverage.

While MRCM attempts to find securities with a catalyst to accelerate value realization, this was not that type of investment. We built this position to hold for the long-term given its incredibly attractive valuation and business quality. That being said, we recognized that the family patriarch had recently passed away and that the company had promoted a non-family member to the CEO role.

Ultimately our investment appreciated when ASHG announced that it was being acquired by an international buildings material company at a premium of more than 100% of our initial purchase price.

Rocky Brands (RCKY): +4.7% contribution

RCKY is a manufacturer of work and military boots with its roots dating back to 1932. Beginning in early 2015 the company began to face a multitude of operating headwinds that caused EBITDA to fall from $23mm to $9mm and the stock price to crater by 50%. These headwinds included secular pressure from Amazon compounded by a poorly timed acquisition of an undifferentiated leisure brand, along with cyclical factors impacting two key customer cohorts - the oil & gas and agricultural industries. Fed up with the company's performance Mike Brooks, the company Chairman and largest individual investor, shook up the management team, ultimately promoting his son to CEO and hiring a new CFO.

Through our conversations with the management team we came to appreciate that they were taking the necessary steps to right the ship. They immediately implemented an expense reduction plan that included the closure of their Los Angeles office and employee terminations with total estimated savings of $3.5mm per year. Management also revisited their inventory balance, striving to reduce SKU's to improve purchasing power, simplify operations, and release excess capital.

We established a position because we did not think that these positive changes were reflected in earnings estimates. Furthermore, the company had recently incurred certain non-recurring expenses, making historical performance look much worse than our forecasts. Perhaps most importantly, our downside was limited as the company boasted almost $14.00/sh in tangible book value, largely consisting of receivables and inventory with little fashion obsolescence risk.

The stock has appreciated based on operating improvement from the cessation of non-recurring expenses, implementation of cost savings programs, and conversion of excess inventory into cash. The company recently sold its leisure brand which should allow them to focus on their core operations.

Calloway's Nursery (CLWY): +4.4% contribution

CLWY is a nursery (plants, not children) with 19 stores in the Dallas Fort Worth area. For many years it operated with flat revenue and low margins. In early 2016 a prominent value investor bought 56.7% of the company through his investment partnership, took over the board and replaced management. Under new leadership, CLWY immediately began growing the top-line while expanding margins.

By the time we found CLWY the stock had already doubled since those early days in 2016. Nonetheless, we built a position based on the thesis that the company could still extract excess costs and that our investment would have meaningful downside protection due to the company's strong asset base. We were also hopeful that CLWY would begin selling some of its 11 owned stores and leasing back the property in a financially accretive transaction (property owners in the Dallas Fort Worth area buy properties at a 7% cap rate implying ~14x EBITDA while CLWY is currently trading at ~6x).

Since our investment the stock has appreciated due to continued operating improvement and the issuance of a special dividend. The company has yet to execute on any sale lease backs.

LONG-SHORT: LARGEST NEGATIVE PERFORMANCE CONTRIBUTION

Thor Industries (THO), Short Position: -1.0% contribution

Thor is one of the largest recreational vehicle manufacturers in the U.S., with brands such as Airstream, Dutchmen, Heartland, and Jayco. The recreational vehicle market is highly cyclical as it is a discretionary purchase, and manufacturers operate with high fixed costs. While we believe that the cycle is nearing the top, we did not short the stock based on the assumption of a collapse in customer demand. Instead we focused on rising input costs, notably aluminum, lumber, and plastics, as well as an incredibly tight job-market in THO's manufacturing base of Elkhart, IN. Our thesis was that THO would be unable to offset these costs pressures with continued demand growth, leading to margin erosion. This thesis proved to be incorrect and we covered our short at a loss.

BBX Capital Corporation (BBX): -0.9% contribution

BBX is a holding company of real estate, a few small operating businesses, and most importantly, Bluegreen Corporation. Bluegreen is a timeshare operator with a 7-8% share of total gross sales in the U.S. While BBX has always traded at a discount to its sum of the parts, in 2017 management announced and executed an IPO of a minority interest in Bluegreen. We bought BBX ahead of the IPO as we thought it was a cheap way to get exposure to Bluegreen and that Bluegreen was significantly undervalued relative to other publicly traded comparables.

It's obviously rare to find a perfect story and BBX is no exception. Risks to the investment primarily included management's (un)willingness to treat minority shareholders fairly, and the quality of the Bluegreen business due to its more aggressive sales practices and upcoming capital requirements. Nonetheless, having previously invested in time share companies before, we were attracted to the valuation disparity and bought BBX anyway. We ended up selling our position at a loss as it became clear that the risks to the investment were large enough to justify a permanent valuation gap between Bluegreen and its comps.

At MRCM we try to learn from each of our mistakes. With this one we were late to the party and did not complete the type of diligence that we typically conduct before each investment. Ultimately, we ended up questioning our initial thesis and selling at an inopportune time. The loss is a simple reminder in the importance of diligence to gain conviction in our investments.

iShares Russell 2000 ETF (IWM): -0.8% contribution

We selectively manage our exposure to the market by implementing portfolio hedges. The IWM is an ETF that tracks the Russell 2000 and is an excellent security for this purpose. While we started the year without an IWM hedge, we increased this position as valuation levels increased. For instance, we began shorting the IWM in June and ended December with a 15% short position. Over the course of 2017, however, our short position in the IWM averaged 6.6% of our net asset value and had negative contribution to portfolio earnings due to the rising market.

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