MERION ROAD

October 2021

	MRCM Long Short Small Cap	IWM (Russell 2000)	Barclay Hedge Fund Index
Annualized Since Inception	**26.5%**	**14.3%**	**7.5%**
Q3 2021	**0.7%**	**(4.3%)**	**(0.1%)**
2021 YTD	**44.4%**	**12.3%**	**8.7%**
2020	29.5%	20.0%	11.0%
2019	17.9%	25.4%	10.6%
2018	15.7%	(11.1%)	(5.2%)
2017	35.7%	14.6%	10.3%
2016 (Jul-Dec)	1.3%	18.7%	5.4%

	MRCM Long Only Large Cap	SPY (S&P 500)
Annualized Since Inception	**20.4%**	**15.0%**
Q3 2021	**(2.7%)**	**0.6%**
2021 YTD	**12.1%**	**15.9%**
2020	54.3%	18.3%
2019	25.2%	31.2%
2018	(6.0%)	(4.6%)
Dec 18 - Dec 31	0.1%	(0.5%)

Note: All returns are net of management and performance fees. Past performance is not indicative of future results. Historic MRCM return calculations have been adjusted to reflect a methodology change as recommended by auditors.

Before I get into the quarterly commentary I would like to provide a brief corporate update. After more than 5 years of running separately managed accounts I have decided to launch a pooled vehicle that will pursue the same strategy as the Long Short Small Cap accounts. This is an important step in institionalizing Merion Road and will allow me to establish a relationship with a full-service prime broker. I am excited about these developments, and am hopeful that they will increase our opportunity set and improve my research process. I am on schedule to have the fund up and running by end of year.

The long only large cap portfolio fell 2.7% in Q3. I added to our position in Builder's FirstSource ("BLDR") during the quarter. BLDR is the largest national supplier of structural building products and value-added components to the residential construction market. They have been active in consolidating the industry, most notably with the merger of BMC earlier this year. Like other distributors, BLDR benefits from scale advantages that afford them a robust product offering, enhanced purchasing power, and fixed cost leverage. They will continue to acquire smaller competitors and have announced 5 new deals so far this year.

I view the strategic benefit of these acquisitions in three different buckets. There are the core tuck-in acquisitions of facilities and customer lists that increase scale and geographic reach. An example would be the company's May acquisition of John's Lumber, a lumber and specialty product distributor serving the Detroit MSA, at 0.5x revenue. There are product acquisitions that leverage their platform to increase distribution and improve the product offering. For instance, last month BLDR announced the acquisition of California TrusFrame, a designer and manufacturer of prefabricated components like trusses and wall panels, at 1.3x revenue. And lastly BLDR has begun investing in software and services. In June they spent $450mm on the purchase of WTS Paradigm, a software company that addresses the complexity around building configuration, estimating, and manufacturing, at 9.0x revenue. By utilizing software to in the planning process, WTS Paradigm cuts down on material and labor waste, ensures an optimal fit of product and design, and eases the contractor's workload. BLDR has followed this up with a much smaller software acquisition in September.

BLDR is in the very early innings of their software investment, so it is difficult to pinpoint exactly how it will impact the company in the coming years. Management believes that there is a lot of low hanging fruit, pointing to a McKinsey study ranking the construction industry as second to last on overall digitization. If anyone has had any work done to their house, I am sure they can anecdotally attest to this. BLDR plans to leverage WTS Paradigm to increase internal productivity (i.e. improved estimating leading to fewer visits to the job site), cross-sell the software to existing clients, and drive greater adoption of value-added products. So thinking a few years out I think the goal would be to have higher margins on their commodity business, a greater mix of revenue coming from value added products, a stronger relationship with their customer, and an enhanced competitive advantage.

While this all sounds good we cannot forget that, at the end of the day, BLDR serves a highly cyclical industry and has meaningful commodity exposure with lumber prices. I feel good about the medium term outlook for residential construction. Lennar estimates annual housing demand of 1.5-1.9mm units which would imply a 20-50% increase from recent levels; this is not to mention the fact that the country has underbuilt since the financial crisis, so some catch up must eventually occur. Additionally, demographics point to increasing demand as millennials reach household formation years.

I have a lot less confidence on where lumber prices are headed. While the prices of lumber directly impacts BLDR revenue, the change and rate of change impact margins. For instance, last quarter the company earned $2.40 a share on 15% EBITDA margins (annualizing this would put the company at 5.5x earnings). Those results are a bit of an anomaly as the company benefited from an unprecedented surge in lumber prices. Management has done a good job breaking out the impact of these fluctuations and is guiding to a normalized earnings profile of 10% EBITDA margins on $1.6bn in revenue. This would put the company at 7.5x EBITDA and 10x FCF. Over time I would expect normalized margins to increase slightly as the company realizes the benefits of the BMC synergies, optimizes its workflow, and increases its revenue from value added products.

The long short small cap portfolio was up 0.7% in Q3 while averaging a beta adjusted net exposure of 33%. For the YTD period the portfolio has gained 44.4% with a beta adjusted net exposure of 37%. I've become increasingly more positive on our largest position, Rocky Brands ("RCKY"). As a reminder, RCKY recently doubled the company with their acquisition of Honeywell's outdoor boots business. From a big picture, it would make sense for there to be room for operating improvement as Honeywell, a $150bn conglomerate generating $35bn in annual sales, sold off non-core operations generating just $200mm in revenue. Digging in, while the acquisition has strong consumer brands, it appears that their former owners left a lot on the table.

RCKY is in the process of bringing the new business units over onto their ERP which is specifically designed for footwear – previously, the Honeywell brands would have to manually enter product specific information such as sizes and width. Furthermore, the prior owner did not provide the brands with software to predict demand, which meant that they were left to make manual forecasts by SKU. As you can imagine, this was operationally inefficient and most likely resulted in less accurate results. Along a similar vein, the prior owner ran inventory too lean, which left the brands unable to meet retail demand in a timely manner. E-commerce, the clear future of retail, was almost an afterthought. Operations were outsourced and designated "online" inventory was physically separated from inventory to be shipped to bricks and mortar. What this meant was that an online good could appear as sold out, even if there was plenty of stock on the other side of the warehouse. These anecdotes indicate that improved blocking and tackling should lead to both margin improvement and sales acceleration.

While not core to the thesis, management believes that they have a tremendous opportunity to build out the XTRATUF brand that came over with the acquisition. XTRATUF is a waterproof shoe brand that dates its origins to the Alaskan fishing industry. Even though consumers may not demand the performance characteristics of such a technical shoe, they do want authenticity. And XTRATUF screams authenticity. RCKY management has been pleasantly surprised to see just how much demand there is for this line. In fact, they have been refusing to open new accounts to protect the brand and manage supply. A quick search for top men's rain boots of 2021 yields the following results:

- GQ: XTRATUF Legacy Chelsea Boot
- NY Times: XTRATUF Ankle Deck Boot
- NYMag: Timberland White Ledge Mid Waterproof Ankle Boot
- Business Insider: XTRATUF Rubber Deck Boot

A search of ecommerce sites yields similar results. XTRATUF has strong ratings and is consistently sought out by consumers. While all of this bodes well for the core business, it does pose the question of how else to capitalize on this opportunity. Right now the company does very little outside of shoes and I would not be surprised to see them start testing the waters in ancillary products.

In any case the company is trading at about 7x EBITDA and 9x FCF once integration is complete. At 9x EBITDA (which accounts for the higher quality "distribution" business hidden within their retail segment), the company would be worth about $70. If you are willing to look out a few years, I think there should be a pretty clear path to over $100, or roughly a double from current prices.

Sincerely,

Aaron Sallen

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