MERION ROAD

July 2021

	MRCM Long Short Small Cap	IWM (Russell 2000)	Barclay Hedge Fund Index
Annualized Since Inception	**27.2%**	**16.1%**	**8.0%**
Q2 2021	**14.0%**	**4.0%**	**4.0%**
2021 YTD	**41.2%**	**17.4%**	**9.0%**
2020	29.4%	20.0%	10.9%
2019	17.9%	25.4%	10.7%
2018	15.7%	(11.1%)	(5.2%)
2017	34.8%	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	**22.4%**	**15.9%**
Q2 2021	**11.2%**	**8.4%**
2021 YTD	**14.0%**	**15.2%**
2020	53.1%	18.3%
2019	25.0%	31.2%
2018	(5.6%)	(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.

The long only large cap portfolio gained 11.2% in Q2. Sometimes the best thing to do as a portfolio manager is nothing at all, which is largely what I did last quarter. Many of our companies reported very strong earnings back in April. The market shrugged these off as it pondered how much growth would be sustainable, are inflationary trends transitory, and when interest rates will rise. While a slow-down in the broader economic recovery would hurt our portfolio, I remain positive on our position’s market positioning and longer term trends.

For instance, Copart reported 33% YoY revenue growth with EBIT margins expanding to 45%, an all-time high. While the company benefitted from inflation (an interesting hedge the market largely ignored earlier in the year), sustainable increases in ASPs and service offerings bode well for revenue per vehicle growth. Management noted that traffic is still down 20% or more as non-US markets are several months behind the United States on reopening and vaccinations. This volume boost should provide good tailwinds in the coming months.

Take-Two also announced strong earnings and long-term outlook. While last year was a bit of an anomaly, it’s impressive that their key franchise (Grand Theft Auto) grew revenue from $700mm to almost $1bn in the fiscal year – keep in mind that it has now been over 7 years since their last full game release. Similarly, the NBA 2K franchise has continued to grow its user base which now stands at 2.3mm daily users. As the business model continues to shift to more recurrent spend, now at 60%, TTWO revenue becomes more stable, higher margin, and less dependent on key man risk. Additionally, the company has many shots on goal to generate a windfall from IP with a pipeline of 60 games to be released over the next 3 years (9 of which are iterations of previously released titles, ergo less risky).

The long short small cap portfolio was up 14.0% in Q2 while averaging a beta adjusted net exposure of 35%. For the YTD period the portfolio has gained 41.2% while averaging a beta adjusted net exposure of 39%. I am particularly pleased with these results as the bulk of our returns have come from stock selection rather than market exposure. Yet, it is important to keep in mind that 3-6 month periods are relatively short in the grand scheme of things. We will undoubtedly go through rough patches and must not get too excited about recent outperformance.

We own shares in Flexsteel ("FLXS") a residential furniture manufacturer. After making a series of questionable decisions, the prior CEO and CFO were replaced in 2018 and 2019. New management took swift actions to stabilize the business by disposing of excess capacity, exiting non-core product lines and rationalizing SKUs, and scrapping a poorly executed ERP upgrade. While most of the heavy lifting has been completed, the stock remains quite attractive at 7x FCF excluding excess cash on the balance sheet. Comparable companies trade around 9x (again adjusted for cash on the balance sheet).

There are a couple of reasons for this disconnect. FLXS is a relatively underfollowed company with a market cap of $250mm that has zero analyst coverage / earnings estimates. The company likely screens poorly too, as historic revenue growth has been understated due to shuttered business lines. For instance, revenue growth for the remaining business grew 33% YoY last quarter, versus the 20% that was reported. Optics will improve in their next quarterly report as numbers will be on an apples for apples basis.

The fundamentals seem like they are poised to outperform as well. FLXS lost share leading up to the management transition as the ERP debacle disrupted customer orders. Employee turnover subsequently increased given the uncertainty from the restructuring actions. Today the ERP system has been stabilized and employee retention has gotten better. FLXS upgraded its talent in marketing/sales and operations and is regaining share. Furthermore, the company will benefit from broader industry tailwinds with the increased focus on home upgrades; this is evident in their backlog that is up to $140mm vs $34mm at this time last year. While demand has been great, the industry has suffered from cost inflation and supply chain bottlenecks coming out of covid. The company's ability to convert backlog into sales will be dependent upon their ability to source material in a timely manner. Similarly, they must be able to pass through pricing increases in order to maintain margins. I have been encouraged by their performance so far.

Over the past year management has used excess capital to repurchase 15% of their shares outstanding at an average price of $24.33. While they will continue to remain opportunistic on repurchases, they will likely use remaining capital to support growth. Front and center is expanding their e-comm presence. FLXS recognizes that they need to go deeper with Amazon and Wayfair by increasing their 3P business so they can control brand experience, pricing, and customer relationship. Additionally, they recently launched their own DTC brand and are in the process of overhauling the Flexsteel website. They have a goal of doubling revenue from this distribution line. At just 7x FCF it does not seem like we are paying much for this option.

Sincerely,

Aaron Sallen

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