January 17, 2016

WIEDOWER CAPITAL

2015 Shareholder Letter

Year	Wiedower Capital	Russell 2000
2015*	-9.49%	-4.72%

* Started business February 5, 2015. Results are net of fees.

2015 was frustrating, to say the least. After outperforming the majority of the year, everything fell apart in December. On November 30th, we were outperforming by almost 7%, only to lose over 14% just in December. The highlights (make that lowlights) of December were our largest holding, LGI Homes, falling 35% due to three negative headlines in a two week span, oil continuing its collapse, and to top it off one of our companies, Xpel Technologies, had a patent infringement suit filed against them on December 30th, cutting its stock in half on New Year's Eve. I'm still researching the patent infringement case, but more details will be given on LGI Homes and our oil exposure below.

But first, you'll notice above I've compared our results to the Russell 2000. Wiedower Capital is solely focused on companies under a $1 billion market cap and the Russell 2000 is considered the industry standard for small cap indexes. Just like large cap investors benchmark themselves against the S&P 500, small cap investors generally benchmark themselves against the Russell 2000. While the S&P 500 outperformed the Russell 2000 this year, throughout history small-caps have outperformed large caps. My goal is to outperform the Russell 2000 over the long-term, and by default, this would outperform larger cap indexes as well.

For this first shareholder letter, I want to first review our two largest holdings, then go over some mistakes I've made and the lessons I learned from them, and finally close with some general market comments.

LGI Homes (LGIH)

Our biggest position is LGI Homes. At the time of initial purchase (~$16/share average price paid) LGI was both the second fastest growing public homebuilder in the country and it was the cheapest. This initial price dislocation was due to LGI being a recent IPO that not many were following and its concentration in Texas. As the price of oil plunged, people believed that LGI's Texas developments would be crushed. LGI management has repeatedly stated (and proven through results) that they are not nearly as exposed to the oil industry as Wall Street thinks. Throughout 2015, LGI continued its rapid growth and the share price followed, peaking at $35.54 on December 1st, only for it to crash back down and close the year at $23.79. At year end it is now the cheapest homebuilder in the country and is still the fastest growing. So what caused the price collapse?

A lot of overreaction mostly, but I think it's a combination of three things:

1. LGI's November home closings showed good growth, but were lower than expected. This started the decline. December bounced back to be a record month so hopefully this was just a temporary bump.
2. Two days later, OPEC announced they weren't cutting oil production, guaranteeing low oil prices for the near-term. As I said above, many LGI investors still believe they are heavily exposed to oil even though their Texas markets were among their best performing throughout 2015.
3. Less than two weeks later, the Fed announced a hike in interest rates of 0.25%. This was the first interest rate increase since June 2006. Importantly, the Fed made it clear that future increases will be gradual and they intend to keep interest rates low for the foreseeable future.

On the last point, it is generally accepted knowledge that rising interest rates hurt home sales. At first glance, this makes sense: rising interest rates increase mortgage rates which increase the cost of owning a home. But the accepted wisdom just doesn't line up with the numbers. I looked at new home sales vs 30-year fixed-rate mortgages from 1971-2015 (as far back as I could find reliable data) and new home sales are actually slightly correlated WITH rising mortgage rates, not the inverse. When you think about it, this also makes sense. While rising rates do make buying a home more expense, the Fed only increases rates when the economy is doing well, unemployment is low, salaries are increasing, etc. Interest rate increases are normally a sign of good economic times which results in more home sales.

Anyway, that was my long way of saying I think three negative headlines hit LGI's stock in a short period of time and the market overreacted. The fastest growing homebuilder cannot remain the cheapest one for long. I expect the price to rebound once people realize these headlines haven't hurt the long-term value of LGI as much as they think.

Consolidated-Tomoka (CTO)

This is our second largest position at year end. If you follow my investing blog (and you should: traviswiedower.com) you're probably sick of me writing about CTO. To quickly rehash, they are a diversified real estate company that owns over 10,000 acres of raw land outside of Daytona Beach, FL. They are in the process of selling off this land and converting it into income-producing properties, with the desire to convert to a REIT someday. The assets are worth significantly more than the market price, but many people don't like these types of investments because of the time value of money. Selling raw land can be a drawn out process and if it takes 20 years to sell, the investment returns aren't going to be satisfactory. Fortunately, CTO is led by a great management team that is both aligned with us and heavily focused on monetizing the land. When we first purchased shares in August, this was basically my thesis. In November, things changed.

David Winters is the CEO of Wintergreen Advisers, a billion dollar mutual fund that owns 26.1% of CTO's shares and is pushing for a sale of the company. So far, CTO seems to be obliging as they hired an investment firm to "explore strategic alternatives." Basically, they're shopping the company to see what kind of offers they get. The results of this process should be known within a couple months. If CTO is sold, we will almost certainly receive a nice premium to what we paid in a relatively short amount of time. If the company isn't sold, I'm confident in the current management team continuing to run the company as they have, growing it's value over time.

Mistakes

Yes, unfortunately that is plural. As this is my first shareholder letter, one thing I want to emphasize in these letters going forward is mistakes I've made in the preceding period. I haven't attended, but I've heard that Mohnish Pabrai (one of my top investor idols) goes through one investment success and one failure at his annual shareholder meetings. I think that's a great idea. These periodic letters are a perfect time for reflection.

Bad investments are inevitable—no investor bats 1,000. In my opinion, the best way to deal with unforced errors is to admit them to myself, learn some lessons, and move on. I plan on being open about mistakes in these letters with the hope of decreasing the chances I make the same mistake in the future. With all that being said, I made two poor decisions that accounted for our poor performance in 2015.

Oil and gas

As I'm sure you're aware, oil and gas has only gotten worse this year. My mistake here was two-fold. First, I bought full positions right off the bat in the three oil and gas companies I found and liked. These three companies, while individually are relatively small positions, together make up a sizeable "basket" of oil and gas stocks. Building positions gradually is generally the best play for investments, but especially so with commodity stocks in a downturn. It's safer to ease into investments during the downslope and potentially miss some of the upside than it is to go in full right away.

My second mistake was overestimating how forward looking the stock market was on this industry. When I made these three investments in early and mid-2015, I was expecting the supply/demand imbalance to get worse before it got better, but I also felt like this was already priced into the stocks. I was wrong. Way wrong. In theory, the stock market should look "through" the downturn and value these companies on their long-term potential. However, it's become clear these companies just trade in lockstep with oil no matter what. The most frustrating (and surprising) of our three holdings here has been Navigator Holdings. Navigator ships by-products of oil and gas production. These by-products have completely different industry dynamics than oil and gas though, which has not been affected by the downturn. Navigator has put out three straight quarters of good results, yet it trades almost perfectly in-line with the price of oil. I keep telling myself that eventually Mr. Market has to realize Navigator is not affected by the price of oil, but I keep being proven wrong.

With all that being said, I still like all three of our oil and gas holdings. I've rechecked each investment thesis multiple times and I continue to be happy with each of them. This downturn will no doubt bring many bankruptcies, but our companies will not be included. They each have rock solid balance sheets and should come out the other side just fine.

Violin Memory (VMEM)

Violin was both our biggest loser of 2015 and the only position we exited (not counting one short-term investment that worked out well). What Violin produces is extremely technical, but basically they make the most advanced storage arrays for commercial use. Think of storage arrays as external hard drives. In a highly competitive industry, it's impressive that Violin was able to build a truly unique architecture. My big mistake here was overemphasizing how good their technology was. As it turns out, their technology is almost too good. The vast majority of companies who need storage arrays simply don't need Violin's top-of-the-line product and they're happy to choose a competitor with lesser storage arrays. The sales were mediocre before I bought in, but I reasoned that it was inevitable their technology would shine through and the sales would come. I failed to account for the facts that their sales force was getting its ass kicked by better competitors and many of their potential customers just didn't need that much technology.

After three quarters of owning the stock and seeing sales results continue to decline, the nail in the coffin was the final conference call. Facing extremely poor results, management made what I thought were a couple of outrageous claims (if I'm being mean: lies) and I immediately sold the entire position. The company may very well turn its sales force around and go back up (it truly does have huge upside potential), but the thing I am strictest on is shareholder friendly management teams that I can trust. As soon as management made some iffy claims on the conference call, I sold. No company is worth investing in once I've lost trust in management.

Closing remarks

While I am absolutely not a macro guy, I'm starting to see some positive signs for oil to start rebounding as early as late 2016. First, Saudi Arabia cannot keep this up much longer. It's true they can profit off $5 or $10 oil, but the current prices are not nearly enough to balance the country's budget. Some estimates show Saudi Arabia going bankrupt as early as 2017 if current prices continue. Second, many companies haven't seen the brunt of the downturn because they had their oil exposure hedged. When these hedges really start to roll off in 2016, bankruptcies should increase. Third, worldwide oil demand is continuing to increase while at least two major countries (USA and Russia) have already announced significantly decreased production in 2016. For some reason the media makes a huge deal out of China's slowing economy. This is inevitable for a country growing as fast as they have been, but they still increased their oil purchases throughout 2015 and they announced a five-year plan to continue ramping up these purchases. Finally, worldwide storage has flat lined since mid-2015 which insinuates the over-production has already been correcting itself.

None of this factors in the chance of a war in the Middle East breaking out. If you've watched the news in the past six months, you know the chances of this are not even close to zero. One ISIS attack on a large Saudi oil refinery and the price will skyrocket overnight.

On the other side of the story is Iran who is now ramping up production and shale oil that can seemingly turn the spigot on as it pleases, thus acting as a ceiling for oil prices. While Iran claims they'll be exporting a million barrels per day in 2016, virtually every expert says they don't have near enough infrastructure to do so (and it's not like Iran is incentivized to be honest here). The shale oil argument is the one I worry about the most. Unlike many conventional oil fields that take years to develop and decades to run dry, shale oil has a much faster turnaround. The bears say oil will stay low for years because as soon as oil starts to increase, these guys will turn the spigot on and push the price back down. Logically, this makes sense, but I think there's potential for such a large undersupply in the coming years that it won't matter. Also, I doubt most E&Ps, after barely surviving a long, drawn out downturn, will immediately be gung ho about full-on drilling. I imagine a period of deep breaths and balance sheet improvements once oil stabilizes.

These couple paragraphs only touch on the most important headlines, but there are far too many factors in play to accurately predict the length of the downturn and when (or if) the recovery will occur. However, the past month or two is the first time I've started to feel cautiously optimistic that a rebound may be in sight.

Going forward, I will be writing shareholder letters every six months. You can expect my next one in early July. Thank you for investing in Wiedower Capital and let me know if you have any inquiries.

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