MERION ROAD

October 2019

	MRCM Long Short Small Cap	IWM (Russell 2000)
Annualized Since Inception	**18.6%**	**10.1%**
Q3 2019	**6.5%**	**(2.3%)**
2019 YTD	**7.6%**	**14.1%**
2018	17.1%	(11.1%)
2017	37.7%	14.6%
2016 (Jul-Dec)	1.6%	18.7%

	MRCM Long Only Large Cap	SPY (S&P 500)
Annualized Since Inception	**5.9%**	**7.4%**
Q3 2019	**(1.7%)**	**1.4%**
2019 YTD	**17.5%**	**20.0%**
2018	(5.6%)	(4.6%)
Dec 18 - Dec 31	0.1%	(0.5%)

Note: All returns are net of management and performance fees.

The Long Only portfolio started the quarter off strong as most of our positions reported good earnings in July. Unfortunately, these gains were erased in September. This move coincided with broader market movements as value stocks noticeably outperformed growth. To be clear, the factors used to describe value vs. growth are not a reflection of a company's fundamental value (based on industry outlook or competitive positioning) but are rather statistically defined as a multiple of earnings. Simply put, high multiple companies lagged their low multiple counterparts.

This price action, while smaller in magnitude, was somewhat similar to Q4 2018. Last year the potential for rising interest rates disproportionately impacted growth stocks as they are more susceptible to changes in discount rates. Today that risk seems remote and is potentially a tailwind should rates fall farther. Rather concerns around absolute valuation and the ability to turn revenue into earnings seem to be eating at growth stocks today. The failed WeWork IPO perhaps most embodies this sentiment as the market scoffed at the company's rich valuation and questionable business model. While many of our positions do in fact trade at above average multiples, most are long proven businesses that have significant barriers to entry, are cashflow positive (not reliant on capital markets), and have demonstrated the ability to improve margins as they scale.

During the quarter I built a position in Hexcel Corp. ("HXL"). HXL is one of the world's largest carbon fiber and composite manufacturers that primarily serves the aeronautical market, with 2/3rds of their sales going towards Airbus and Boeing. Their demand outlook is strong as the world will continue to need more planes (4-5% growth in passenger miles annually) and advanced materials take share (may account for more than 50% of next-gen planes by weight vs. just 4-6% 30 years ago). HXL has been around for over 70 years and has built a valuable portfolio of intellectual property. Their strategically located facilities integrate them into their customer's supply chain and give them an advantageous cost structure. Furthermore, co-location of polyacrylonitrile precursor with carbon fiber manufacturing allows HXL to shorten the product feedback time and speed up production again leading to cost savings. The company has tremendous insight into future earnings with a backlog that represents more than 8 years of deliveries.

HXL has recently gone through several years of significant capital investments in building new plants, expanding others, and acquiring technology. These investments depressed prior years' cashflow but will not be a burden going forward. Their earnings benefit has yet to run through the income statement as many projects were completed within the last 12 months, and even after completion, it takes time to receive product qualification. I expect our investment to generate a mid-teens return over the next several years, which seems particularly attractive given the potential for a low growth/interest rate environment and my confidence around their earnings profile.

Before moving on to the Long Short portfolio, I would like to touch on IAA, which I wrote about in my letter last quarter. After appreciating by 20% into and following their first reported earnings as a standalone company (which were generally positive), the stock retraced these gains and has been a drag on overall performance. I believe it would be useful to discuss this stock as an example of our approach when things do not go according to plan. Concerns recently arose regarding IAA's relationship with GEICO, a ~20% customer and previously exclusive relationship. Research provided by a company that scans website data showed that they have lost the GEICO business in Texas to their primary competitor; my understanding is that this shift was in retaliation for botched operations during Hurricane Harvey. Similar research has shown that GEICO may be shifting to their competitor in other states as well. While this is obviously a negative development, it is important to note that it is only one known data point – there are many others out there that we do not know. For instance, how much inventory will GEICO pull in states outside of Texas? Is this a temporary shift to teach a lesson or permanent customer loss? Will IAA be able to replace this volume with inventory from other customers?

It is important to remove emotions and focus on the information that we have and my best estimate of the future. I find it hard to believe that the failure to properly serve their customer during a hurricane (i.e. spike in volume) will dramatically impact other states where volumes are not as volatile. And if IAA does in fact lose more volume than I anticipate, I believe that they should be able to somewhat offset it with new customers given capacity limitations. The stock decline has been precipitous, and by my estimate, the market is assuming that IAA loses more than half of their GEICO business and is unable to replace it. This seems incredibly too bearish. I believe that the market's desire to avoid uncertainty and short-termism have overshadowed what remains to be a very attractive long-term story.

The Long Short portfolio was up 6.5% during the quarter while the small cap index fell by 2.3%. As I have said in the past, this portfolio has relatively low exposure to the market (as indicated by its 22% beta-adjusted net exposure over the last three months) which means that results will often move independently from the benchmark. Gains came from both our long positions and short positions, though several of our short positions were particular standouts. One company failed to receive a take-out offer, the possibility of which was artificially propping up the stock, while deteriorating fundamentals in another company came home to roost as the market appreciated the high likelihood of bankruptcy. The biggest gainer from our short-book, however, came from Akerna Corp ("KERN"), a software/services company serving the cannabis industry that came to market via a SPAC (SPACs anecdotally have been pretty bad investments for public shareholders). My thesis was that KERN was purporting to be something that it is not and that there was serious risk to the underlying business. This was proven out in their first quarter as a public company and I have since closed out our position.

During the quarter I built a stake in Transcat Inc. ("TRNS"), a company that distributes and services calibration equipment primarily for regulated industries such as life-sciences and aerospace/defense. While distribution is a highly competitive field (you can buy this equipment on Amazon), servicing is not. End users of the equipment are required to have it calibrated periodically which leads to recurring demand. Some have in-house calibration labs, some rely on the OEM, while others use 3rd party service providers such as TRNS. 3rd party providers are valuable because they can service equipment from multiple manufacturers whereas an OEM would only work with their own product. In-house labs are becoming less prominent as end-users may not want to distract from their core business or are facing labor shortages.

Customer density is critical as it lowers transportation costs and maximizes the utilization of technicians. TRNS is the largest North American player in the 3rd party space and the industry is highly fragmented, which provides ample room for consolidation. TRNS has historically acquired small competitors at an attractive multiple and these transactions will likely play a key role going forward. While the price has appreciated somewhat, I still like TRNS given its strong existing cash flow, margin enhancement opportunities from a recently acquired automation company, and the potential for future accretive acquisitions. In my experience there are few <$200mm companies that have this level of business quality, market positioning, and capacity for future growth.

Sincerely,

Aaron Sallen

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