Eidelman Virant
CAPITAL

11th of April, 2017

Dear Clients and Friends,

The S&P 500 and Russell 2000 Indices gained 6.1% and 2.5% respectively in the first quarter of 2017, continuing the upward momentum from last year. Though President Trump's flurry of executive orders, Congress's failure to repeal and replace Obamacare, the Fed's third interest rate hike, and the recent U.S. military strike in Syria caused uncertainty throughout the quarter, the equity markets marched higher. Some pundits have called the post-election market surge the "Trump Rally," attributing the recent market gains to his pro-growth agenda. Many of our clients (particularly those who are not Trump fans) are asking: "Is the recent market rally warranted? Can Trump really be good for the market?"

We think the recent market strength has very little to do with Trump and more to do with the continued global economic recovery and relative valuation of stocks compared to fixed income. Consumer confidence and business optimism surveys recently hit 16-year highs and international growth continues to improve. Even though the Federal Reserve Board has indicated its expectations for short-term interest rates to revert back up toward 3% over the next few years, markets are skeptical and 10-year U.S. Treasury bonds yield just 2.3%. With such low potential returns from the fixed income market, U.S. stocks appear more attractive on a long-term basis given their net payout yield of 4% (dividends plus net stock buybacks) plus potential growth.

While attractive relative valuations to bonds and positive momentum bode well for the market over the near term, we believe some caution is warranted. Absolute stock valuations are at historically high levels, investor sentiment remains overly optimistic, and insider selling levels remain elevated. All of these factors have historically acted as headwinds and could imply modest future market returns. Fortunately, we feel we are still able to find good individual investment opportunities that offer attractive prospective returns while minimizing risk.

What matters most for our client's portfolios is our ability to find 30-40 investment ideas that meet our strict criteria of having exceptional management, low debt levels, durable competitive advantages, and trade at a price that we think offers an attractive return. If we can do this, we feel our clients' portfolios can perform well even if the broader markets face challenges.

Last month, David and I went to the Seaport Global Industrial Conference in Miami and each sat down with the management team of fifteen different companies over two days. We interviewed management teams on their management culture, incentives, competitive advantages, market outlook, balance sheet, and many other factors. We were struck by how outstanding many these companies were in their respective markets. We met with the country's largest maker of hardhats, snow plows, aerial platforms, auto seats, wood flooring, and commercial kitchen equipment. In many cases, these companies met all of our criteria except for price, so they will be added to our bench list. We will follow them and wait for the right opportunity to buy when the risk/reward is stacked heavily in our favor.

We remain fully invested in a portfolio of securities that meet our criteria of outstanding management, low debt levels, niche competitive positions, and trade at low valuation levels. We remain optimistic that such a portfolio gives us the best chance to continue to achieve superior returns in the future.

In firm related news, I'm thrilled to announce that we have recently hired Matt Lederman as our new Director of Business Development & Investor Relations. His primary responsibility will be to develop new business opportunities in addition to managing investor relationships. Prior to joining Eidelman Virant, Matt was responsible for marketing and consultant relations at New York-based Pinnacle Asset Management. Prior to Pinnacle, Matt held various sales and marketing positions with Alternative Access Capital, Bank of America, and Merrill Lynch. Matt received his B.S. from Vanderbilt University and his M.B.A. from Washington University in St. Louis. We look forward to introducing Matt to all of our current and prospective clients.

If you have any questions, please feel free to give me call anytime.

Sincerely,

Tom Eidelman, CFA
Managing Director

<u>New Purchases</u>

JP Morgan 8.2% Sr. Bonds due 2027 (Mexican Peso Denominated) – Price $5

These JP Morgan bonds are BBB-rated bonds yielding 8.2% due in ten years. In addition to 8.2% interest, we bought these Mexican Peso denominated bonds because we believe the peso is undervalued. From Dec. 2013 to Dec. 2016, the peso depreciated from approximately 13 pesos/dollar to 20 pesos/dollar with a chunk of this decline occurring when President Trump was elected due to his anti-NAFTA trade rhetoric. The Mexican Peso now stands at a roughly 50% discount to the dollar on a purchase power parity basis. A simplistic example of this is that a McDonalds Big Mac hamburger costs $5.06 in the U.S., but just $2.33 in Mexico as of January, 2017 according to the *Economist* magazine. We believe the peso could appreciate 25% relative to the dollar over the next couple years and when added to the healthy coupon rate on these bonds, could deliver 15% annualized returns for the next few years as trade fears abate.

Lennar Corp. B Shares (LEN-B) - Price: $41.80

Lennar (LEN-B) – Lennar is one of largest homebuilders in the U.S, representing nearly 5% of all new U.S. new home sales. What distinguishes Lennar from its peers is the team-oriented culture and quality of management which includes CEO Stuart Miller (son of the founder) who has been at Lennar for 25 years and owns 11% of the company. What attracts us to Lennar right now is the limited supply of new housing and pent up demand which will continue to drive housing starts and pricing higher and could result in 10%+ earnings growth for LEN for the foreseeable future. Lennar could also unlock value by spinning off some of its ancillary businesses (estimated at $12 per share), such as Fivepoint, which has 20 million square feet of commercial space. We also chose to buy the Lennar “B” shares as they trade at a 17% discount to the A shares, despite having ten times the voting rights. Historically, LEN shares have traded at 80% of the S&P 500 PE ratio due to cyclicality. If Lennar can execute and the valuation revert to its historical relative PE ratio, LEN-B shares could be worth $60 per share, a 40% premium to the current price.

Pure Cycle (PCYO) – Price: $5.55

Pure Cycle owns a rich portfolio of water assets in Denver, Colorado and may be at an inflection point for earnings and revenue growth. PCYO provides water to landowners, oil & gas drillers, and homebuilders. PCYO’s assets include 25,000 acre feet of surface and groundwater which can serve 60,000 taps, 931 acres of land between downtown Denver and the Denver Airport which is zoned for a 4,400 home development called Sky Ranch, 14,900 of irrigated farm land, and 14,000 net mineral acres, some of which is being leased to Conoco. While PCYO’s share price has flatlined around $5 per share the past few years, the surrounding Denver area has boomed. The S&P/Case Shiller CO-Denver Home Price Index has risen 55% over the past five years. An $824m new Marriott hotel and convention center is opening in April 2018 just two miles from PCYO’s Sky Ranch property and Panasonic just completed its North American headquarters with 300 jobs within four miles of Sky Ranch. Oakwood homes has sold out its 3000 home development two miles northwest of Sky Ranch and they are a likely bidder for the Sky Ranch lots along with KB Homes, DR Horton, and Lennar. Adding together the opportunity in ground, waste, and fracking water along with the Sky Ranch development, we see a potential $3.5B revenue opportunity. We think PCYO’s assets and future recurring revenue streams are worth over $12 per share, more than twice the current share price.