Eidelman Virant
CAPITAL

Quarterly Letter June 2016

13th of July, 2016

Dear Clients and Friends,

Despite a temporary selloff of global stocks due to “Brexit” fears, the second quarter was positive for the markets and our client’s portfolios. The volatility created some good investment opportunities and we’ve found some ideas we are excited about. While individual investment ideas are what drive results, it’s still important to analyze the bigger picture. Despite Brexit, political uncertainty in the U.S., and terrorism, the stock market continues to climb higher. While valuations remain above historical averages, we believe the markets will continue higher supported by low interest rates and strong market momentum.

One risk we are keeping a close eye on is rising inflation. Inflation (as measured by core CPI excluding food and energy) grew 2.0% year-over-year, and is near its fastest pace since 2012. Employment was full enough that wages climbed 2.6%. Oil prices have rebounded significantly from their lows. Median existing home prices are up 4.7%, medical care 3.6%, and rent prices up 3.2%. Gold, another inflation indicator, is up 16%. If inflation increases over the Federal Reserve’s 2% target rate, they may have to start raising interest rates. For the moment, inflation is right at the Fed’s target; however, we will keep a close watch and position portfolios appropriately.

Since a few clients inquired about reducing equity exposure amid Brexit fallout fears, I’ll explain why we thought it was a actually a buying opportunity. Pundits feared a United Kingdom (UK) exit from the European Union (EU) would mean dire economic consequences for the UK as the flow of trade and labor would grind to a halt. Greater concern surrounded the potential for some or all of the other 27 countries to follow the U.K. lead and leave the EU; thus experiencing similar fallout. Is this speculation cause for concern for our portfolios? We don’t think so.

While experiencing political and economic uncertainty, the U.K. will likely experience a temporary economic decline as global businesses take a “wait and see” approach to investments in the U.K. Longer term, the U.K. will either revote to join the EU, become a paying market member like Norway, or just make new bilateral trade agreements. In the long run, these options may not be economically different. On the other hand, the EU may learn from its mistakes and actually become stronger. Other countries would have a much more difficult time leaving the EU since they belong to the Euro currency, whereas the U.K. already had its own central bank and currency. Finally, in terms of the direct U.S. impact, U.S. exports to the U.K. represent just 0.7% of U.S. GDP. In summary, the U.K. will be just fine and the impact to U.S. stocks should be minimal.

In summary, we are optimistic looking forward. We continue to look for special situations similar to the companies outlined above and capitalize when such stocks trade at a discount due to outside factors such as Brexit fears. We will continue to invest in companies with our ideal combination of superior management, strong market position, low debt, and attractive valuation. Thank you for your continued business and support. If you have any questions, please do not hesitate to give me a call anytime.

Sincerely,

Tom Eidelman, CFA
Managing Director

HOLDING UPDATES

Conifer Insurance (CNFR, Price: $6.94) – Our investment in Conifer got off to a rough start. Conifer is a story of a successful insurance management team, having built and sold out North Pointe Holdings, and bringing the band back together to create an even more successful company. We love management's niche strategy, experience, and personal financial commitment to the company. However, a combination of increased competition in liquor liability and changes in auto insurance legislation in Florida stunted growth and increased costs out of the gate. Looking forward, we are even more optimistic given the discounted share price. We see the company growing significantly and earning close to $1 per share in the not-too-distant future. We think such earning power would warrant the stock trading up to its tangible book value of $10 per share, a 43% premium to the current share price.

Gastar Preferred (GST-PA, $13.50) – Last quarter I wrote about Gastar, an oil & gas company with key assets in a valuable "stack" play in Oklahoma. What a wild ride this stock has been! Shortly after purchasing, the stock rose from $4 to $13 on successful drilling results by neighboring companies. A few days later, it fell dramatically on news that they weren't able to sell some of their acreage they were marketing. A week after that, shares rose back near their highs when the company raised equity capital and their next door neighbor Payrock, with nearly identical assets, sold for a very high price of $12,000 an acre. Using the same per acre valuation, Gastar's value would be worth over 2x that of the amount of senior debt and preferred stock outstanding. Our preferred shares are like lending $1m to a person with a $2m house. Since this security has gone up so much, why don't we sell? Because we think with such valuable assets, this preferred stock should go back to par value of $25, a 85% premium to the current price. We still love this investment.

Red Lion Hotels (RLH, $7.26) – We think Greg Mount at Red Lion hotels has done a phenomenal job transforming the company for future growth. RLH went from a company with 100% ownership of 20 or so poor performing seasonal hotels to an asset-light licensing model with industry leading technology. They are leading the industry in growing all the important hotel metrics such as revenue per room, daily room rates, and operating income. While the big chains (like Marriot and Starwood) combine, this leaves owners of those hotels now competing with another hotel with the same name right down the street. These franchised owners could differentiate themselves by becoming a Red Lion franchisee and get access to technology to help get guests booked on travel websites along with technology such as online checkout and opening their rooms via cellphones. With only 100 hotels (including a new one opening in St. Louis by the airport), the runway for growth is very exciting.

Telephone & Data Systems (TDS, $29.66) - Telephone & Data Systems operates U.S. Cellular, the fifth largest U.S. wireless company. U.S. Cellular has 4.9 million subscribers in 23 states and TDS owns a smaller cable and broadband offering with another 1.2 million subscribers. The company operates in rural areas where they have the highest quality networks, less competition from larger peers, and better economics. Their subscriber base has been steadily increasing the past two years and smart phone penetration has increased to 75%. More smartphones has led to higher data usage and an increase in in average revenue per customer. We believe TDS's assets could be much more valuable if combined with a larger competitor and that such a scenario is increasing likely. The company has rebuffed offers from potential acquirers for more than a decade, however, the founder passed away last month which we believe increases the likelihood that the company will be sold. Based on price paid per subscriber in recent wireless acquisitions such as the T-Mobile/Metro PCS deal, the wireless business alone could be worth over $42 per share. The analyst covering the company at Citigroup estimates that company could be worth as much $74/share in a takeout scenario, more than twice the current price.

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