August 11, 2017

2017 6 Month Shareholder Letter

Period	Wiedower Capital	Russell 2000	S&P 500
2015*	-9.49%	-6.62%	-1.37%
2016	17.48%	21.28%	11.95%
2017 1st Half	5.97%	4.98%	9.34%
Cumulative	12.80%	18.88%	20.73%
Annualized	5.26%	7.64%	8.35%

* Started February 24, 2015. Results are net of fees.

There hasn't been a ton of action in the portfolio over the last six months with only two new positions added. Our portfolio continues to trend towards two separate buckets of investments—long-term compounders I plan on holding for many years and then shorter term investments that are simply good, cheap companies. Now when I say "shorter term" I don't necessarily mean less than one year, I just mean I don't view them as fantastic businesses that I hope to own for five or ten years. Instead, they are above average businesses that I plan to own until they reach fair value—whenever that may occur.

LGI Homes (LGIH) was a perfect example of this second bucket. We originally purchased it in mid-2015 when I thought it was far too cheap. We then sold it earlier this year as it approached my estimate of fair value. LGI was a good business (better than most homebuilders), but I had no intentions of ever owning it for many years. It ended up taking ~2 years to reach my estimate of fair value so that's when I exited.

On the other hand, the three companies we own that I count as long-term compounders are Elbit Vision Systems, Interactive Brokers, and Where Food Comes From. All three share my favorite traits that I look for in companies: founder-led, high insider ownership, profitable, zero debt, increasing revenue, and long runways for growth.

The main reason I prefer these compounders is how much easier they are compared to companies that are bought and sold within a year or two. Finding companies to own for long periods of time lowers the number of decisions I have to make. Another thing I like about large industry tailwinds (that generally means large industry growth) is the effect it has on competitive dynamics. The best type of company growth either doesn't affect competitors or it even benefits them. Industries that are growing 10-20% per year are less likely to see competitors directly target each other (via price wars and things like that) because all competitors are probably growing revenue (even if they're losing market share). It's harder for companies to grow in mature markets so the competitive dynamics are generally much worse.

These compounders with long runways for growth are my favorite companies to own, but unfortunately there aren't a lot of them out there that are also simple businesses I can understand and available at reasonable prices (and I don't mean traditionally cheap like 10x earnings, I just mean reasonable when looking out 10 years into the future). We've only made two investments in 2017 and both fall into the second bucket of above average businesses that are too cheap. I've done write-ups on both of these companies so you should be familiar with them. Therefore, I'll just give updates on what's happened as of late.

Franklin Covey (FC)

Franklin Covey posted Q3 results at the end of June and they were a bit of a mixed bag. Optically, they looked bad in the near-term, but medium to long-term the outlook is better than expected. Management gently lowered Q4 and full year 2017 guidance (basically saying they'll hit the low end of their previous guidance), mostly blaming the timing of some contracts from last year (which is whatever, seems like every management team blames timing when they miss earnings). While I expected the stock to sell off some given the worst short-term outlook, I'm surprised it's fallen as much as it has (~17%). There were four big positives that came out of the call:

1. They closed three offices in the US. Over 90% of their client partners were working out of their homes and on the road so it was kind of pointless to have these last few offices. Now all of the client partners work from home and the back office functions from these three offices were consolidated. Management estimates this will save $5 million per year, which will drop straight to pre-tax income.
2. They reorganized into two segments—All Access Pass and education. They talked about many benefits of reorganizing this way, but the bottom line is they think this will be more efficient and increase incremental margins by a few percent.
3. The price for All Access Pass will be increasing 10% any day now. I either missed it or management never specified, but they've actually been running an introductory offer for clients to sign up for All Access Pass (10% off). This introductory period is over, which will see new All Access Pass clients paying 10% more.
4. Some clients are starting to sign multi-year contracts instead of just 12-month contracts. This is great for revenue predictability and being resistant to downturns (and in general is a good sign that clients like All Access Pass so much they're willing to commit to it for multiple years at a time).

In addition to those four items, the two most important metrics (retention rate and average revenue per user) both continue very positive trends. Across the board, average revenue per All Access Pass user is more than their traditional clients and retention rate remains over 90%. Altogether, I think the operating leverage on this new business model is going to surpass what I discussed in my write-up. Management wouldn't give 2018 guidance, but confirmed adjusted EBITDA in the low forty millions is in the ballpark. I was previously estimating 2018 adjusted EBITDA of $36.4 million, so that's a full $5-7 million lower than what management insinuated for 2018. And I believe most of that difference is from higher flow through and more operating leverage than I originally thought. I didn't discuss adjusted EBITDA in my write-up, but obviously that higher number will flow down to owner earnings as well.

All in all, I think Franklin Covey is an even better buy than when I initially bought in (and when I substantially added to my position after Q2 results). The price is a little lower and the 18-month outlook is even better. It's already by far our largest position (~26%), but I may add more as the stock continues to creep lower. This may be obvious given our position size, but it is the best risk/reward investment that I have found in the market today. The transition to their new business model will start lapping in Q1 2018 so I expect the market to start taking notice over the coming quarters.

Calloway's Nursery (CWLY)

Calloway's released fantastic Q1 earnings and we're now up ~35% on this 11% position. Calloway's is traditionally an extremely seasonal business where Q2 (springtime) accounts for >100% of their earnings for the year. The other three quarters generally lose money or are flat-ish, so it was quite surprising to see Q1 with a 17.8% operating margin. I'm hesitant to put too much weight into one quarter, but after Q1 results it'll be hard for them not to have meaningfully higher margins than I predicted for full year 2017. When I purchased the stock I thought they could scale operating margins up to around 11%, but if they surpass that it can easily add $1-2 to my estimate of fair value. On the other hand, it's also possible Q1 pulled forward some revenue from Q2. Therefore, I want to wait another quarter or two before changing my views on valuation too much.

For now I'm continuing to hold, but if the stock keeps running up I will sell at some point (my current estimate of fair value is mid-$6s). I don't like paying short-term capital gains, but I'm also not going to hold a stock that reaches (or

exceeds) my estimate of fair value. I would be happy to own Calloway's for a couple years if that's what it took to reach fair value, but if I have to pay short-term capital gains because the price runs up in six months… well, that's not a bad result either.

Negatives

I've had quite a few frustrating experiences over the past year buying into new positions. There is nothing more maddening than finding a great stock, buying a starter position, and then the stock runs up before I get a full position. As concentrated as I am (nine positions currently), I can't afford to be correct on investments and not get the full benefit from them. This exact scenario happened with both Fogo de Chao and Elbit Vision Systems. On the other hand, I bought a full position in Calloway's Nursery as it ran up and then it immediately came back down. If I was patient our average price could be 10-15% lower. Finally, I was very patient buying into Where Food Comes From slowly and got what I thought was a great average price over a several month period. All of this caused quite a bit of frustration and me thinking I need to improve my buying process.

First, I realized that not buying a sizable position right from the start is basically me trying to time the market, which is antithetical to my investing theory (cognitive dissonance is becoming a common theme in these letters…). I've also come to realize that I don't care about small positions nearly as much as large ones (I guess this makes sense to some degree). But it feels like a waste of time to have a 3% position because stock moves in either direction don't affect the portfolio enough. Thus, I end up not following those small positions as closely, which obviously isn't a desired result. So I've decided that all new positions need to be at least 7% going forward. If it's an exceptional situation (price, near-term catalyst, etc) I may buy in larger right off the bat, but as long as I start around 7% that's a meaningful position. All new positions being at least 7% also creates a higher hurdle for adding a stock to the portfolio. There's no flirting with small new positions—I'm either invested in a meaningful way or I'm out. There is evidence to support this method by the way. Everyone knows that as a group, money managers underperform the market over the long-term. However, there have been several studies that show that if managers only invested in their higher conviction ideas (5%+ sizing) then far more would outperform. It seems most investor's returns actually get diluted down by these small positions.

Second, I wanted to systematize my buying process so I created a checklist that I now go through before I place any order (buy or sell). I have no idea if the checklist would have made a difference in those situations described above, but at the very least I'm trying to take some emotions out of the buying process and make sure I'm in the right state of mind before placing any orders. I also think following the same process with every buy and sell can only be a good thing.

Positives

One area I really feel I've improved upon over the last nine months is idea generation. In late 2016 I joined SumZero, MicroCapClub, and Seeking Alpha Pro. I have already benefitted greatly from each—either from reading investment write-ups, connecting with other investors, or in the case of MicroCapClub, discovering a completely new stock that we eventually invested in (Elbit Vision Systems). Combine those websites with Value Investors Club, Corner of Berkshire and Fairfax, and all the investing blogs I follow, I've probably read a couple hundred investment write-ups in 2017 alone. Some investors don't like sourcing ideas from others, but there are no points for creativity in investing. With that being said, I view other investment write-ups as idea generators, not research resources ("trust, but verify"). Write-ups give me an overview of the thesis, which I find to be a great jumping off point when I go to research the company on my own. There's a big difference between investing solely off what someone else says vs using those as idea generators and doing/redoing all the research myself. Being a one-man shop, the more inbound investment ideas I look at the better—it partially replaces the need for an analyst to do that for me.

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