MIDWOOD Capital Management
Investment Management Since 2003

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Letter to Investors
First Quarter 2019

Net Returns[1]	Q1 2019	Since Inception	Annualized
Midwood Capital Partners, L.P. (net)	**10.6%**	**304.4%**	**9.5%**
Barclay Equity Long/Short Index	3.2%	104.3%	4.8%
S&P 500	13.6%	268.2%	8.9%
Russell 2000	14.6%	246.4%	8.4%

The pause in interest rate hikes that Fed Chairman Powell signaled in early January became codified with the Fed's January 30 meeting as the Fed dropped explicit references to future interest rate increases in its formal statement accompanying that event. Thus, an already ebullient equity market found fuel to keep rising in February. The rise in equities slowed in March as weakness in economic indicators in Germany and China exacerbated fears of slowing global economic growth, a trade deal with China failed to materialize, and various U.S. economic indicators (*e.g.*, consumer confidence, housing) disappointed, among other factors. Notwithstanding March's decline, equities had an impressive quarter. It was the S&P 500's best start to a year since 1998 and the index's biggest quarterly gain since 2009.

With this being the Fund's 16th year of operation, we have seen many market environments like this one to start the year. We often find such market backdrops to be frustrating as fundamentals take a back seat to momentum and sentiment. The equity market's rise has come in the face of a consistently negative trend in earnings estimates. For example, looking at the bottom-up EPS estimates for the S&P 500, the numbers have declined over 6% from last October to the first week of April. Call us crazy, but we do believe earnings matter and question the implicit multiple expansion behind this year's rally. Fortunately, despite our

[1] Returns are shown net of all fees and expenses, including an accrual for the incentive allocation to the General Partner of the Fund, and are subject to a year-end audit. Since Inception and Annualized figures reflect performance from Midwood Capital Partners, L.P.'s launch on 12/1/2003. Individual limited partner returns may vary. Barclay Long/Short Equity Index data from BarclayHedge. Index returns are total returns inclusive of reinvested dividends as reported by Bloomberg. The listed indices provide a reference against peer funds and the overall U.S. market and are not benchmarks or targets of the Fund.

skepticism and conservatism, the Fund performed admirably during the first quarter, especially with our exposure consistently remaining below 50% net long.

Our outlook has not changed as we enter the second quarter. Again, we have been fortunate to start the period with solid performance. We are very optimistic that the first quarter earnings season will be a driver of further gains for both our longs and shorts.

First Quarter Performance

We were pleased with the Fund's performance in the first quarter. Our long book performed exceptionally well contributing 18% to our gross return, and we generated some alpha in our short book. Our largest long positions were key drivers of our first quarter returns.

Gross Returns	Midwood Capital Partners, L.P.			
	January	February	March	1st Quarter
Long	10.9%	8.3%	-1.8%	18.0%
Short	-6.2%	-0.7%	0.7%	-6.2%
Total[2]	4.7%	7.6%	-1.1%	11.5%
Net Returns	5.0%	6.3%	-0.9%	10.6%
Russell 2000	11.2%	5.2%	-2.1%	14.6%
End of Month Net Long Exposure	48.5%	49.2%	49.8%	

Significant positive contributors to Q1 performance included:

- Nexstar Media Group, Inc. (NXST; $115.30; $5.3 billion market cap)[3]: This stalwart of our portfolio was the top contributor to Q1's performance, adding over 430 bps to our gross return. The stock delivered a total return of 38.5% in the first quarter as the market digested the planned acquisition of Tribune Media Company (which will make it the nation's largest independent broadcaster), the company delivered record financial results for the fourth quarter of 2018 and reiterated its forward free cash flow guidance, and the company announced proceeds from station divestitures (a requirement for approval of the Tribune deal) that were 30% higher than consensus expectations. We have owned NXST for nearly eight years and have watched it grow from approximately $200 million in market cap to over $5 billion. NXST remains the Fund's second largest position as we continue to see compelling value
- DIRTT Environmental Solutions Ltd. (DRT CN; C$9.08; C$769 million): We have commented on this technology-driven manufacturer of highly customized, prefabricated interiors for work environments several times since our *Fourth Quarter 2017 Letter*. The stock found its footing in 2018 after struggling early last year as

[2] Totals may not add due to rounding.
[3] Stock prices and market caps for all securities as of 4/18/2019.

new management executed well in terms of both growth and profit improvement. The company generated record revenue and its second largest EBITDA quarter ever in the fourth quarter, driving a nice bounce in the stock. The stock climbed over 39% in the first quarter, contributing 419 bps to the Fund's gross return. DRT CN remains the Fund's third largest position

- R1 RCM Inc. (RCM; $10.04; $2.6 billion market cap): This leading independent provider of revenue cycle management services to acute care hospitals and physician groups remains our largest position. The stock traded idiosyncratically in January despite providing very bullish guidance early in the month ahead of the bellwether J.P. Morgan Healthcare Conference. The stock began to make a move upward at the end of January, ultimately rising nearly 22% in the first quarter. RCM contributed 353 bps to the Fund's gross return in Q1
- Limbach Holdings, Inc. (LMB: $9.04; $73 million market cap): LMB is the 9th largest mechanical systems contractor in the U.S., designing and installing HVAC and mechanical, electrical and plumbing systems for commercial and institutional building owners. We acknowledge that the company scores low on the business quality scale, but the stock had been beaten down to an absurdly low level at the end of 2018. Its diminutive market cap belies a business with genuine scale: revenue of approximately $550 million and backlog of nearly $560 million. The stock bounced 106% in the first quarter. While it was not a large position, it still delivered 155 bps to the Fund's gross return in Q1

Our short performance in the first quarter was acceptable. As one would expect in a small-cap market that returned nearly 15%, most of our top losing positions (seven out of ten) in the quarter were short positions. Significant negative contributors to Q1 performance included:

- PHI, Inc. (PHIKQ; $0.49; $9 million market cap): PHIQK provides helicopter transportation services to the oil and gas industry as well as emergency medical transport services. The company faced a March 15 maturity date for its $500 million of senior unsecured debt. Our hypothesis was that this asset rich but cash flow challenged company had multiple options to effectively address its maturing debt and deliver significant upside to shareholders above its trading price, in particular by monetizing its air medical services business. <u>We were wrong</u>. We underestimated the degree to which the controlling shareholder (who was also a senior secured lender to the company) would engage in self-dealing as part of a restructuring process. The company filed for Chapter 11 bankruptcy protection on March 14. We expect a contentious process between the controlling shareholder/senior creditor and the unsecured creditors. We also expect the formation of an equity committee[4], which is an important step in the preservation of value for shareholders. We managed risk in this situation through our position size, but it still cost us 126 bps in the first quarter. We have held onto our position as we maintain our conviction that there should be residual value to the equity materially above the current market cap

[4] The United States Trustee will hold a meeting to form an equity security holders committee on 4/25/2019.

- RuffCo ($862 million market cap): We mentioned this manufacturer and distributor of health and wellness products for pets in our *Fourth Quarter 2018 Letter to Investors*. While the stock fell significantly during Q4 2018, we noted that we remained short. We continue to question the profit potential in the company's core business and the return profile of its foray into veterinary clinics. The stock rebounded nearly 34% in Q1, a move which was not supported by any change in the fundamentals. Significant insider selling continued during the first quarter. RuffCo remains the Fund's largest short position
- ChowCo ($1.5 billion market cap): We mentioned this marketer of fresh, refrigerated pet food in our *Second Quarter 2018 Letter to Investors*. Our hypothesis is predicated on several components, including: a) ChowCo is a niche business, having achieved only $193 million of TTM sales after more than a dozen years in operation, making it undeserving of a $1.5 billion enterprise value; b) the business is very capital intensive – requiring refrigerators in every retail location, unlike any other pet food manufacturer – with poor returns on capital to date; c) the company has been unable to leverage its revenue growth into profit growth because of a continuing need to increase its marketing spend. While it was frustrating to have the stock appreciate over 31% in Q1 (costing the Fund 94 bps), we maintain conviction in our hypothesis and the stock remains a top five short position
- Recro Pharma, Inc. (REPH; $8.36; $184 million market cap): We highlighted REPH in our *Fourth Quarter 2018 Letter to Investors* – when the stock was at $7.91 – believing that one key catalyst would be FDA approval of REPH's new drug application for Intravenous Meloxicam (IVM), a non-opioid drug for moderate to severe acute pain. REPH had a PDUFA date for completion of the FDA's review by March 26, 2019. Our analysis indicated that the probability of IVM's approval was high. Unfortunately, however, REPH received a second Complete Response Letter on March 22 indicating that the FDA would not approve its NDA in its present form. The stock, which had crept up to $9.72 prior to the announcement, fell as much as 43%. However, management has already taken actions that reinforce our belief – and the market's – that the company will maximize value for shareholders by curtailing its acute care drug development program and monetizing its valuable CDMO business. These positive developments have caused the stock to recover from the mid-$5s. REPH dragged on the Fund's performance by 74 bps in the first quarter

Exposure & Concentration

We ended the first quarter with net long exposure of 50%, comprised of 92% gross long and 42% gross short. This compared to net long exposure of 47% at December 31, 2018.

The number of core positions in the Fund stood at 51, comprised of 23 longs and 28 shorts, compared to 50 on December 31.[5] Our top ten longs comprised 79% of the Fund's equity at

[5] Core positions exclude positions less than 0.25% of equity; positions in index securities not included in calculation of top positions.

March 31 compared to 77% at December 31. Our top 10 shorts comprised 25% of the Fund's equity compared to 26% at December 31.

As of March 31, the Fund had its largest net long exposures to Media (18% net long), Capital Goods/Transportation (17%), and Healthcare (16%). The Fund's largest net short exposure was to Energy & Materials (-2%).

Highlighted Long Position

The Fund held 23 long positions at March 31. One of our newer positions is Limbach Holdings, Inc. (LMB: $9.04; $73 million market cap). LMB is the 9th largest mechanical systems contractor in the U.S., designing and installing HVAC and mechanical, electrical and plumbing systems for commercial and institutional building owners.

LMB operates in two business segments:

- **Construction**: ~80% of total revenue; 11-13% "normalized" gross margins. LMB manages large construction and renovation projects primarily for HVAC, plumbing, sheet metal fabrication and installation, specialty piping and electrical services
- **Services**: ~20% of total revenue; 20-25% gross margin. LMB provides recurring facility maintenance or smaller general construction services primarily related to HVAC, plumbing or electrical services

Typically, we find contracting businesses with their thin margins, potential for losses on complex projects, and percentage of completion accounting to be unattractive businesses. LMB is not much different, except for its Services business which carries a better margin profile. In fact, write-downs on projects in the company's Mid-Atlantic region were the primary reason why the stock was decimated – down 73% – in 2018. LMB lowered its 2018 EBITDA guidance with its second quarter earnings release and then cut its guidance dramatically – from $19 million at the midpoint to $9 million – with its third quarter earnings report. Needless to say, management's credibility was severely damaged.

However, we are convinced that the company's soon to be announced FY 2019 EBITDA guidance[6] will reflect the beginning of a turnaround in the underperforming Mid-Atlantic region and illustrate the value in the stock at today's price. Although the stock has more than doubled off its December 2018 lows in the mid-$3's (where we were aggressive buyers), we believe the stock could double again still.

What happened in 2018?

LMB's management took write-downs on projects in the Mid-Atlantic region for each of the first three quarters of 2018. The cumulative write-downs – about half of which occurred in the third quarter – totaled $18.4 million and dragged down LMB's consolidated gross margins by 500 bps over the first nine months.

6 Management held a conference call on 4/16/2019 to discuss its Q4 2018 results but deferred providing 2019 guidance until the company issues its Q1 2019 results in about a month.

A total of five projects in the Mid-Atlantic were included in the $9.6 million Q3 write-down, of which one project achieved full completion in early November, two projects were expected to achieve "substantial completion" in December, and two projects are expected to carry into May and June of 2019. Management expected the bulk of the labor-induced problems mentioned above to be completed by 12/31, with only "trimming and commissioning work" for the remaining two projects to continue in 2019. Importantly, the two projects continuing into 2019 were already in a loss position, and LMB has taken the full loss on the P&L through the end of Q3 2018 under GAAP. Thus, LMB did not anticipate any further write-downs on those projects as they get completed and factored that into their Q4 2018 guidance.

Mid-Atlantic write-downs resulted from a temporary human capital/labor problem. According to management, typical headcount in this region is ~200 craft workers. At the peak in September of 2018, total headcount swelled to 350 workers. However, LMB has already acted on this labor problem, and management reduced this number to a more normalized level of about ~200 at the end of 2018 and ~190 currently.

In response to the underperformance in the Mid-Atlantic, LMB took four critical actions for 2019:

- The regional manager who was responsible for the recent Mid-Atlantic cost over-runs was fired and a new regional manager started on 11/15/2018
- LMB created a new "co-COO structure" and deployed interim leadership and project management from other business units to the Mid-Atlantic region
- LMB shortened the Mid-Atlantic reporting cycle to weekly from monthly
- LMB announced they will only be selling "large HVAC projects" in the Mid-Atlantic region after 6/30/2019

Compelling setup from here

LMB's business excluding any contribution from the Mid-Atlantic region performed well during 2018, with year-to-date gross margin of over 15.2% vs. reported gross margin of 10.9%.

Prior to formally releasing its Q4 2018 results on April 15, recent information from the company indicated to us that management had effectively ringfenced the Mid-Atlantic issues. On March 18, LMB published an updated investor deck for the Roth Conference with new slides regarding the "Mid-Atlantic Turnaround." At the conference, CEO Charlie Bacon said, "We just had to right size the [Mid-Atlantic] business, and unfortunately, we took a lot of pain through the books and our share price took a hit and it was unfortunate, but I understand how that works, [I] didn't like it, but we're back on track." On March 28 LMB announced a delayed 10-K filing and postponed its Q4 2018 earnings call due to needing additional time to reflect a refinancing of its credit agreement in the 10-K. Within the press release, the company released preliminary FY 2018 results, reporting that FY 2018 EBITDA was in the middle of the previously revised guidance range (suggesting $7 million of Q4 EBITDA), which implied there were no more curveballs out of the Mid-Atlantic region at

the end of the year, and that the debt covenants were not breached as the lenders required a minimum of $6 million of EBITDA for the quarter.

On March 28 management also reported that backlog as of December 31, 2018 was $505 million in Construction (+16% growth sequentially) and $54 million in Services (+5% growth sequentially). Lastly, management reported that revenue was expected to be at the top end of their guidance range of $530 to $550 million.

LMB's release of its Q4 2018 results on April 15 reinforced our belief that the worst is behind it with respect to the Mid-Atlantic challenges. We further believe that 2019 will reflect more normalized profitability in LMB's Construction segment. Its growing backlog and revenue, combined with this normalized profitability, should enable LMB to deliver 2019 EBITDA above $20 million. Applying a 7x EBITDA multiple (larger public peers trade for 8-9x) to our base case EBITDA of $23 million, and accounting for 2019 cash generation, we arrive at an $18 price target for the stock.

Highlighted Short Positions

The Fund held 28 core short positions at March 31. One of our larger positions is HammerCo, a $3.8 billion market cap producer of recreational vehicles (RVs). While HammerCo is an industry leading company, we believe the company and the stock have considerable downside risk due to:

- Cyclical industry post-peak: The RV industry is historically highly cyclical. And as a big-ticket, discretionary consumer purchase, it has contracted early and severely in economic slowdowns. For example, in the last business cycle total RV wholesale shipments peaked in 2006 (before the overall economy peaked), declined 9.5% in 2007, and then contracted at an accelerating rate until a trough in 2009. The total peak to trough drop in wholesale shipments was 58% in the last cycle.

  Total wholesale shipments declined 4.1% in 2018. However, looking at the full year figures masks more recent trends as first half 2018 shipments were robust. Wholesale shipments fell 22.0% in the second half of 2018 and declined 27.5% during the first two months of 2019. Industry participants like to assert that the current slowdown is attributable to surplus production by manufacturers that has created a temporarily bloated inventory situation among RV dealers. Participants promote the notion that more and more consumers have adopted the RV lifestyle to argue that industry conditions will rebound, and growth will resume in the near term. We fall into the "post-peak" camp and believe that the industry is very vulnerable to a slowing economy, waning consumer confidence, and rising interest rates. RVs, after all, are a large discretionary purchase that declines in value.

  As the market share leader, HammerCo is subject to whatever trends are impacting the industry. In addition, we have arguably seen a few hundred basis points of slippage in the company's towable market share over the last five years as a

subsidiary of a competitor has rapidly grown its business with a unique distribution strategy

- Late-cycle leveraged acquisition of European manufacturer: Earlier this year HammerCo acquired the leading European manufacturer of RVs at a purchase price of ~$2.1 billion with over 80% of the consideration in cash funded by a new credit facility. The recovery in the European RV market lagged that in the U.S. after the financial crisis, but registrations have been growing at an 8.2% CAGR from 2013 to 2018. Growth in new vehicle registrations did slow in 2018 to 6.8%, and, according to Jefferies, HammerCo "management acknowledge[d] in Q1 commentary the deal may have occurred late in the European expansion cycle."[7] Management did not predicate the deal on any hard cost synergies as there is no overlap in operations and has only made generic references to "mutual benefits to be derived from sharing design, R&D, technology, engineering and manufacturing excellence."[8] One of the most specific benefits that HammerCo hopes to capture is in transferring designs for the European company's Class B motorized vehicles to its own product portfolio. Class B is a very small category in North America but one in which HammerCo has deficiencies in this market.

  HammerCo has become a leveraged company late in the RV/economic cycle, going from having zero debt to $2.2 billion. While its leverage ratio pro forma for the European acquisition is not egregious at approximately 2.6x debt/trailing EBITDA, management has put forth aggressive assumptions about the European business' EBITDA growth in 2019, and its legacy EBITDA has declined significantly with the recent decline in wholesale shipments. And it's worth noting that during the Great Recession, HammerCo's EBITDA fell nearly 75% in this highly discretionary, cyclical business. We believe the company has greatly increased its risk profile at a tricky point in the industry cycle

As it became very clear last year that the North American industry had over-produced and created an inventory problem at retail, sentiment did shift on HammerCo and its peers, driving the stock down over 50% from mid-September to late December. However, based on optimistic assumptions that the industry is dealing effectively with the dealer inventory problem and consumer demand will recover – monthly retail sales have been negative year-over-year since July 2018 – HammerCo's stock has rebounded 44% from its December low. We believe this optimism will prove unjustified and foresee 30% downside in the stock.

2019 marks Midwood's 16th year of operation. We have experienced many changes to our business but few changes to our investment philosophy and strategy over this time. We continue to employ intensive due diligence and a bottom-up strategy to identify long investments with superior business models, strong management teams, and attractive long-term fundamentals, combined with extremely compelling valuations that offer returns above

[7] Jefferies LLC initiation report 3/28/2019, p. 6.
[8] HammerCo's investor presentation 3/06/2019, p. 10.

the market averages. We also remain highly motivated to preserve capital in difficult market environments through the quality of our long book and by deploying a meaningful portion of our capital in our short portfolio.

As always, the Fund is open monthly for new investment. We welcome your comments and questions. Thank you for your continued trust and support.

Sincerely,

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