Greystone Capital Management
Concentrated Value Investing

Q3 / October 2024

Clients and Friends,

During the third quarter of 2024, returns for separate accounts managed by Greystone ranged from +8.0% to +10.7%. The median account return for separate accounts managed by Greystone Capital was +10.1%, net of fees. Year-to-date, the median account return is +16.0%, net of fees. Third quarter results compare favorably to both the S&P 500 and Russell 2000 returns of +5.9% and +9.3%. Because client portfolios are invested in a concentrated way consisting of small companies mostly outside of the major indices, our returns should typically vary from the returns generated from those indices.

Sources of positive performance this quarter came from both business specific events and a rising small cap market. Like all quarterly periods, three months represent just a small part of our broader mandate to outperform over a long period of time. As I've mentioned, we will benefit from any broad market tailwinds that happen to blow in our direction but remain firmly focused on business specific performance.

To that end, I'm happy to report that nearly all our businesses reported excellent Q2 results, catalyzing positive share price performance directly tied to increases in future earnings power…a dynamic that has been evading us for some time. Should this trend continue, we will be rewarded…over time. Changes in long-term earnings power happen gradually, despite what stock prices may suggest.

With record flows into small caps this summer, it's possible some confidence has been restored in our area of the market. It's likely premature to mark a sustained rotation into small companies, but a 50bps rate cut along with strong forward earnings growth and cheap valuations may have set the stage for positive long-term returns.

In terms of our positioning, I certainly won't complain if flows continue to move in our direction, but I haven't the slightest idea how your portfolios will react when the market is up or down. I am, however, more certain that the current environment favors *our* strategy, as we are in a ~~stock pickers~~ *business owners'* market. I've frequently discussed (unbiased, I might add) the downfalls of passive exposure to small caps and microcaps, as poor index construction lends itself to overexposure to a large portion of companies carrying both operational and financial risk, a deadly combination we strive to avoid. This means that selectivity matters. Business strength matters. Quality people matter. On these metrics, your portfolios score highly, and separates us from the larger, diversified selection of small companies. I continue to find great individual opportunities that fit our desired criteria, one of which is discussed below.

Come what may, our business owner mentality allows me to virtually ignore the constant stream of noise that doesn't serve our needs, for the benefit of our shared investments. My goal remains to focus on the things that matter, finding and owning businesses that we can hold alongside each other for the long-term. Our interests remain aligned.

Portfolio Commentary

Sold Positions

NN, Inc. (NNBR)

During the quarter I sold our entire stake in NN, Inc., despite our recent purchases along with my optimism about the investment. The reasons for the sale are two-fold. First, we made two new investments recently, one toward the end of last quarter and the other in Q3, which represent much better uses of capital than our smaller position in NNBR.

Second, I've been doing a fair amount of reflection on past portfolio mistakes and successes, leading me to the realization that owning higher quality businesses, with no room for anything else, is my desired path forward. NNBR is not a great business. A potentially great investment, but not a great business. There is a big difference. One is a shorter-term return stream with a fixed valuation / price target, and a larger than desired room for error. The other is what your portfolios should contain if we want to maximize long-term results. To date, my biggest investment mistakes have been selling quality businesses too early and replacing them with lower quality businesses under the guise of cheapness/opportunity cost. Our returns would be much better if I stopped doing this. Moving forward, I think it's prudent to focus on (and own) higher quality businesses that can compound their value over a long period of time. I am currently penning more thoughts on this topic which I look forward to sharing once complete.

New Positions

During the quarter I added significantly to our holding in **Leon's Furniture Limited**. I will use the remaining portion of this letter to discuss the investment in more detail.

Leon's Furniture Limited (LNF.TO / LEFUF)

Decades ago, furniture retail was very much my family's business, as my great grandfather inherited a furniture store, H. Feinberg Furniture Co., from his father in the early part of the 20th century. The store employed many family members, including my Uncle, who later ran the store with his wife for many years, and my Dad, who worked as a salesman before and after college. Although financial details are sparse, two store locations made it possible, according to a 1924 issue of the Wilmington Evening Journal, for *'the firm to absorb entire factory productions, thus enabling it to enjoy advantages in buying not possible with stores whose purchases are limited to carload and trainload lots.'* That was the 1924 version of scale. Unfortunately, two locations in the deteriorating cities of Chester, PA and Wilmington, DE didn't stand the test of time, but as a certain value investor demonstrated, well-run furniture stores with scale can be excellent investments.

Warren Buffett purchased Nebraska Furniture Mart ('NFM') from the legendary Rose Blumkin in 1983, paying $60.5mm, or about 16.0x pre-tax earnings. I could fill the rest of this letter with stories about Rose herself as she was quite a character (I'll spare you), but the purchase was much more than a bet on the jockey. Buffett was interested in scale economics. It's safe to say the investment was a homerun,

as just a year after the purchase, pre-tax earnings for NFM were $21mm, and today Nebraska Furniture Mart is one of the largest and most profitable furniture stores in the US.

NFM achieved that mark by following a simple, but hard to replicate formula for success (from Berkshire's 1989 Annual Report):

- Unparalleled depth and breadth of merchandise at one location;
- The lowest operating costs in the business;
- The shrewdest of buying, made possible in part by the huge volumes purchased;
- Gross margins, and therefore prices, far below competitors', and
- Friendly personalized service with family members on hand at all times.

This formula created a loyal customer base that enjoyed wide selection, convenient shopping and low prices, allowing NFM to scale considerably while widening their competitive moat.

From Berkshire's 1984 Annual Report:

> *"By unparalleled efficiency and astute volume purchasing, NFM is able to earn excellent returns on capital while saving its customers at least $30 million annually from what, on average, it would cost them to buy the same merchandise at stores maintaining typical mark-ups. Such savings enable NFM to constantly widen its geographical reach and thus to enjoy growth well beyond the natural growth of the Omaha market."*

The powerful feedback loop for NFM consists of low prices at the stores, which attract customers, enabling the business to generate high sales per square foot (via high asset turnover ratios) while achieving scale advantages in the form of low prices from suppliers, passed onto the customers in the form of ever lower prices, thus attracting more customers…and so on.

While not considered a low-cost retailer, I believe Leon's Furniture is a functional equivalent of NFM, where scale enables similar competitive advantages compared to the rest of the industry.

Like NFM, Leon's possesses the following attributes:

- Unparalleled scale and operating footprint
- Significant cost and purchasing advantages over competitors
- Wide selection, availability and friendly customer service
- A family run business with a focus on the customer
- Advertising scale and efficiencies leading to strong customer traffic and high market share

Leon's is a 110-year-old furniture retailer, now the largest in Canada, holding the #1 positions in furniture, #1 in appliances and the #2 position in mattress sales. Since its founding, Leon's has been family owned and controlled by the Leon family, where founder Ablan Leon and his sons grew the business from a single store on a street corner in Welland in 1909, to a 302-store behemoth now doing over $2.5 billion in annual revenue. The majority of stores are corporate owned (202) while the remaining locations are franchised, which has been a strong business for Leon's, enabling them to enter into smaller geographies with high quality operators in areas where other furniture retailers were not successful. An important part of recent history includes Leon's purchase of their largest competitor

in 2013, The Brick. Revenues have tripled since that period, and the acquisition brought with it significant scale, top line growth, and geographic diversification.

Today, I estimate that Leon's controls slightly above 15% of Canada's retail furniture market, which I think can grow to 25% within the next decade. In conjunction with further market share gains, Leon's has several internal initiatives set to drive sales and margins upward from here. These include optimizing their store footprint and square footage, centralizing their distribution, growing their warranty and insurance businesses, and monetizing their vast portfolio of real estate holdings, discussed in more detail below.

Despite the cyclicality of the furniture industry, Leon's has separated itself from the pack by demonstrating remarkable durability during its history, with stable margins and zero unprofitable years during the past *two decades*. This, along with strong returns on capital, has led to a compounding of earnings per share of greater than 8.5% during the past 10 and 20 years. I believe there is plenty of runway for continued growth.

The history of Canadian big box retail (of which Leon's and The Brick were some of the first concepts) reveals that large format stores generally gain 10-20% market share each decade, sometimes more, which they've driven upwards as a category from the low-30s in 1980 to 60-70% today. For furniture specifically, these market share gains should disproportionately accrue to Leon's. Despite low barriers to entry, furniture retailing is a very tough business. One doesn't have to look far to read about waves of bankruptcies during each cycle, along with an industry history that reveals many hopefuls trying and failing to operate successfully, including Magnavox, Beatrice Foods and even General Mills, to name a few. As a result, the number of retailers has declined for more than a decade as larger competition (Sears, Eaton's, Zellers, etc.) has gone out of business, while smaller mom and pop operations face challenges with economies of scale and supply chain issues, along with generational business transfer problems with children who aren't eager to enter the family furniture business.

As a result, continued decline in supply along with industry cycles will benefit Leon's, as weaker competitors exit the market or go out of business, allowing the company to absorb additional square footage or incremental sales in certain geographies. A good example of this dynamic is playing out so far this year, where despite housing, consumer and industry softness, Leon's reported positive same stores sales growth through Q2, likely absorbing incremental sales following the bankruptcy of smaller competitor, Bad Boy Furniture.

More importantly, Leon's sits in an important part of the value chain to consumers, given longstanding changes to both manufacturing and distribution among furniture manufacturers. Today, furniture *brands* have all but disappeared (I would struggle to name the brand of any piece of furniture in my house) given fragmentation, outsourced manufacturing, constantly changing consumer taste and little to no marketing presence. Despite some product differentiation, retailers are mostly brand agnostic and view most product lines as fungible, able to be swapped out for something better at any point in time. As a result, retailers now hold all the power, and in a market with a dominant retailer, all roads go through them. Therefore, Leon's controls access to the market, not only as the largest player, but also as the de facto retailer to introduce new brands into Canada. A recent partnership with mattress-in-a-box company Resident is a great example of Leon's using their owned distribution and store footprint to allow Resident to connect with their customers in exchange for marketing dollars, pushing potential Resident customers to Leon's stores. This of course results in zero customer acquisition costs for any mattress or furniture purchases made on a visit.

Leon's advantages will widen over time. The company consistently ranks in the top ten TV advertisers in the country, often surpassing Tim Hortons and even McDonald's in certain geographies. I estimate that Leon's spends around $100mm annually on marketing, which they can ratchet up or down depending on market conditions, dwarfing their competitors spend.

Like the NFM case study, scale benefits will continue to accrue. Leon's is currently the largest importer of shipping containers into Canada, providing them with massive purchasing cost advantages when compared to their competition. Leon's pays around 1/3rd of competitor pricing for a standard 40 ft. shipping container, while maintaining standard markups, enabling them to post gross margins significantly in excess of mom-and-pop operations, and on par with some of the best run retailers in the US. I estimate Leon's cost structure to be significantly favorable compared to the average mom and pop operation in terms of both purchasing power (gross margins) and operating expenses per unit. The average mom and pop store must mark their prices up significantly just to breakeven on a per unit basis, while Leon's can use their cost advantages to offer everyday low prices and sit on the value end of the spectrum, further widening their competitive advantage. In addition, relationships with over 500 suppliers and a wholly owned logistics subsidiary means Leon's has on the ground presence in Asia, another leg up over competitors. These advantages were demonstrated during the pandemic, where Leon's scale and purchasing power made them one of the only furniture retailers who could obtain available product.

As mentioned, Leon's has been family run since it's founding, with the Leon family still owning and controlling 70% of the business. Many members of the family, starting with founder Ablan Leon's 11 children, have passed through the business in various roles, with grandson Terry Leon most recently serving as long-time President and CEO.

The Leon's have been excellent stewards of capital (likely due to their large ownership stake), highlighting my preference for owner-operator led businesses, and have proven to be excellent operators during the past few decades. They also implemented a compensation structure that is rare among family-owned businesses, with fair base salaries and no egregious stock-based compensation. They are true owners of the business and have treated the capital as such.

One area in which they have historically fallen short is investor communication. Don't get me wrong, I love a healthy disdain for Wall Street. But in this case, I believe both the strength of the business along with the potential value is not being captured in the current price. I also believe it will start to be recognized shortly.

In 2021, following a 6-year stint with the business as a VP of Operations, Leon's hired Mike Walsh as CEO, making him the first ever non-family member CEO to take the reins. Since his hiring, Mike has quickly demonstrated his skill as an operator and capital allocator, meaningfully adjusting Leon's inventory assortment coming out of COVID, returning significant amounts of capital, and putting a plan together to unlock significant shareholder value. Mike was also behind the recent IR push, serving to highlight the strength of Leon's business. Mike has an extensive track record as a successful Canadian big box retailer, and we stand to benefit from his skillset in the foreseeable future.

All in all, the furniture business has a long runway for continued market share gains and cash flow generation, with some internal projects that could also boost margins over time. I would be a happy shareholder of the furniture business alone, at the price we paid.

But there's more.

As a result of their large store footprint, Leon's is currently sitting on a portfolio of 12.2mm square feet of residential and industrial real estate, 5.6mm of which is owned, unencumbered. Many of these properties were purchased decades ago, with value rising in accordance with historical increases in real estate prices. Currently, the entirety of this real estate sits on Leon's balance sheet at a value of $275mm.

In May of 2023, Leon's unveiled their plan to unlock the value of their real estate via IPO, which will commence in line with favorable market conditions, likely by year end 2025. Importantly, this is the same strategy that was enacted by both Loblaw Companies and Canadian Tire, two of Canada's largest big box food and retail businesses, who spun off their portfolios of real estate in 2013. Using similar prices per square foot and measured against current market data, I value Leon's real estate portfolio to be worth somewhere between $1.2 – $1.6 billion. The current market value of *the business* is $1.8 billion.

Not only will the IPO serve to unlock the value of the real estate by providing a public valuation but will also provide Leon's with a sizeable chunk of cash to be used for buybacks and/or a special dividend. With limited reinvestment needs and shareholder friendly management, I believe a decent windfall will be doled out to shareholders following the transaction. Although there will be a negative impact to earnings and cash flow in the near term due to increases in lease payments following the transaction, Leon's will collect sizeable distributions from the REIT, partially offsetting these lease payments, and should more than make up for it with increased market value.

Lastly, to finish icing our cake, one of Leon's distribution centers and corporate headquarters sits on a 40-acre lot in prime downtown Toronto, the monetization of which is currently underway. Leon's plans to partner with developers to build 4,000 homes in addition to a new corporate headquarters. The land has already been converted from a general employment area to a regeneration area, and secondary approval to move forward with a development plan will likely be granted in 2025. Maximizing that parcel of land will require the building of residential, high-rise, low-rise, rental units and town homes, and will likely result in a value between $200-400mm to the company.

Amazingly, our purchase price for the business inclusive of all the assets was less than 6.0x EBITDA and 9.0x free cash flow. As Leon's continues to grow, optimize the store footprint, centralize distribution, and unlock the value of the real estate, I believe earnings power will increase, and both the strength of the retail business and the value of the real estate will shine through. Capital returns will be another catalyst, as Leon's has returned nearly $1.0B to shareholders between dividends and buybacks during the past decade, even repurchasing 10% of shares outstanding during 2022 alone.

One industry insider pointed out that the furniture business is one with 'low barriers to entry and high barriers to exit', meaning there are plenty of ways in, but the only way out is through success. Leon's has demonstrated their success thus far and we are betting on its continuation. Given our large margin of safety and favorable risk/reward profile, Leon's is now positioned within our top five holdings.

As always, please feel free to reach out anytime if you would like to further discuss the business or our investment.

Broad Market Commentary

This will be my third consecutive letter with nothing to contribute to this section, putting its future existence in question. During most quarterly periods, despite what seems to be a lot going on in the world, I spend very little time reading about or thinking about macro news and the broad market, likely a reflection of each topic's utility. In fact, I've historically embraced Peter Lynch's approach to macroeconomics, which dictates:

"…if you spend 14 minutes per year on economics, you've wasted 12 minutes."

Yet, each quarter, I typically dedicate a portion of my time (and yours) to writing about this topic. Why?

Nobody is beating down my door to provide my take on the economy, and you can sleep well at night knowing the future success of your investments is not dependent on my awareness of every macro issue, nor my ability to predict changes in economic activity. However, the pressure to make these communications as useful as possible is self-imposed, and this section has outlived its usefulness. Continued macro commentary, of any kind, leads to a focus on the wrong inputs and emphasis on things that do not matter.

Unfortunately, investment managers often feel the need to have an opinion on every business along with issues related to the economy. I felt this way for some time. Unsatisfactorily, when asked some variation of the question: where do you think stocks are headed? My answer was always, *'I have no idea'*. When at idea dinners or conferences, when asked about specific businesses or industries, *'I have no idea'* was again a common answer. To some, I may have seemed ignorant and uninformed. But focus and simplicity are two important traits to lean into when investing, and if you could see how I spend my time, it would reveal that I pay little attention to anything outside of what might positively drive the value of your portfolios. That means I won't know everything and can't be all things to all people. Therefore, retaining the humility to say 'I don't know' will be crucial for long term success. Consequently, I no longer feel the need to sound informed on topics that carry little relevance to my decision making.

Most importantly, I can't recall one useful takeaway from any of my prior Broad Market Commentary sections of previous letters. When it comes to our investments, however, the lessons I've learned from each, the insights and patterns derived, along with industry related information has stuck. If these letters contain my thoughts on investing – whether company specific, process related or lessons learned – and if I want them to be valuable pieces of communication and progress of my evolution as an investor, shouldn't I spend more time writing about those topics?

Spending time thinking about – and even worse, writing about – the broad market or my thoughts on the direction of stocks in general is what's known as expiring knowledge. It becomes irrelevant / useless as soon as the next quarter begins. Think of it as *what* vs. *why*. Relating to our investment in Leon's Furniture, knowing *what* the PE multiples for publicly traded furniture businesses are, is expiring knowledge. It changes often and isn't particularly relevant at any point in time. Studying *why* big box retail has dominated in Canada, or *why* the industry is shrinking, is permanent knowledge, with long lasting benefits.

Author Morgan Housel sums it up nicely:

> *'Long-term knowledge is harder to notice because it's buried in books rather than blasted in headlines. But its benefit is huge. It's not just that long-term knowledge rarely expires, letting you accumulate it over time. It's what compounds over time. Expiring knowledge tells you what happened; long-term knowledge tells you why something happened and is likely to happen again. That "why" can translate and interact with stuff you know about other topics, which is where the compounding comes in.'*

A good question to ask for something worthy of inclusion in these letters is: will this matter and will I care about this one year from now? Five years? Ten? If the answer is no, the focus should be on longer lasting information.

From here, I will spend more time writing about lessons learned from past / current investments, along with things I'm incorporating into the firm as my experience grows. Hopefully, this will translate into these letters becoming better, and more useful to everyone.

Recent Developments

The firm continues to grow, and we onboarded some like-minded partners during the past few months. It remains an excellent time to allocate to our strategy and I always welcome outreach and conversations from patient, like-minded investors. Please don't hesitate to reach out if you would like to learn more.

In August I was invited on The Compounders Podcast to discuss Greystone and some aspects of my investment process. Please feel free to give it a listen. Thanks to Ben Claremon and Bobby Kraft for the invite.

Lastly, for those interested in donating to the Buncombe County victims of Hurricane Helene, they could use all the help they can get, as many lost their homes, places of business, and their loved ones. I went to college nearby and I can speak to the quality and strength of the community, which I know will emerge stronger from this disaster.

As always, thank you for the opportunity to manage your hard-earned savings. Please feel free to reach out anytime. Thank you for reading.

Adam Wilk
Greystone Capital Management
www.greystonevalue.com
Email. adam@greystonevalue.com
Direct. 302.593.4483

Disclaimer: *Past performance is no guarantee of future results. Investing involves risks which clients should be prepared to bear, including but not limited to partial or complete loss of principal originally invested. Investing in small and microcap companies can result in additional volatility and higher risk due to comparatively low market capitalization, more sensitivity to economic and market conditions, and more limited managerial and financial resources. In addition, small companies typically trade in lower volume, making them more difficult to purchase or sell at the desired time and price or in the desired amount. Please refer to Form ADV Part 2 brochure for more information about Greystone Capital Management and its personnel.*