Fairlight Alpha Fund LP

Q4 2023 Letter

Dear Partners,

Fairlight Alpha Fund's fourth quarter 2023 returns were 2.0% net of fees. This compares to 11.7% for the S&P 500 Total Return index. Overall, since inception the fund has returned 432.2% net of fees and 41.2% on an annualized basis.

Performance vs. the S&P 500

We track the net asset value of Fairlight Alpha Fund (the "Fund") over time as calculated by our fund administrator based on our portfolio positions and prices over time on a dollar basis. The fund financials are also audited each year by an independent auditor with the assistance of the Fairlight management company and the fund administrator.

The tables below show the S&P 500 total return and partnership net returns, after fees, for each year 2019-2023, followed by the compounded returns over the same period, as well as the annualized gains.

Annual Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	26.3%	18.4%	7.9%
2021	…………………………	146.5%	28.7%	117.8%
2022	…………………………	15.8%	-18.1%	33.9%
2023	…………………………	6.9%	26.3%	-19.4%

Compounded Returns

Year		Fairlight Alpha Fund	S&P 500 (Total Return)	Difference
2019[1]	……………………........	38.1%	17.9%	20.1%
2020	…………………………	74.4%	39.6%	34.7%
2021	…………………………	329.9%	79.7%	250.2%
2022	…………………………	397.9%	47.2%	350.7%
2023	…………………………	432.2%	85.9%	346.4%
Annualized Gain	…………………………	41.2%	13.7%	27.6%

(1) The S&P 500 returns represent the total return index, i.e., with dividend reinvestment included. Increases in value arise from stock price appreciation as well as dividend reinvestment. This provides a fairer comparison to the fund.
(2) The Fairlight Alpha Fund performance is shown net of partnership fees and expenses.

[1] The Fairlight Alpha Fund was launched on 01-Mar-2019 and so the 2019 performance and returns are presented for a 10-month period.

The fund had a positive return for Q4, but overall lagged the S&P 500 (Total Return) for the year. We use this index as a benchmark because it's well known, simple and over time provides a good benchmark to aim to outperform. In 2023 it exceeded historical averages, while the fund and many small caps performed less well. We discuss below some of the figures that highlight the relative cheapness of our portfolio holdings and how this may give an indication for future performance.

Market and Portfolio Performance

If one were to look at Fairlight as a single-stock, in essence treating the portfolio on a look-through basis, it would give an insight into the underlying drivers of performance. It would be trading at a valuation of 6.8x, with current annual growth of 27.8% and incorporating cash gives a valuation of 3.5x (EVE).

If you take the portfolio look-through valuation metrics above combined with what we have seen historically, we are well positioned for the future. Stocks can be cheap and stay cheap of course, but we also always look for businesses that have inflection points, or a high probability of future growth, so that a stock value at 4x, will become a 3.5x, 3x stock and so on in the future and so even if there is no re-rating of value we will benefit from growth and business execution.

In terms of the market there are some signs that there could also be some tailwinds ahead. It's difficult to predict the overall performance of small caps versus large caps, but we pick individual stocks based on relative cheapness and the particular ideas for each one and so they should do well in any set of market conditions. We are mindful not to take many risks that relate to macro, commodity, or rate cycles, but the current rate environment and what we see as a "normalization" of rates should benefit some of our positions (e.g. the bank positions). As discussed below, though, these would just be an additional tailwind because these ideas should do well in any environment, because there are unique aspects to their business position.

A Review of Specific Ideas

Starting off with the ECIP banks as mentioned above, particularly Citizens Bancshares (CZBS) and M&F Bancorp (MFBP), these have particular business benefits irrespective of what the rate cycle pans out to do this year. As mentioned in previous letters these have issued ECIP preferred stock which they can now leverage onto their balance sheet (with this stock counting as AT1 capital and giving preferential capital treatment). This growth is still playing out and will likely take many years to come to full fruition.

In essence both these banks (along with many of the other ECIPs) are in the process of doubling in size. Their balance sheets will double, deposits will increase, and loan books will grow. This, as many reading this will already know, is because the program was set up to encourage the Community Development Financial Institutions (CDFIs) and Minority Depository Institutions (MDIs) to grow and help their communities.

Against this backdrop, and partly because of the fear induced in the US banking market earlier last year, they have become cheaper than they were in early March of 2023 (particularly in the case of MFBP). Both are priced at around 5x, although there will be an update at the end of January from the FFIEC report filings. So, these banks are cheaper than they should be (compared to any other non-ECIP bank), have growth ahead of them, and extremely high capital adequacy levels. For example, CZBS reported that its CET1 ratio at the end of Q3 was 19%, and total risk-based capital ratio was 20%.

Last quarter we talked about a new idea: McCoy Global Inc. (MCB.TO). This is an interesting company in that it is cheap, growing and has pivoted in terms of business strategy in recent years. All of this combined with what we think are some (understandable) market misunderstandings about the business.

The company manufactures, develops and researches hydrocarbon drilling technology and has historically been primarily a manufacturer of drilling equipment with a focus on quality engineering. It has pivoted over the last several years towards technology innovations that can assist with the automation of drilling processes, removing people from what is called the "red zone" the most dangerous area of an oil rig near the drilling equipment itself. The company aims to reduce what might take a team of 8 staff in the red zone, down to 2-3 and ultimately automate many processes that require manual, physical intervention. This will save lives and reduce accidents.

We will talk more about McCoy this year, because we think they have a very interesting business model, are smaller than many competitors and have a lot of growth ahead of them. The management has also exercised excellent capital allocation for the business, buying back 5% of stock in the last 6 months as well as having a history of smaller strategic acquisitions that have added huge value to the company, both in terms of financials and in terms of their long-term business plan.

One example of this was their purchase of 3PS in 2017. They purchased this company, which enhanced their sensor technology to be used in drilling equipment, for US$6.1 million. This purchase included land and production facilities along with the business. Partly due to accretion in value of these assets in subsequent years they were able to sell the facility and leaseback for more than $6.5 million. This essentially made the purchase a net gain to the company financially as well as adding value to the business.

Outside of North America there are many exciting companies, sectors, and areas where specific developments are throwing up new opportunities. Anyone looking at the financial press, or television news will be hearing a lot about the latest technological developments in AI, robotics, and technology in general. Many companies in these areas have very high (perhaps justified) valuations, such as Nvidia, Tesla, and Amazon. These specific examples are growing, in exciting areas of the economy, and are perhaps like the larger cousins of the kinds of stocks we look for with growth, and inflection in their business prospects.

The reason we mention these names is that within the ecosystems of these technologies and technology companies there are pockets of extraordinary opportunities that appear periodically. For example, Shelly Group, which has been discussed by many smaller investors, is still extremely attractive, even though it has increased in value a lot over the last twelve months. This is a company growing at over 50% per year, which guides for a "conservative" level of growth in the 40-45% range. It has exceptional management split between a seasoned large company CEO (the CEO Wolfgang Kirsch used to run MediaMarktSaturn a leading European consumer electronics retailer) and a technology powerhouse in Dimitar Dimitrov (co-CEO), who loves the product so much that he interacts with end users on internet support groups and message boards. The company was in the low teens normalized earnings when we first purchased and although it has run up a lot, given the huge level of growth it is arguably not much more expensive than when we first purchased. We don't typically use PEG ratios, but that might be a good metric to use for Shelly, and would give a value below 0.5, depending on the growth estimate used (and an estimate for Q4 earnings).

There are other examples we are seeing across different countries where there are cheap valuations tied to very high growth companies and we will discuss those that we find as we proceed through the year. One other aspect of these companies, which are often technology companies, is that there has been a fundamental shift over the last two decades in terms of what valuations mean in the accounting sense.

It used to be that company income statements were based on revenues, operating expenses and administrative expenses for salary, marketing, research and development and other line items and this made sense when companies bought physical equipment, factories, and tangible assets. These days, many if not most expenses, are tied to intangible assets such as software, IP, data and other non-physical assets. These are often expensed in the income statement and there is no clearly defined asset that appears on the balance sheet for the expense.

So, when looking at technology companies like those above there is an increasing level of distortion regarding what the income statement is actually showing. Costs to develop software, technology, as well as associated research, marketing and development reduce the level of income, or conversely produce no assets that are shown in company accounts. It is very difficult to estimate what the value of a pool of data, a network of servers, or lines of code is to a company. This was the case in prior decades as well, for companies with patents, or a hugely valued brand (think of Coca-Cola). So combined with the exciting growth opportunities above, we try and estimate the offset for these factors in earnings when looking at these types of companies.

Unique Companies and Opportunities

It's interesting to look at specific examples of special companies that are either private or are subsidiaries of other companies. One interesting example we looked at was Pantone®, a company that essentially has a monopoly on color, or at least the standardization of color. They are well known to many probably through their Pantone Matching System (for accurate color printing and representation), guides and books, digital solutions, and perhaps their Color of Year award: Peach Fuzz anyone? If readers think about it, they probably will be able to think of the times they have interacted with or used this company's services. In decorating and paint selection, swatches often use the Pantone system, colors in fashion often indirectly depend on trending Pantone colors, furniture, home goods, digital printing and vehicle colors often depend ultimately on pantone color systems and trends.

There are also many examples of specific Pantone® colors that are perhaps famous and instantly recognizable as part of other company's brand identity. Tiffany & Co.'s famous egg blue color is Pantone® 1837 (Pantone® color code deriving from the year of Tiffany's foundation), the golden arches of McDonalds (Pantone® 123, 350 and 1795), Target Red (Pantone® 186), Post-It Notes (various colors rebranded in 2022). Technology may have eroded some of Pantone's business, and yet it still persists due to its trusted color accuracy and printing color systems. We look for companies that are in the earlier stages of their growth, due to this kind of unique product or service, and that will become recognized in their niche of the market.

Looking Forward to 2024

The next year is shaping up to be an exciting one. Although there are many geopolitical issues around the world, there are large advances being made across a variety of technological and business fronts, and we are optimistic. Researching stocks and businesses around the world gives one an unusual bottom-up perspective on the world, that is often different from the perspective from reading economic articles or news pieces. From the ground-up view there are tens of thousands of companies with millions of employees working to improve processes, advance new products and create new innovations that will benefit everyone. And we aim to find those that are exceptionally special.

We look forward to the year ahead and to searching for those opportunities when and where they appear. We wish everyone a great year ahead and thank our investors for their support.

Yours,

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