IRONVINE
CAPITAL PARTNERS, LLC

Second Quarter Letter to Clients

July 30, 2012

To our investors and other interested parties:

As many of you know, we recently began managing money for clients in the same way we manage our personal assets. We've been very fortunate thus far in our careers to spend so much of our working hours analyzing businesses—an activity we enjoy and are extremely passionate about. We wake up excited each day about the prospects of going to work and building this business over several decades. Thank you for your continued support.

In these letters (this being our first), we will try to articulate how we go about doing things. We hope that readers, after reviewing our letters, will have an understanding of how we look at businesses, how we assess management teams, how we estimate corporate values, and how we define risk. You won't read economic forecasts, predictions on monetary policy, or commentary on political activity here. In our communications with you, we'll focus almost solely on the economic characteristics of businesses and the employment of capital.

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Our accounts were down on average 0.50% in the second quarter. For context, the S&P 500 fell 2.75%. Year to date, our accounts have increased 9.64% on average while the S&P 500 has returned 9.49%. These returns are calculated net of fees, and are presented on a total return basis (please see the disclosures at the end of this letter for a review of calculation methodologies). We will be sending each of you your individual account performance under separate cover.

Note that your portfolios will have varied from the average if cash contributions were made within the quarter. Longer term, performance across accounts will tend to converge because each of our portfolios will ultimately hold the same positions in nearly identical proportions to one another.

We don't give a tremendous amount of consideration to quarterly performance—we expect it to fluctuate wildly with general levels of market sentiment rendering it useless as a guide to business progress. Over rolling periods of three to five years, however, (the time frame we will grade ourselves on) underlying business developments will be the arbiter of our returns. As Ben Graham was known to say, 'in the short run, the market is a voting machine, but in the long run, it is a weighing machine.'

At quarter end, we had roughly 70% of our capital deployed across ten businesses with position sizes ranging from 5% to 12.5%. We are enthusiastically searching for more businesses to add to this already fine collection of assets. We would love to be 'all in', but we won't dilute our existing portfolios with inferior franchises for the sake of being fully invested. We couldn't agree more with a wise man who once wrote: 'We'll try to resist the temptation to do something marginal simply because we are long on cash.'

Successful investment operations require long-term thinking. Most market participants—primarily due to pressure from their clients to outperform—struggle to adhere to this discipline, and instead give significant weight to delivering strong near-term results. A fully-invested posture without question to business valuations or other risks is one the consequences of this pressure. This is a mistake that we'll try to avoid by developing a client base that thinks in clumps of years, and values risk aversion and losing less money in falling markets above maintaining pace with peer groups over short periods of time. This won't be easy—it will without question lessen the speed at which we grow personal wealth—but we know it's right. We have no interest in gathering assets for the sake of getting rich quickly. We have an overwhelming majority of our personal money invested right next to our investors and will try to grow it in a sane and safe manner. We like that our fortunes will move together in that manner—that seems fair to us.

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Our Investing Principles

We view our role as capital allocators no different than the head of a large conglomerate would (or how they should, rather). We have a finite amount of capital to invest in projects or businesses (small stakes in businesses through equity purchases, in our case) that, over time and on average, are expected to earn an acceptable rate of return. What is acceptable? To us (we have more than 90% of our personal worth invested right alongside you), we find that a return capable of doubling our money every five to six years—without leverage, and while maintaining a strict focus on risk avoidance—is both attractive and achievable. Mathematically, this requires us to generate 12% - 14% *average* annual returns—they won't be linear, and they might fall short. But this is our quest, we feel up to the challenge, and we will be disappointed with ourselves—and invite your criticisms—if we fail to succeed.

How do we plan on getting there?

As time has progressed and we've grown more experienced, our strategy has become singular. You won't see us attempting to time the general price level of the market, investing in turnarounds, or placing bets on macroeconomic outcomes. No, we will follow a narrow path of purchasing, at attractive prices, stakes in a small collection of outstanding businesses that generate returns on capital superior to those of the average enterprise. But that's not enough. The competitive positions of these businesses must be capable of enduring through time, such that those returns persist. Furthermore, and arguably of as much importance, they must be led by management teams that think and act like owners—not only in their day to day operations of the business, but also through consistently allocating capital in ways that build per share intrinsic value. This approach to studying investment possibilities can be summarized succinctly using three words: Business, people, and price—a three-legged stool of business analysis. They are the foundational components of the process that guides us through the investigation of hundreds of businesses annually.

We've found that the most prolific businesses are those that generate extremely high returns on capital but require little in the form of incremental capital to grow. These businesses are a very rare breed indeed—most capital light businesses have modest growth prospects.

There is another breed of business we hold in nearly as high esteem. These are businesses that, for an extended period of time, can employ large amounts of *incremental* capital (meaning, in excess of maintenance CAPEX) at very high rates of return. This activity—deploying free cash flow into new, highly cash generative assets and repeating the process year after year—has the same value-creating effect of compound interest experienced in the savings accounts of yesteryear. Note that this phenomenon is uncommon. Very few companies can endure unfettered without their economic prospects deteriorating,

whether that be through changes in technology, increased competition, or myriad other reasons. When we think we've found something durable, our research intensifies.

On the opposite end of this continuum is the business that's forced to invest increasing amounts of capital at unsatisfactory rates of return—or, even worse, does so by choice. The prevalence of the latter has taught us to obsess over management teams and the boards that guide them. A great business can prove to be a terrible investment if the people in charge 1) lack a sound understanding of corporate finance or 2) are more incented to build an empire than build value. Amazingly, we have lost count of offenders of both types. We evaluate a management team's capital allocation decisions based on these seven levers:

- Reinvestment in the business for organic growth
- Stock repurchases
- Dividends
- Debt reduction
- Acquisitions of other businesses
- Disposing of operating units or other assets
- Accumulating cash

In different circumstances, the application of these tools will have varying impacts on value. Some create value—others destroy it. Executives should understand how the alternatives contribute to such. Ideally, they do so following a long-term, returns-based framework. For example, they might ask the following:

- What is the estimated cash on cash return generated by this decision?
- What is the risk of this return failing to come to fruition?
- What is the capital invested in this decision going to cost?
- Does this decision generate returns in excess of that cost?
- Is there a better use for this capital?

When we uncover a business with exceptional long-term economics paired with a management team we trust, we turn our attention to the price tag. The basic question we ask ourselves is whether the business being offered provides us with a reasonable amount of safety above and beyond our required return should our analysis turn out to be wrong. We value businesses just as we would a bond—by discounting a conservative estimate of the coupons we expect to earn over its life. Unlike most bonds, however, equities, <u>if chosen wisely</u>, don't have fixed coupons or maturities—*their coupons can grow into perpetuity*. Today's yield, plus a conservative estimate of tomorrow's 'coupon growth', provides us with an estimate of the forward return we hope to realize over our holding period. This is a useful analytical tool—equity yields allow us to compare new investment opportunities to those of the businesses we already own stakes in (in addition to Treasury yields, and the yields in other risk assets such as high yield credit or mortgage products).

We should also point out what we mean by equity coupons. Our analysis is focused on cash, not GAAP earnings or EBITDA. Earnings and EBITDA fail to charge companies for capital. Take, for instance, two debt free companies (companies A and B) that generate $100 million each in EBITDA. Company A is valued in the equity markets at 10x EBITDA ($1 billion) while Company B is valued at 15x EBITDA ($1.5 billion). A hasty comparison of the two would argue that Company A was cheap relative to Company B. Suppose that after taxes and necessary investments in fixed and working capital, Company A (the seemingly cheaper business of the two) is left with just $20 million. Company B, however, requires very little capital to sustain its core operations and, after paying taxes and making a small investment in maintenance capital,

is left with $85 million. Which business would you rather own? Let’s compare the two coupons again. By focusing on cash generation, what’s revealed is that Company A’s free cash flow yield of 2% ($20MM in free cash flow / $1,000MM valuation) is inferior to Company B’s 5.6% ($85MM / $1,500MM). We like to say that cash can be deposited in the bank—EBITDA can’t.

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Here in the summer of 2012, we remain as confident as ever that time arbitrage—the act of capitalizing on opportunities to make sound, long-term investments driven by selling unrelated to underlying business progress—remains present. In 1965, the value of a business was found by discounting the future cash flows that would be available for distribution to its owners. This calculation holds today, as it will in 2065. For the predictable, long lived, high quality businesses that we focus on, corporate values fluctuate significantly less than equity markets would suggest. We believe this gives us a competitive advantage. As markets live in fear of what headlines might emerge in the next day, our portfolio companies continue to invest capital at attractive rates of return based on what the world will look like in the *next decade*. We like who we’re partnered with.

Thank you for your investment. As always, should you have any questions related to the content of this letter, our process, or your specific portfolios, please let us know.

Note: This letter is a reprint from July 30, 2012 while Matt Barnes was employed at McAdams Wright Ragen Inc. Ironvine Capital Partners, LLC was subsequently created and commenced managing client assets in November 2013. The Ironvine Concentrated Equity Composite was created on December 1, 2013, with an inception date of April 1, 2012. A review of the performance record for compliance with the portability requirements of the GIPS standards was completed by an independent accounting firm. The verification and performance examination report are available upon request.

Important Disclosure Concerning Performance Information:

Data used in this letter to compute average performance for the second quarter includes three (3) accounts that were being managed for the full quarter, and two (2) accounts being managed for the full year to date. At the end of the second quarter, there were 11 additional accounts being managed using this strategy but not included in the performance data because the inflows occurred during the quarter. These portfolios will be included in subsequent quarterly performance data. In the second quarter, account level performance was -0.48%, -0.38%, and -0.65%, respectively. YTD, account level performance was 9.59% and 9.69%, respectively. All performance figures reflect the deduction of fees. In both the second quarter and YTD periods, two of the manager's personal accounts were included. In these instances, the performance calculation adds back commissions paid then deducts a model fee of 1%. All portfolios have, and have had through the stated reporting periods, similar compositions in the positions held. The average was computed by summing the performance of each portfolio and dividing it by the number of portfolios managed for the full period. The data is strictly for illustrative purposes and is by no means indicative of or a guarantee of future returns. These performances figures have not been audited.

Equity index information is provided for informational purposes and is not directly comparable to your own account performance, which may differ substantially from any index shown. The S&P 500 in an unmanaged index based on the prices of 500 large-cap, publicly traded US companies, and cannot be invested in directly. The S&P 500 is more diversified, in terms of number of holdings and market sectors, than individual portfolios advised by MWR and does not contain non-equity assets, such as cash or fixed-income investments. We caution you that there are a number of significant differences between your own portfolio and the S&P 500 Index and that comparison is therefore appropriate only for limited purposes. MWR-advised portfolios typically contain cash equivalents in varying amounts at different times, in addition to equity securities. Diversification does not ensure against market loss and there is no guarantee a diversified portfolio will outperform a non-diversified portfolio.