



Ballast Equity Management, LLC Q1 2019 Strategy Commentary

Market Overview

U.S. equity returns rebounded sharply in the first quarter of 2019. Growth stocks outperformed value stocks and smaller companies generally outperformed the stocks of large-cap companies. Within every equity style and size, low-quality stocks, as ranked by Standard & Poor's Quality Rankings, sharply outperformed high-quality stocks. An important step in the Ballast Equity Management investment process is our Quality Rankings model. This proprietary tool considers factors including financial leverage, interest coverage, stable and growing earnings, high operating margins, and stable and growing returns on invested capital. Ballast's proprietary rankings show a similar underperformance by high-quality stocks in the first quarter, following significant out performance by high-quality stocks in the downdraft of Q4 2018.

According to our Quality Rankings, high quality stocks underperformed low quality stocks by 3.93% during the quarter. It should be noted that high-quality stocks outperformed low-quality stocks by 5.72% during the Q42018 market selloff. During the entire 6 months (9/30/2018 – 3/31/2019) high-quality outperformed low-quality stocks by a positive 5.24% on average, based upon Ballast's Quality Rankings model, demonstrating the importance of owning high quality companies this late in the business cycle.

Ballast Strategy Performance

After producing strong outperformance in the market's late 2018 downturn, Ballast delivered strong absolute returns in the first quarter of 2019, yet each of its strategies lagged its respective indexes. More information including since-inception performance for each of the strategies may be found at www.ballastequity.com.

A cornerstone of Ballast's investment philosophy is its insistence on investing our own and our clients' capital in the stocks of high-quality businesses, as defined by high returns on invested capital (ROIC) sustained through proven and durable competitive advantages. Further, we will only invest in those businesses after a careful assessment of the downside risk, believing that the combination of quality and reasonable valuations maximizes compounding of wealth and provides a smoother ride through full market cycles.

The **Ballast Quality Midcap Strategy** produced a return, before fees, of 13.7% in the first quarter of 2019. While attractive on an absolute basis, this performance lagged the returns of 16.5% and 14.4% of its benchmarks, the Russell Midcap Index and Russell Midcap Value index, respectively.

Quality Midcap Top Contributors

Ballast holding Xilinx, Inc. (XLNX) was the top contributor to performance during the quarter. Xilinx is a leading provider of programmable logic devices (PLD) to clients in the data storage, military, industrial, automotive and wireless industries. Familiarity with the tools and software necessary to program the

company's devices lead to high customer switching costs, a distinct competitive advantage. Xilinx, being one of the only two PLD players in the industry, exhibits strong ROIC of 16% and high operating margins of 30% plus. Ballast has recently trimmed the holding into strength, but it continues to remain a core holding as we see 5G wireless product growth continuing for several more years.

Ballast holding MSCI Inc. (MSCI) was also a top contributor to performance. MSCI, Inc. engages in the provision of investment decision support tools, including indices, portfolio risk and performance analytics, and corporate governance products and services. MSCI was added as a new portfolio position during the 2018 year-end market selloff. Asset-based fees have been a leading driver of revenue growth over the past several years as the extended bull market has unlocked the leverage potential of its index business. We believe MSCI has strong competitive advantages due to its well-known MSCI branded products which ETF, mutual fund, and hedge fund managers utilize to benchmark their investment performance. Once a manager has decided on a specific index, it typically does not swap it out for an alternative. This creates significant switching costs and generates recurring subscription-based revenues evidenced by ROIC of 12% and operating margins north of 40%. We believe these competitive advantages are sustainable well into the future and view MSCI as a long-term core position.

Quality Midcap Top Detractors

Healthcare Services Group, Inc. (HCSG) was the greatest individual detractor to performance during the first quarter of 2019 as many nursing homes (HCSG's end customers) have run into financial difficulties. Healthcare Services Group, Inc. provides management, administrative and operating services to the housekeeping and dietary services departments of the healthcare industry. The company services approximately 3,700 nursing homes, 50 hospitals and 50 alternate healthcare delivery sites in 47 states. While these numbers are significant, the opportunity for growth is compelling; the AHCA estimates that there are about 23,000 long-term and post-acute care facilities (skilled nursing facilities) in the US and outsourcing revenue generated by HCSG and its peers approximates just 11% of the \$27 billion long-term care market. Business performance of Healthcare Services Group is strong, as evidenced by ROIC of 19%. Taking advantage of the weakness, we added to our position as we believe the company's shares sell at a significant discount to Ballast's estimate of fair value.

Integrated Device Technology Inc. (IDTI) was a detractor during the quarter only because it has hovered around its \$49 takeout price all while the market rebounded sharply. IDTI is in the process of being acquired by Renesas Electronics Corp. (TSE: 6723) for \$6.3 billion in cash. Under the terms announced in September 2018, shareholders of Integrated Device Technology Inc will receive \$49 in cash for each share held, representing a 29.5% premium over the closing stock price of Integrated Device Technology Inc. on August 30, 2018. IDTI was a significant contributor to performance in 2018 and was eliminated during the first quarter of 2019 as it achieved long-term tax status.

The **Ballast Quality Smallcap Strategy** produced a return, before fees, of 10.8% in the quarter, lagging the 14.6% and 11.9% returns of its respective benchmarks, the Russell 2000 and Russell 2000 Value.

Quality Smallcap Top Contributors

Summit Financial Group, Inc. (SMMF) was the greatest individual contributor to performance during the quarter as many of our financials rebounded as fears of margin compression due to a flattening yield curve subsided. Summit is a \$2.2 billion financial holding company headquartered in Moorefield, West Virginia. Summit provides community banking services primarily in the Eastern Panhandle and Southern regions of West Virginia and the Northern, Shenandoah Valley and Southwestern regions of Virginia through its bank subsidiary, Summit Community Bank, Inc., which operates 33 locations. Summit also operates Summit Insurance Services, LLC, and recently closed the acquisition of West Virginia-based Peoples Bankshares, Inc. on 1/1/19. We continue to like Summit long-term as it has a strong return on tangible common equity of 16%, a high net interest margin of 3.6%, and trades at a reasonable 1.7x price to tangible common equity.

Another top contributor in the quarter was **John B. Sanfilippo & Son, Inc. (JBSS)**. JBSS is one of the largest and most efficient processors of private-label nuts in the U.S. JBSS retains crop specialists who work hand in hand with select growers helping the company better forecast macro and microeconomic trends in the industry. With this information, JBSS can generate a more effective pricing strategy for walnuts, peanuts and pecans based upon anticipated pricing pressure from farmers. No competitor has the depth of involvement along the supply chain as JBSS giving it a distinct competitive advantage over competitors. The Fisher name, its biggest brand, claims considerable brand equity with consumers also giving it a strong advantage over smaller competitors. We continue to like JBSS as it has grown its returns on invested capital to over 12% and believe this will continue as it expands into healthier snacks such as Orchard Valley Harvest and new product offerings from its recently acquired Squirrel and Southern Style Nuts brands.

Quality Smallcap Top Detractors

Allied Motion Technologies, Inc. (AMOT), a global provider of motion control products and solutions, was a detractor in the quarter as one-time inventory adjustments at a few major customers hurt results. We continue to like AMOT as order activity and backlog levels remain strong with a book to bill above 1 during the quarter. We believe AMOT can increase its returns on invested capital from its current level of 9% as it expands its multi-product motion solutions offerings (rather than just components) by targeting the robotics, material handling, and factory automation industries. Ballast recently added to the position at these depressed valuations as we believe its new strategy will bear fruit over time.

AMN Healthcare Services, Inc. (AMN), a provider of healthcare workforce solutions and staffing services to healthcare facilities, was a detractor in the quarter. The company operates through the following segments: Nurse and Allied Solutions, Locum Tenens Solutions, and Other Workforce Solutions. The recent weakness in share price is primarily due to a greater than planned disruption from operating process changes and technology upgrades after it moved its Locums Tenens business to a new technology platform. Its nurse and allied segments have also been weak due to lower utilization rates from a large client. Ballast continues to hold AMN as favorable demographics and a shortage of skilled healthcare workers has driven its Returns on Invested Capital north of 14%. Nonetheless, AMN remains on Ballast's watch list as we have been disappointed by some missteps by management. We have trimmed the position over the last year at higher levels and continue to wait for business improvement before we add to the name.

The **Ballast Select Value Strategy** produced a return, before fees, of 14.38% in the quarter, lagging the 15.82% return of the Russell 2500 Index, but exceeding the 13.12% return of the Russell 2500 Value Index.

Select Value Top Contributors

Xilinx, Inc. (XLNX) (discussed above)

MGP Ingredients, Inc. (MGPI), a manufacturer and distributor of food, beverage, specialty wheat protein, and starch food ingredients, was a top contributor to performance in the quarter. MGPI operates through two segments; Distillery Products and Ingredient Solutions. Its Distillery Products segment consists of food grade alcohol and distillery co-products, such as distillers feed and fuel grade alcohol. The Ingredient Solutions segment produces and distributes wheat starches and wheat proteins. MGPI's alcohol products (whiskey, rye, bourbon, vodka) are produced for the premium beverage market. MGPI's whiskey-heavy spirits mix has been growing around 7% which is about 2% higher than the industry average resulting in average returns on invested capital of 20%. Ballast continues to hold MGPI and like it long-term as it expands its distribution channels, achieves distillery economies of scale, and demonstrates continued success with its own brands of premium bourbon and rye products.

Select Value Top Detractors

AMN Healthcare Services, Inc. (AMN) (discussed above)

Emergent BioSolutions Inc. (EBS) focuses on protecting and enhancing life by providing specialty products for civilian and military populations that address accidental, intentional and naturally emerging public health threats. EBS is a leading biodefense contractor, driven by sales of anthrax vaccines and other biodefense product offerings. The stock was a detractor in the first quarter of 2019 as some follow-on U.S. government contracts were smaller than anticipated. We recently added to the name and continue to like its leading position in the industry. Its products must get FDA approval which helps to limit new entrants. In addition, the shelf life for anthrax vaccine is only 4 years resulting in stable recurring revenues.

Ballast's Outlook

Ballast does not attempt to predict the direction of the markets over the coming quarter or year but does focus its efforts on building high conviction portfolios of quality businesses. Our objective is to reward clients with performance that is above our benchmarks and peers over a full market cycle with less volatility, thereby offering a smoother ride toward achieving each client's long-term investment goals. We will note that after a strong period of performance for risk assets, investors should assess their asset allocations and the quality of those assets they own. We believe that an emphasis on quality businesses coupled with undemanding valuations will support long-term success. We owe our gratitude to our clients for their commitment to our strategies and remain invested alongside them with substantial portions of our personal, liquid assets.

Disclaimer:

Returns are for the respective composites of Ballast Equity Management. Gross returns are calculated net of trading fees. All dividends are assumed to be reinvested. The returns of the BQV Midcap Strategy are compared to the historical performance of the Russell Midcap Indices as they are a widely used benchmarks for mid capitalization securities. The returns of the BQV Smallcap Strategy are compared to the historical performance of the Russell 2000 Indices as they are a widely used benchmarks for small capitalization securities. The returns of the Ballast Select Value Strategy are compared to the historical performance of the Russell 2500 Indices as they are a widely used benchmarks for SMID capitalization securities. An investment with Ballast Equity Management (BEM) should not be construed as an investment in a program that seeks to replicate, or correlate with, these indices. Market conditions vary between the BEM products and these indices. Furthermore, these indices do not include any transaction costs, management fees and other expenses, as do the BEM Products. Lastly, BEM may invest in strategies and positions that are not included in these indices.

No client or potential client should assume that any information presented should be construed as personalized investment advice. Personalized investment advice can only be rendered after engagement of the firm for services, execution of the required documentation, and receipt of required disclosures. Investing carries risk of loss.

Ballast Equity Management, LLC is a registered investment advisor. For additional information about the firm and its professionals please visit the SEC's website at www.adviserinfo.sec.gov