



**BALLAST EQUITY  
MANAGEMENT, LLC**

STABILITY. QUALITY. VALUE.

## **Ballast Equity Management Q2 2019 Commentary Draft**

Following the wild gyrations of the equity markets in late 2018 and first quarter of 2019, returns were more modest during the quarter ending June 30, 2019. Each of the Ballast Equity Management strategies exceeded its primary and secondary indexes during the quarter and we are pleased to note that the BEM Quality Value Midcap strategy marked its three-year anniversary on June 30 with competitive performance. More information including since-inception performance for each of the strategies may be found at [www.ballastequity.com](http://www.ballastequity.com).

### **Ballast Strategy Performance**

The **Ballast Quality Value Midcap Strategy** produced a return, before fees, of 5.76% for Q2 2019, exceeding both the Russell Mid Cap Value Index return of 3.19% and the Russell Mid Cap Index return of 4.13%. Notably, the Strategy's three-year annualized performance of 12.76%, before fees, also surpassed the returns of 8.96% and 12.15% for the Russell Midcap Value Index and Russell Midcap Index, respectively. Security selection added value in several sectors; most impactful were holdings in Consumer Discretionary, Materials, Financial Services and Technology.

### **Quality Value Midcap Top Contributors**

The leading contributors to performance of the BEM Quality Value Midcap Strategy during the quarter were Total System Services and Copart.

**Total System Services (TSS)** is a leader in payment processing services to banks and other financial institutions. Ballast believes the company benefits from high switching costs, with large price reductions being necessary to incentivize a customer to change to one of its competitors and sustainability of growth driven by a continued move to card payments. Its leadership position was heightened during the quarter with the announcement of an all-stock "merger of equals" with competitor Global Payments (GPN). It is anticipated that the merger will quickly be accretive, with mid-single-digit growth in earnings in 2020 and low double-digit earnings growth in 2021 and thereafter.

**Copart, Inc. (CPRT)** is the largest player in the automotive salvage market duopoly, providing auction and related services to approximately 40% of the North American market. Service revenues are generated from fees earned from consignors (insurance companies and charities, primarily) and buyers (including salvage yards, rebuilders, remanufacturers and scrap recyclers). Growth opportunities include the expansion by CPRT into non-U.S. markets, including the U.K, where the company is the leading salvage auctioneer, Brazil, Germany and the U.A.E. CPRT has a long history of generating real economic returns, supported by its competitive moats, and delivers a robust 25% return on invested capital.

## Quality Value Midcap Top Detractors

The leading detractors to performance of the BEM Quality Value Midcap Strategy during the quarter were Core Laboratories and Waters Corporation.

**Core Laboratories (CLB)** is an oil-services company that helps oil and gas companies better understand how to improve production levels and economics with core and reservoir analysis. The strategy of CLB is to focus on high end energetics segment of the market (50% of CLB's revenue in its Production Enhancement segment in 2018) while ceding share in the standard perforating gun market. Competitive advantages include its intangible assets (patents, proprietary technology and human capital) and network effects (multi-client reservoir studies). The cyclical nature of the oil services business is a primary risk; that risk was highlighted in the second quarter and impacted the stock price of CLB as worries heightened over possible global economic slowdowns driven by potential tariffs and trade wars. Ballast believes the competitive advantages of CLB to be sound and shares are currently well below our estimate of fair value.

**Waters Corporation (WAT)** is a leading supplier of analytical instrumentation and consumable products to pharmaceutical, life science, biochemical, industrial, academic and government customers. WAT designs, manufactures, sells and services liquid chromatography equipment (70% of the business) where it has a market leading position. It has a #3 position in the Mass Spectrometry market (20% of revenues) and a #1 position in thermal analysis (10% of revenues). A large installed base of customers and high switching costs stand as its primary competitive advantages. Ballast believes these to be sustainable due to the long upgrade cycles and superior technology of WAT. Capital spending by large pharmaceutical companies is the greatest risk to WAT and recent political rhetoric has rattled many investors conviction in health care stocks.

The **Ballast Quality Value Smallcap Strategy** produced a return, before fees, of 4.48%, well ahead of the 1.37% and 2.10% returns, respectively, that were delivered by the Russell 2000 Value and Russell 2000 Indexes. Company selection helped performance, particularly in the Healthcare, Consumer Discretionary and Technology sectors.

## Quality Value Smallcap Top Contributors

Top contributors to the performance of the BEM Quality Value Smallcap Strategy were Computer Services, Inc. and UniFirst Corporation.

**Computer Services, Inc. (CSVI)** is an "under the radar" provider of financial technology solutions and regulatory compliance software to banks, financial institutions and a variety of other industries nationwide. High switching costs in the heavily regulated markets served by CSVI result in high contract renewal rates of over 90%. Contracts between CSVI and many of its customers have long durations. As an example, customers of its NuPoint banking platform have average contracts extending eight years. Business performance has been consistently high, with returns on equity and returns on invested capital in excess of 20%. Record sales of the company's core products, expansion into new geographic markets and higher cross-sales have boosted recent results.

**UniFirst (UNF)** was founded in 1936 and is the second largest provider of rental uniforms in North America, with a 6% market share. UNF will design, launder, service and deliver a customized garment to a specific employee on a weekly basis and has a specialty uniform business handling nuclear and clean room garments. Other services include servicing first aid cabinets and providing cleaning supplies. In

addition to its scale advantage, UNF management points to its corporate values, which include customer focus, respect for others and a commitment to quality, as its source of competitive advantage. Returns on invested capital stand at 8% and shares trade at a discount to Ballast's fair value.

### Quality Value Smallcap Top Detractors

The greatest detractors to performance of the BEM Quality Value Smallcap Strategy during the quarter were Kingstone Companies and Hollysys Automation Technologies.

**Kingstone Companies (KINS)** is the holding company for Kingstone Insurance Company, a provider of property and casualty insurance to individuals and small businesses. The company has operated for over 125 years and has consistently earned an underwriting profit each year, including 2012 when results were impacted by Hurricane Sandy. Risks to the business include such catastrophic events and its business results and financial condition may vary significantly. Shares fell in the second quarter as the company announced losses from multiple winter catastrophe events and the results of a claims review process that resulted in a reserve charge. While impactful to financial results in the near term, these reserve charges will strengthen the company's balance sheet. Returns on invested capital are 10% and shares are currently at a significant discount to Ballast's view of fair value.

**Hollysys Automation Technologies (HOLI)** is a leading supplier of process control systems for high-speed railway signaling systems in China where 76% of the company's sales are derived. Divisions of the business are Industrial Automation, Rail Transportation and Mechanical and Electrical Solutions. HOLI is benefitting from the long-term upcycle in China's demand for industrial automation and its competitive advantages include technology patents, brand recognition and its vast servicing network. A primary risk to the company, a slowdown in Chinese growth, was highlighted in the most recent quarter, as fears of trade wars rose. Ballast continues to see a compelling opportunity, with HOLI producing strong free cash flows, returns on invested capital of 13% and shares selling at a significant discount to fair value.

The **Ballast Select Value Strategy** produced a return, before fees, of 6.72% for the second quarter, exceeding the 1.90% and 2.96% returns of the Russell 2500 Value and Russell 2500 Indexes, respectively. Company selection was a strong contributor to results, particularly within the Healthcare, Materials and Consumer Discretionary sectors.

### Select Value Top Contributors

Top contributors to the performance of the BEM Select Value Strategy during the quarter were Total System Services and Broadridge Financial Solutions, Inc.

**Total System Services (TSS)** was discussed above in commentary for the BEM Quality Value Midcap Strategy.

**Broadridge Financial (BR)** offers products for investor communications, securities technology and operations outsourcing and is a critical intermediary between issuers and investors in the U.S. proxy system. BR's proxy voting service processes 95% of all publicly traded U.S. companies, as well as mutual funds and ETFs, when those companies are held in "street name" and 72% of the shares voted outside the U.S. Its Investor Communications Services (ICS) segment handles approximately two billion investor communications annually. BR has considerable scale and its primary competitive advantage is high switching cost sustained through recurring revenues that equal 60% of income. BR deploys cash for

buybacks, dividends and acquisitions; most recently the company announced the \$300 million purchase of RPM Technologies, a leading Canadian provider of wealth management software solutions and services. Risks to the company include the regulation of fees the company may charge by industry overseers NYSE, SEC and FINRA.

### Select Value Top Detractors

The greatest detractors to performance of the BEM Select Value Strategy during the quarter were Core Laboratories and MGP Ingredients, Inc.

**Core Laboratories (CLB)** was discussed above in commentary for the BEM Quality Value Midcap Strategy.

We cited **MGP Ingredients, Inc.** (MGPI) as a top contributor to performance of the BEM Select Value Strategy in Q1 2019. Shares fell in this top 10 holding during Q2 2019, resulting in it being the second greatest detractor to performance. MGPI is a manufacturer and distributor of food, beverage, specialty wheat protein, and starch food ingredients, operating through two segments, Distillery Products and Ingredient Solutions. 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. Risks include the lumpy nature of premium beverage sales and the costs of commodity inputs to its products, such as corn and wheat flour. Shares are currently at a significant discount to Ballast's estimate of fair value.

### Ballast's Outlook

Ballast offers no prediction on the direction of the markets over the coming quarter or year. Our team does focus its efforts on building high conviction portfolios of quality businesses as we seek to reward clients with performance that is above our benchmarks and peers over a full market cycle with less volatility. We believe this is the best way to help clients meet their financial goals and for us to do the same with our personal assets managed along-side. As we begin the third quarter of 2019, news sources remind us that we are now in the longest (121 months!) economic expansion in U.S. history. Those same sources report daily on the erratic behavior of short-term traders as they digest the latest news on tariffs, trade wars, Fed policy and political machinations. Block out the noise. Focus on stable, quality companies purchased at reasonable valuations. This remains our advice. We are grateful to our clients and invite other like-minded investors to contact us if we may be of service.

**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.

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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](http://www.adviserinfo.sec.gov)