



Ballast Equity Management Q3 2019 Commentary

More information including since-inception performance for each of the strategies may be found at www.ballastequity.com.

Ballast Strategy Performance

The quarter ending September 30 saw modest returns in U.S. mid-cap stocks while returns of small cap indexes were slightly negative. The quarter included a brief, yet sharp, period in September where value stocks outperformed their growth counterparts, leading many to wonder whether the long-awaited leadership of value stocks might be at hand. We remain in one of the longest economic cycles without a recession, yet investors appear complacent about risks that include the trade war between U.S. and China, tensions in Iran, the Middle East and Russia, negative interest rates for significant segments of the credit market and slowing global growth. While a positive outlook by investors can be beneficial, a realistic look at these risks and an understanding that the easy money has been made is in order. That sense of realism has led Ballast to lower its exposure to cyclical businesses and sell certain holdings where share prices had exceeded our estimates of intrinsic value.

The **Ballast Quality Value Midcap Strategy** produced a return, before fees, of .69% for Q3 2019, lagging the Russell Mid Cap Value Index return of 1.22% while slightly ahead of the Russell Mid Cap Index return of .48%. Security selection added value in the Technology sector but detracted from performance in the Consumer Staples and Industrials sectors. An underweight in Real Estate companies also detracted.

Quality Value Midcap Top Contributors

The leading contributors to performance of the BEM Quality Value Midcap Strategy during the quarter were J&J Snack Foods Corporation and Tyler Technologies.

J&J Snack Foods (JJSF) is a leader and innovator in the snack food industry, providing affordable branded niche snack foods and beverages to foodservice and retail supermarket outlets. Its competitive advantage, in Ballast's view, is its branded food products such as Superpretzel, Bavarian Bakery and other soft pretzels, Icee and Slush Puppie frozen beverages and Minute Maid frozen juice bars. JJSF has a 75% market share in soft pretzels at food service locations and a 90% share in retail supermarkets.

Tyler Technologies (TYL) provides integrated technology and management solutions and services for public sector with a focus on local governments. Tyler's Enterprise Software segment provides municipal and county governments and schools with software systems to meet their information technology and automation needs for mission-critical back-office functions such as financial management, courts and justice processes. Its Appraisal and Tax segment provides systems and software that automate the appraisal and assessment of real and personal property, as well as property appraisal outsourcing services for local governments and taxing authorities. High switching costs stand as Tyler's competitive advantage; its business model is envious with recurring revenue growing 4-5% a year through pricing, a 98% customer

retention rate and incremental margins in its subscription business of over 70%. While no business is truly recession proof, Tyler's business model is likely as close as they come.

Quality Value Midcap Top Detractors

The leading detractors to performance of the BEM Quality Value Midcap Strategy during the quarter were Fluor Corporation and Cimarex Energy.

Fluor Corporation (FLR) Fluor is one of the world's largest engineering, procurement, construction and maintenance companies, working with clients to design, construct and maintain their capital projects. Shares of Fluor fell during the quarter after the company announced the results of its strategic review. Fluor plans to sell its government segment and construction equipment rental business Ameco, reduce overhead by \$100 million, and cut the quarterly dividend to \$0.10 from \$0.21 per share. After consideration, Ballast exited its position in Fluor as our investment thesis for the company had changed. Fluor had mispriced several contracts resulting in significant cost overruns which we believe will take several quarters to run off. Ballast deployed the proceeds into other holdings showing share price weakness during the quarter.

Cimarex Energy (XEC) is an independent oil and gas exploration and production company with principal operations in the Permian Basin and Mid-Continent areas of the U.S. Ballast believes XEC management to be good allocators of capital and has owned the company with the expectation of significant near-term cash flow growth supported by its superior assets, strong production growth and minimally levered balance sheet. Unfortunately, XEC was a victim of the energy cycle, with takeaway capacity out of the Permian Basin and natural gas differentials leading to a higher than expected rate of cash burn. A desire by Ballast to reduce the exposure of the portfolio to cyclical holdings prompted us to sell our position in Cimarex, but this holding may be revisited in the future.

The **Ballast Quality Value Smallcap Strategy** produced a return, before fees, of 3.34% for Q3 2019, well ahead of the (.58)% and (2.40)% returns, respectively, that were delivered by the Russell 2000 Value and Russell 2000 Indexes. Company selection helped performance, particularly in the Healthcare, Industrials and Energy sectors. An underweight in Real Estate companies detracted from returns.

Quality Value Smallcap Top Contributors

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

Cambrex Corporation (CBM) is a biotechnology company focused on developing and commercializing new and generic therapeutics. The company supplies its products and services worldwide to innovator and generic pharmaceutical companies. Cambrex's portfolio growth strategy has a focus on the later stages of the clinical trial process. It also works to secure long-term supply agreements to produce active pharmaceutical ingredients and intermediates for newly approved drug products. Shares rose over 40% during the quarter following an announcement that Cambrex would be acquired by Permira, a global private equity firm that has made significant investments in the pharma services space.

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.

Quality Value Smallcap Top Detractors

The greatest detractors to performance of the BEM Quality Value Smallcap Strategy during the quarter were MGP Ingredients, Inc. and Oil States.

MGP Ingredients, Inc. (MGPI) is a producer and supplier of premium distilled spirits and specialty wheat protein and starch food ingredients. MGPI was the leading detractor to performance in the quarter as shares fell 26% on the news of its quarterly results. Sales of aged, premium whiskey products were well below expectations. While this report was disappointing, Ballast continues to hold MGPI and like it long-term as it expands its distribution channels and achieves distillery economies of scale. 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%. Shares are trading at a significant discount to Ballast's estimate of fair value.

Oil States International, Inc. (OIS) provides specialty products and services to the drilling, completion, subsea, production and infrastructure sectors of the oil and gas industry. Oil State has three main divisions: Well Site Services, Downhole Technologies and Offshore/Manufactured Products, representing 43%, 22% and 35% of revenues, respectively. In its Downhole Technologies division, GEODynamics is a market leader in the sale of perforating charges, the explosives used to prepare the well for hydraulic fracturing. Due to the nature of the business, barriers to entry are high, which supports high margin products. A risk to the business is that the segment is levered to the number of new wells completed in the U.S.; overall the end markets of OIS are subject to volatile energy prices.

The **Ballast Select Value Strategy** holds 30-50 small and mid-cap businesses in which our team has the highest conviction. The Strategy produced a return, before fees, of 1.75% for Q3 2019, exceeding the .13% and (1.28)% returns of the Russell 2500 Value and Russell 2500 Indexes, respectively. Company selection was a strong contributor to results, most notably in the Healthcare sector. Like Ballast's other strategies, the low relative weight to Real Estate companies detracted from returns.

Select Value Top Contributors

Top contributors to the performance of the BEM Select Value Strategy during the quarter were Cambrex Corporation (CBM) and J&J Snack Foods (JJSF), each of which is discussed above.

Select Value Top Detractors

The greatest detractors to performance of the BEM Select Value Strategy during the quarter were MGP Ingredients, Inc. (MGPI) and Cimarex Energy (XEC), each of which is discussed above.

Ballast's Outlook

Ballast seeks to add value for our investors over a full market cycle by playing strong defense when markets become volatile and participating in rising markets. While overused, the quote attributed to legendary coach Bear Bryant that “offense sells tickets, but defense wins championships” is one we take to heart each day, as we assess the potential for losses within our portfolio holdings. Quality businesses, purchased and owned at discounts to intrinsic value, help Ballast play defense for our clients’ portfolios and our personal funds that we invest alongside them. Quality, represented by strong returns on invested capital supported by durable competitive advantages, also provides an element of offense. It generates strong and growing cash flows and stable and growing earnings. Quality is the foundation for returns on capital that capable leaders can reinvest into projects that earn yields in excess of the capital costs of the enterprise.

The Ballast team believes that we are entering the sweet spot of the business cycle for our style of quality value investing. Late in the business cycle we would expect more volatility; quality tends to shine when volatility is high as investors seek the stability these businesses offer. 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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