



**BALLAST EQUITY
MANAGEMENT, LLC**
STABILITY. QUALITY. VALUE.

Ballast Equity Management, LLC Q1 2020 Commentary

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

Ballast Strategy Performance

After a positive start in 2020, markets experienced a long-awaited correction during March. Each correction in history is different, but this time is quite unlike the last, the financial crisis of 2008, due to its combination of the COVID-19 pandemic, Saudi/Russia oil trade wars, supply and demand shocks and the swift fall marked by days of sharp volatility. While monetary and fiscal stimulus levers have been pulled and there may be more such levers to activate, stemming the pandemic itself and the protecting the health of our people must be addressed in order to fully restart the markets and the economy.

During the quarter, the three Ballast Equity Management strategies performed to our expectations, protecting clients' and our own assets from the full impact of the drop experienced by their respective benchmarks. This downside protection reflects Ballast's insistence on holding high quality businesses purchased at reasonable valuations. Performance was further aided by reductions we made among the cyclical holdings of the strategies during late 2019.

The **Ballast Quality Value Smallcap Strategy** produced a return before fees of (26.11%) and net of fees of (26.30%), outperforming the Russell 2000 Value and Russell 2000 Indexes returns of (35.66%) and (30.61%), respectively. Security selection detracted from performance in the Consumer Defensive and Technology sectors, while adding value in all other sectors for the quarter.

Quality Value Smallcap Top Contributors

The top contributors to performance for the quarter, **Simulations Plus, Inc. (SLP)** and **Emergent Biosolutions, Inc. (EBS)**, each had tailwinds provided by their work in solving the COVID-19 crisis.

Simulations Plus produces software and provides consulting analytics for use in drug discovery. SLP is approaching a 20% market share of the pharmaceutical, biotechnology, and generic companies that would be potential users of its software and consulting services. During the quarter, SLP introduced its StrategiesPlus COVID-19 ACT Program to aid researchers in their fight against the global coronavirus pandemic. This program is designed to help speed pharmaceutical research and accelerate the process of regulatory approval, contributing to resolving the COVID-19 pandemic.

Emergent BioSolutions Inc. is a leading maker of vaccines and other products that address public health threats. The company is a leading biodefense contractor, driven by sales of anthrax and smallpox vaccines and other biodefense product offerings. In mid-March, EBS announced that it has entered into a collaboration agreement with Novavax, Inc. to support the development of a vaccine candidate to protect

against COVID-19. Emergent BioSolutions has started preparations for this program and anticipates that the COVID-19 vaccine candidate can be used in a phase I study within the next four months.

Quality Value Smallcap Top Detractors

Top detractors from performance were **Allied Motion Technologies, Inc. (AMOT)** and **Oil States International, Inc. (OIS)**.

Allied Motion Technologies fell during the quarter on fears of slower growth in its end markets that include automotive, industrial, medical, aerospace and defense. The company is a leading provider of motion control products to both original equipment manufacturers and end users. Ballast believes that AMOT is in the early innings of a growth trajectory based on its new strategy targeting multi-product motion solutions, rather than just components, complemented by accretive acquisitions. Such an acquisition was made during the quarter with the purchase of Dynamic Controls, a subsidiary of Invacare Corporation. AMOT delivers high single digit Returns on Invested Capital and its shares are currently at a significant discount to Ballast's estimate of fair value.

Buffeted by the combination of the Saudi/Russia price war, COVID-19 demand destruction and the likelihood of exploration and production companies cutting budgets, shares of Oil States International fell sharply during the quarter. Risks to the business include its leverage to the number of new wells completed in the U.S. and the sensitivity of its end markets to volatile energy prices. While keenly aware of those risks, Ballast recognizes that the barriers to entry for competitors are high, supporting the high margin, market-leading products OIS supplies through its Well Site Services, Downhole Technologies and Offshore/Manufactured Products divisions. We took advantage of the weakness in share price to add to OIS.

Quality Value Smallcap Additions

Ballast took advantage of the Q1 2020 sell-off by adding a new position in **Watts Water Tech Inc. (WTS)**, a high-quality cyclical provider of safety, energy efficiency, and water conservation products. Also added was **Core Laboratories (CLB)**, which we had sold late in 2019 as we reduced our cyclical exposure, and department store operator **Kohl's Corp. (KSS)**. Kohl's stores are currently closed due to COVID-19 and its business faces many challenges, but KSS is one of the few retailers to deliver positive free cash flow and has been buying back 4-5% of its stock each year. We believe it will benefit as competitors struggle during the downturn.

The **Ballast Quality Value Midcap Strategy** produced a return before fees of (21.50%) and net of fees of (21.69%), outperforming the Russell Mid Cap Value and Russell Mid Cap Indexes returns of (31.71%) and (27.07%), respectively. Security selection detracted from performance in the Energy and Consumer Defensive sectors, while adding value in all other sectors for the quarter.

Quality Value Midcap Top Contributors

Top contributors to performance for the quarter were **MSCI, Inc. (MSCI)** and **Masimo Corporation (MASI)**.

The rise in indexing of investment portfolios has created a booming business for providers of the indexes, themselves, including MSCI. Asset-based fees from its index business continue to be a driver of revenue growth. The company benefits from a strong brand and high switching costs, as many ETFs, mutual funds

and hedge funds use MSCI indexes. This represents a steep challenge for rivals that is unlikely to be surmounted. Additionally, MSCI offers Environmental, Social and Governance ratings that stand as an impressive source of growth. MSCI currently has strong operating margins of 42% and Returns on Invested Capital of 21%.

Masimo Corporation is a medical technology company that develops, manufactures and markets a range of non-invasive patient monitoring technologies. The company benefits from a narrow moat supported by switching costs for its clients. MASI is currently active in efforts to tackle the COVID-19 crisis and has adapted its SafetyNet technology to provide secure cloud-based solutions to monitor and report the temperature, respiration rate, and oxygen saturation of home-based COVID-19 patients to patient surveillance platforms. MASI generates strong financial performance as reflected in Returns on Invested Capital of 20%.

Quality Value Midcap Top Detractors

Leading detractors from performance during the quarter were **Oil States International, Inc. (OIS)**, which was discussed above, and **Euronet Worldwide, International (EEFT)**.

While classified as a Technology company, EuroNet Worldwide shares fell along with their financial services clientele during the quarter. EEFT is a leading provider of electronic payment and transaction processing solutions for financial institutions, retailers, service providers and individuals, operating through its EFT Processing, Epay and Money Transfer segments. Sentiment shifted against EEFT during the quarter as transaction volumes, particularly in money transfer, are sensitive to economic conditions and employment levels. Ballast sees ownership of EEFT as attractive, given the strong operating performance of the company and a share price that is significantly below our view of fair value.

Quality Value Midcap Additions

Ballast took advantage of the downturn to add **Southwest Airlines (LUV)**, a higher quality cyclical company, to the Quality Value Midcap strategy. We also added **Fair Isaac International (FICO)**, the ubiquitous provider of the FICO Score, the standard measure of consumer credit risk and provider of analytics software and tools used across multiple industries to manage risk, fight fraud and build profitable customer relationships. As in the Quality Value Smallcap Strategy, we added positions in **Core Laboratories (CLB)** and **Kohl's Corp. (KSS)** and added to existing positions that had been hardest hit, including **Vail Resorts (MTN)**. While heavily impacted by the correction, these are resilient businesses that we believe have the financial strength and durable competitive advantages to persist and add value for our clients.

BQV Select Value Strategy

The **Ballast Select Value Strategy** produced a return before fees of (21.14%) and net of fees of (21.34%), outperforming the Russell 2500 Value and Russell 2500 Indexes returns of (34.64%) and (29.72%), respectively. Security selection detracted from performance in the Consumer Defensive sector, while adding value in all other sectors for the quarter.

Select Value Top Contributors

As in the Quality Value Midcap strategy, the leading contributors to performance for the Select Value strategy during the quarter were **MSCI, Inc.** and **Masimo Corporation**, both of which were discussed above.

Select Value Top Detractors

Leading detractors from performance during the quarter were **Euronet Worldwide**, which was discussed above, and **First Defiance Financial Corporation (FDEF)**.

Shares of First Defiance fell during the quarter along with its small bank peers. FDEF offers traditional banking services as well as property, casualty, life and group health insurance products to its clientele in Ohio, Michigan and Indiana. FDEF has a record as a solid, dependable financial institution capable of delivering better-than-peer profitability metrics. Cash has generally been used to pay dividends and buy back share. During the quarter, FDEF completed the acquisition of its peer, Ohio-based United Community Financial Corp.

Select Value Additions

As in the Quality Value Midcap Strategy, Ballast took advantage of the downturn to add **Southwest Airlines (LUV)** to the Select Value strategy. As in the Quality Value Smallcap and Midcap Strategies, we added positions in **Core Laboratories (CLB)** and **Kohl's Corp. (KSS)**.

Focused on the Long Term

When traveling through a market correction, experience in times of crisis matters. The Ballast team has invested together for over twenty years. Deep experience and investing through many market cycles does not let us see into the future, but it does give us the wisdom to stand by our convictions and appreciate the range of potential outcomes that exist. In the best case, we are back to business in the U.S. within a matter of weeks, full employment resumes and the economy is back to normal in a few months. In the worst case, unemployment rises significantly, demand shocks persist, and we wade through a deep recession.

Regardless of when the COVID-19 crisis is contained, there is no way that our lives will resume as if this had never happened. Nor will companies conduct their business precisely as they did in the past. Viewing the changing world through this lens, we remain confident that our emphasis on quality businesses offers an excellent array of solutions for investors in small and mid-cap equities. Businesses that possess strong balance sheets, stable and growing cash flows and high returns on invested capital are best positioned to adapt to these challenging times, and to endure and generate wealth for our clients.

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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