



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

Ballast Equity Management, LLC Q2 2020 Commentary

Ballast is proud to note that its Quality Value Smallcap Strategy has attained a three-year track record as of June 30, 2020 with performance that outpaced both relevant indexes. Additional information and since-inception performance for each of the strategies may be found at www.ballastequity.com.

Ballast Strategy Performance

Investors apparently listened when, in late March, Federal Reserve Chairman Jerome Powell said, “we’re not going to run out of ammunition.” The second quarter was marked by robust returns bolstered by immense levels of stimulus, both fiscal and monetary, along with hopes for a reopening of the economy and a resulting quick exit from the recession. Returns were most pronounced in consumer cyclical and energy stocks that had sold off sharply in the first quarter’s correction. Returns for lower quality companies, as ranked by Ballast’s Quality Ranking model, outpaced the returns for higher quality companies, presenting headwinds for the Ballast Quality strategies.

The **Ballast Quality Value Smallcap Strategy** returned 15.74% and 15.48%, gross and net of fees, lagging the 18.92% and 25.42% returns, respectively, of the Russell 2000 Value and Russell 2000 Indexes. An overweight and strong selection in Technology companies aided performance, while security selection in Consumer Cyclical and Materials companies detracted as highly cyclical companies held by the index in those sectors rallied. Year-to-date, the Ballast strategy returned (14.48%) and (14.90%), gross and net of fees, in comparison to returns of (23.49%) and (12.98%), respective for the Russell 2000 Value and Russell 2000 Indexes.

Quality Value Smallcap Top Contributors

Just as they were in Q1 2020, **Simulations Plus, Inc. (SLP)** and **Emergent BioSolutions, Inc. (EBS)** were the top contributors to performance for the quarter, each with continued 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. Its StrategiesPlus COVID-19 ACT Program, launched in early 2020, is designed to help speed pharmaceutical research and accelerate the process of regulatory approval, contributing to resolving the COVID-19 pandemic. Positive results are also expected as employees of pharma and biotech customers return to work following the COVID-19 pandemic and commit to new engagements with SLP.

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. As part of the Department of Health and Human Services' Operation Warp Speed program, EBS will provide development and manufacturing services and capacity to innovators of leading COVID-19 vaccine candidates selected by the U.S. government such as AstraZeneca and Novavax.

Quality Value Smallcap Top Detractors

Top detractors to performance during the quarter were **Summit Financial Group, Inc. (SMMF)** and **AMN Healthcare Services (AMN)**.

Summit Financial Group, Inc. declined during the quarter on COVID-19 related impacts, including substantial increases in its current expected credit losses. Summit, a \$2.5 billion financial holding company headquartered in Moorefield, West Virginia, provides community banking services in Virginia and West Virginia through its bank subsidiary, Summit Community Bank, Inc. We continue to like Summit long-term as it has a strong return on tangible common equity of 15%, a high net interest margin of 3.7%, and trades at a discount to our view of fair value. The financial strength of SMMF has prompted its board of directors to authorize repurchase of up to 750,000 shares of the company's common stock.

AMN Healthcare Services, Inc., a provider of healthcare workforce solutions and staffing services to healthcare facilities, detracted from performance. The company delivered strong Q1 operating performance, but guided earnings expectations lower due to COVID-19 related demand. The company operates through its Nurse and Allied Solutions, Locum Tenens Solutions, and Other Workforce Solutions segments. Ballast continues to hold AMN as favorable demographics and a shortage of skilled healthcare workers support its Returns on Invested Capital of 13%. Shares currently are priced at a substantial discount to our view of fair value.

Quality Value Smallcap Portfolio Activity

After lowering cyclical exposure and reducing risk in the portfolio in late 2019, we added some cyclical exposure back in early April and May with small purchases of companies including Core Laboratories, Oil States International, and Kohl's. New positions were initiated in US Physical Therapy, a provider of outpatient physical therapy services, and debit card provider PaySign, Inc. US Physical Therapy was previously a holding in the Ballast strategy and has been a top contributor to its long-term performance. These additions were funded through trimming more fully valued holdings such as Simulations Plus, Emergent BioSolutions and Ligand Pharmaceuticals.

Ballast historically has had low turnover in its strategies, but the unusual and quickly changing environment has created risks and opportunities that prompted above average activity. Following the quarter's sharp rise, Ballast believed the rally was a bit overdone. We reduced risk again in June as we pared back positions, including Kohl's, and Oil States International, that offer more cyclical exposure.

The [Ballast Quality Value Midcap Strategy](#) returned 20.77% and 20.50%, gross and net of fees, beating the 19.95% return of the Russell Mid Cap Value Index while lagging the 24.60% return of the Russell Mid Cap Index. Relative to the Value Index, Ballast's performance was helped by an overweight to Technology companies, its underweight in Utilities and security selection in the Energy sector. An underweight to Consumer Cyclical companies and security selection in that sector detracted from performance as highly cyclical companies held by the index in that sector rallied. Year-to-date, the Ballast strategy returned

(5.19%) and (5.64%), gross and net of fees, in comparison to returns of (18.09%) and (9.13%), for the Russell Mid Cap Value and Russell Mid Cap Indexes.

Quality Value Midcap Top Contributors

Core Laboratories (CLB) and **Skyworks Solutions (SWKS)** were the leading contributors to performance for the Ballast Quality Value Midcap strategy during Q2 2020.

Ballast had exited **Core Laboratories** in late 2019 citing the opaque nature of the current energy cycle. As an opportunistic addition, we purchased shares of CLB in April and benefitted from a substantial increase in share price during the quarter. Core Laboratories helps oil and gas companies better understand how to improve production levels and economics with core and reservoir analysis. Competitive advantages include its intangible assets (patents, proprietary technology, and human capital) and network effects (multi-client reservoir studies). Ballast believes the competitive advantages of CLB to be sound and the company well managed but trimmed its position in June and maintains a smaller stake due to the challenging nature of its business.

Skyworks Solutions, Inc. shares rose in recognition of improving demand in April and management's belief that business performance will be stronger in the second half of 2020 with COVID-19 restrictions lifted. Skyworks is a leading supplier of radio frequency components to smartphone makers and other electronics manufacturers and benefits from the move to 5G as well as the need for its radio frequency chips in high-end 4G handsets. The company produces operating margins of 27% and Returns on Invested Capital of 23%.

Quality Value Midcap Top Detractors

Quality Value Midcap holdings **Washington Trust Bancorp (WASH)** and **Extra Space Storage (EXR)** were the leading detractors from performance during the quarter.

Washington Trust Bancorp is the oldest community bank in the nation and the largest bank headquartered in Rhode Island. Earnings fell below expectations during the quarter and loan loss provisions were charged to earnings that were attributable to the economic forecast caused by COVID-19. Falling interest rates and asset prices – approximately 18% of the bank's core revenues are derived from its wealth management business – impair the near-term outlook for the business. That said, Washington Trust is a quality business with net interest margins of 2.6% and 19% return on tangible common equity. Shares trade well below Ballast's assessment of fair value.

Extra Space Storage shares were down modestly during the quarter. While self-storage businesses have proven to be defensive, the severity of the pandemic raises concerns over how customers will prioritize the services offered by EXR among their other more essential expenses. These concerns are warranted, yet we believe EXR's size and scale gives it a significant cost advantage and marketing presence over smaller peers. The company also benefits from its West Coast portfolio (which contributes an estimated 25%-30% of profits) due to zoning laws restricting the addition of new supply.

Quality Value Midcap Activity

As with Ballast's Quality Value Smallcap, activity was higher than normal during the second quarter and followed the same pattern of adding cyclical exposure on price weakness during April, selling more highly valued holdings and then paring the cyclical exposure back again late in the quarter. Ballast added shares in holdings including Cracker Barrel, Core Laboratories, Southwest Airlines and Vail Resorts using proceeds from trimming Alliant Energy, Scotts Miracle Grow, MSCI and others.

Ballast historically has had low turnover in its strategies, but the unusual and quickly changing environment has created risks and opportunities that prompted above average activity. Following the quarter's sharp rise, Ballast believed the rally was a bit overdone. We reduced risk in June by trimming holdings that had rallied the most, including Kohl's, Southwest Airlines and Oil States International.

The [Ballast Select Value Strategy](#) returned 17.20% and 16.93%, gross and net of fees, lagging the 20.60% and 26.57% returns, respectively, of the Russell 2500 Value and Russell 2500 Indexes. The portfolio's overweight in Healthcare and underweight in Utilities helped performance, while security selection in the Consumer Cyclical and Financial sectors detracted. Year-to-date, the Ballast strategy returned (7.58%) and (8.02%), gross and net of fees, in comparison to returns of (21.17%) and (11.05%) for the Russell 2500 Value and Russell 2500 Indexes.

Select Value Top Contributors

Reflecting the "best ideas" nature of the Select Value strategy, **Core Laboratories (CLB)**, a top contributor in the Quality Value Midcap strategy and **Emergent BioSolutions, Inc. (EBS)**, a top contributor in the Quality Value Smallcap strategy, were leading contributors to the Select Value in Q2 2020. Each is discussed above.

Select Value Top Detractors

Summit Financial Group, Inc. (SMMF) and **Balchem Corporation (BCPC)** were leading detractors to the performance of the Select Value strategy during the quarter.

Summit Financial Group, Inc. was the greatest individual detractor to performance of the Select Value strategy and is discussed above.

While down only slightly, **Balchem Corporation** was the second largest detractor to performance of the Select Value strategy. BCPC manufactures ingredients, nutrients, and chemicals for an array of end markets that includes human nutrition, animal nutrition, and industrial applications. Switching costs are the primary competitive advantage of the company. A substantial opportunity for the company is its partnership with Curemark in the development of an Autism drug candidate where no drugs are currently approved. While some segments of BCPC's business will benefit from COVID-related impacts, such as grocery store foods and food preservation, others will be challenged, including weaker demand in food services, the animal protein markets, medical device sterilization due to fewer elective surgeries, and lower fracking activities.

Select Value Activity

Drawing from the best ideas of Ballast's Quality Smallcap and Quality Midcap strategies, our investment team incrementally added to cyclical names including Core Laboratories, Oil States International and Kohl's during April and May, using proceeds from more fully valued holdings. Following the quarter's sharp rise, Ballast believed the rally was a bit overdone. As a result, some of this cyclical exposure was pared back during June and gains were realized in holdings including Emergent BioSolutions, Kohl's and Southwest Airlines.

Focused on the Long Term

Looking ahead, it is important to consider that recent gains were driven by the stimulus, by an optimistic view that the worst of the pandemic is over and that progress on potential vaccines will soon yield results. We relish an optimistic view of the world, as well. We see the strides that several of our portfolio companies are helping make in addressing the COVID crisis and we are heartened by the durable business performance that our holdings have delivered. That said, we must balance our optimism with consideration of what can go wrong, including a second wave of the pandemic and further lockdowns, troubled relations between China and the U.S., continued civil unrest and a possible Democratic sweep of the elections leading to higher taxes and tougher regulatory burdens. With this balanced view, we will continue to be selective as we invest alongside our clients in durable businesses.

Disclaimer:

Returns are for the respective composites of Ballast Equity Management (BEM). Gross returns are calculated net of trading fees. Net returns are calculated net of trading fees and net of the firm's maximum advisory fee of 1.00%. 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 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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