BALLAST
ASSET MANAGEMENT

SECOND QUARTER 2019 LETTER

For the second quarter of 2019, the Ballast Portfolio returned 0.7% before fees and 0.5% net of fees, compared to 3% for the Russell 2500 and 1.9% for the Russell 2500 Value.

		Periodic Returns					Annualized Returns	
		2015*	2016	2017	2018	2019 YTD	1 Year	3 Years
Ballast Portfolio[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	12.4%	-2.9%	14.3%
	Net	-8.0%	22.6%	12.4%	-3.2%	11.9%	-3.8%	13.1%
Russell 2500[2]		-6.9%	17.6%	16.8%	-10.0%	19.2%	1.7%	12.3%
Russell 2500 Value[3]		-5.8%	25.2%	10.3%	-12.4%	15.2%	-1.9%	9.0%

Performance (as of 6.30.2019)
*2015 performance from 8.11.2015 through 12.31.2015

There is an old saying that I remember hearing often when I was a kid: Plan for the worst, hope for the best, and settle for whatever you get. I did not really appreciate it at the time, but I guess that was my first lesson in risk management. Several decades after first hearing those words, I invested in a small cattle operation. In addition to thinking I may be able to turn a small profit on the endeavor, I wanted to share some of the experiences of my upbringing with my own children. I learned a lot about work ethic using a post-hole digger to build a fence.

I was a proper analyst at that time and decided to apply some of my Wall Street expertise to the cattle business. Rather than simply buying cows and turning them loose in a pasture to feed on native grasses, I decided to cultivate the pasture and plant a hybrid strain of Bermuda grass that had a broader leaf blade. Based on my calculations, the nutrition from this grass would enable me to increase the number of cows per acre by 40% or so. That increase in cows per acre should lead to better fixed cost absorption, and therefore greater profitability. When I was finished, and I had a beautiful field of lush, green grass, I showed my father, fully expecting a look of admiration from the old cowboy. I had improved on something he had been doing for decades! The first words out of his mouth were, “What are you going to do when it gets dry?”

Two years later, Texas had a drought, and I had to sell part of the herd to balance the cows’ need for grass with the land’s ability to produce. Of course, during dry periods, many ranchers also trim their herds, so the supply of cows being sold goes up without a subsequent increase in demand. My degree in economics came screaming into focus as I watched prices plummet. Lesson learned.

At Ballast, we use that “plan for the worst” mentality when we first look at a stock. It is the reason the first question we ask ourselves in our process is, “How much money can we lose when we are wrong?” We quantify that risk in terms of a downside price target. Rather than buying a stock at a certain discount to intrinsic value, or with some calculated "margin of safety," we look to buy within 20% to 30% of the ultimate worst-case scenario. After quantifying that downside, we calculate the upside to come up with a reward-to-risk ratio. We want that ratio to be 3:1 or greater – in part, to offset the risks we cannot or do not know about.

At the portfolio level, we utilize a proprietary risk management model to contemplate the risk of "shocks to the system" (recessions, trade wars, bubbles bursting, falling/risking interest rates, etc.). We use this model as a tool to prevent us from being overly exposed to systematic risks. We also use the model in order to decipher when market perception of risk differs materially from our assessment of the real risk (i.e., the effect on revenue, earnings and valuation multiples of the stocks we own). This process enables us to not only plan for the worst, but to recognize when market perception differs from reality, and either take advantage of those situations with new investments or remain steadfast in our current holdings.

Second Quarter Performance

Finishing essentially flat for the quarter does not exactly tell the story. It is like taking a sailboat around the world and ending up at the same harbor. The second quarter had its fair share of storms along with sunny days. The market whipsawed on vacillating trade tensions with China, a shift in sentiment from a rising rate environment to the prospect of a Fed easing cycle, and Brexit.

Frankly, the speed at which the Fed went from tightening to contemplating easing surprised us. At the beginning of the quarter, the portfolio was slightly more weighted to companies that would benefit from rising rates (i.e., banks), and thus slightly at risk to falling rates. During the quarter, in anticipation that falling rates and a flattening yield curve would negative affect the profitability of asset-sensitive banks (net interest margin), we reduced that exposure. In addition, we slightly increased exposure to investments that would benefit from lower rates, either due to funding costs or the relative attractiveness of higher dividend yields (i.e., REITs). At this point, our risk exposure to the direction of rates is balanced, such that we are not making a call one way or the other. We would rather performance be driven by the underlying fundamentals of our stocks than hubris, thinking that we know better than the market where rates are going.

Our significant weighting in technology stocks hurt us in the quarter due to heightened concerns of trade talks breaking down with China. The indiscriminate selling in tech suggests the market views a trade war with China as bad for technology companies. However, our fundamental analysis shows that tariffs on Chinese goods have very little impact on most of our holdings, either from their supply chains or demand for products. Our companies were victim of the proverbial baby getting thrown out with the bathwater. While a bit frustrating in the near term, we believe these things will sort themselves out as the companies' fundamentals eventually overwhelm negative sentiment.

It is not always easy to "settle for whatever we get," but the reality is, we cannot control short-term outcomes. We follow our process and take solace in the fact that whatever time it takes for market value to reflect business value is not completely lost. To illustrate, we expect the companies we own to generate in excess of 15% ROE in aggregate for at least the next couple of years, which breaks down into roughly 8%-10% growth and 5%-7% returned to shareholders via dividends and buybacks. To the extent buybacks are executed below fair business values, our upside accretes faster than 15% a year. Even if valuation multiples never expand to reflect fair business value (although they always do so eventually), the solid fundamental growth at a high ROE should still provide attractive rates of return.

New Positions Initiated

Frontdoor (FTDR)

Frontdoor (FTDR) provides home warranties on appliances and major systems covering 2.1 million homes. It has 46% market share – roughly 4x the next largest competitor, in a business where scale is a significant competitive advantage via network density and operating leverage, which should support above average return on capital. As a subscription business with roughly 70% recurring revenue and an 84% second year or greater renewal rate, it is relatively insensitive to the business cycle, which helps protect our downside.

Last year's margins were depressed by parts shortages and extreme weather, which had been a headwind for the stock of this recent spin-off, providing an attractive entry for a growing, asset-light business at 6.5% FCF/EV. Longer term, the company is adopting a digitized business infrastructure, which we expect will drive margin expansion and a pro forma year-three FCF/EV of greater than 10%. The key near-term initiative is changing its pricing model from a statewide model to zip code-based. This should improve matching contract prices with local cost to serve and drive better margins over the next two to three years. Beyond that, investments in social media could reduce the cost of customer acquisition and/or boost top-line growth.

Huntsman Chemical (HUN)

Huntsman Chemical (HUN) is a global chemical company with a primary focus on polyurethanes, including MDI, propylene oxide, polyols, and TPU. Polyurethane products are used primarily to produce rigid and flexible foams as well as coatings, adhesives, sealants, and elastomers. Huntsman also produces MTBE as a coproduct of its propylene oxide manufacturing process. MTBE is blended with gasoline to reduce vehicle emissions and enhance the octane rating of gasoline.

Over the last few years, the company has transitioned more and more to specialty chemicals and up the value chain, which should increase margins and provide greater stability during downturns. Continuing balance sheet improvement should support a higher recessionary multiple. Secular changes in insulation and materials adhesion within aerospace and autos ought to drive faster growth than the in-line-with GDP growth typical of chemicals. Nonetheless, HUN has one of the lowest valuations in the chemical peer group, trading at 6.1x EV/EBITDA and 9.8% FCF/EV, despite earning median or better ROA, ROE and ROIC.

IES Holdings (IESC)

IESC is a holding company with four lines of business: (1) installation of wiring in new residential buildings, (2) electrical and mechanical design, service, and construction services to commercial and industrial markets, (3) communications infrastructure, and (4) industrial solutions, including maintenance and repair of electrical equipment, and manufacture of custom-engineered electrical enclosures. Its customer relationships, scale, and balance sheet provide a modest competitive advantage over its typically mom-and-pop competition.

The company has been on our radar for several years because of its hidden asset value: $355m of net operating loss carryforwards (NOLs), which it will monetize over time for about $250m in present value by our estimate. That's more than half the $395m market cap and also enterprise value since it has negligible net debt. The value is attractive on an operating basis too, with about a 9% prospective free cash flow yield. That valuation is probably related to a couple of operating issues the past two years that recent quarters have shown to be genuinely temporary. As important, we significantly increased our estimate of the potential upside following the hiring of Gary Matthews as CEO in March.

Matthews has a distinguished history in CEO roles and most recently as an operating partner with Morgan Stanley's private equity division. He has basically the perfect mix of acquisition and operating experience to build on the foundation established by the prior CEO (who returned to his prior role leading the residential business). The CEO's private-equity-like incentive stock compensation agreement implies 180% upside to the stock over 4-5 years if he hits the maximum target. (Our base case is 130% upside, with optionality for 150%-200%.) When we asked the CEO what we ought to expect the company to accomplish over the next five years, he said: (1) margin improvement, (2) moderate organic growth, (3) cash flow redeployed into acquisitions at 4-5x post-synergy EV/EBITDA (versus IESC typically at 8-12x) to accelerate NOL monetization and, refreshingly honest, (4) a recession weathered.

To the CEO's first three points, we would add that internal compounding, further top-line growth and acquisitions will increase its size making it more "investable," potentially attracting more attention from Wall Street and rerating the stock's multiple. On his fourth point, we would note that downside is moderated by the already discounted valuation and that cyclicality in the residential segment, while significant, is somewhat moderated by low overhead and variable costs that can flex rapidly. Data center construction, which ought to be insensitive to the business cycle, drives communications and is significant to industrial solutions. The remaining business is longer-term construction projects or retrofit and repair projects.

Northern Technologies International Corp (NTIC)

Northern Technologies (NTIC) develops and markets corrosion protection technologies. For decades, they've provided corrosion solutions for auto and industrial manufacturing under the Zerust brand. Zerust technologies have a broad range of use cases, like encasements that protect driveshafts from surface rust during production or rust-preventing drawer liners for toolboxes (available on Amazon). The company distributes both directly and through a unique international joint venture network. We think Northern offers a favorable asymmetric reward-to-risk, especially as growth from new markets accelerates. Beyond its high-ROIC legacy auto and industrial businesses, the company is looking to two new markets for growth.

First, they are developing corrosion resistance applications for the oil and gas market, where corrosion of equipment and infrastructure is a significant ongoing expense. Northern has seen early traction with its soil-side bottom protection on aboveground storage tanks. The product has recurring revenue, healthy margins, and a long runway with existing customers. As the industry accelerates adoption of chemical protection, the upside will be tremendous for Northern.

The second growth lever involves Natur-Tec, an internally developed technology for compostable plastic resin. Today, Natur-Tec's compostable can-liners, cutlery and straws can be spotted on campuses, food courts, and arenas in the West Coast states. Importantly, Natur-Tec's compostable plastic resin performs favorably against traditional plastics at a competitive price point, and their resins can be used on existing plastic extrusion and molding equipment. As more cities and countries adopt zero-waste initiatives, Natur-Tec offers attractive upside for NTIC shareholders.

Exited Positions

GameStop (GME)

Although we still think the shares are undervalued, we exited this disappointing position because our thesis was no longer supported. Lack of strategic vision and management vacuum makes realization of the latent value less likely while the prospect of systemless streaming cloud-based gaming platforms could accelerate the transition from disc to digital game distribution.

Zayo Group (ZAYO)

We initiated our position in Zayo during the 4Q when the shares pulled back. Weak operating results coupled with a slapstick plan to split the company were ill received by the market. Despite the uncertainty around the near-term direction, we saw limited downside based on the replacement value of the extensive fiber and network assets. We also believe that these assets have increasing strategic value as consolidation pushes large-scale dark fiber assets like Zayo's into the hands of a few service providers. Further, the company has tremendous optionality in a REIT conversion, if ruled favorably by the IRS. Shortly after our initiation, news broke that several private equity funds were interested in bidding for Zayo. In May, Zayo agreed to be taken private by EQT and Colony Capital. After the announcement, we sold the position in order to fund other investments.

Cardtronics (CATM)

When we originally purchased CATM, there was fear in the marketplace that cash usage would decline rapidly. However, empirical evidence from the company, along with Fed data, disputed this point. Check usage was declining, but that was due to credit cards and debit cards. Cash usage at convenient stores was still growing on a same-store sales basis. In addition, banks were increasingly using CATM in cobranding campaigns and the company had a strategic asset in its Allpoint network. Since then, Financial Technology (Fin Tech) has really changed the landscape with alternative ways to "spend" money or reimburse people, such as Venmo, ApplePay and tap to pay. Further, the environment for ATMs and surcharges has become increasingly hostile in Europe (specifically the UK) and Australia. These new threats, along with stocks with better prospects, led us to sell this 1% position.

Reduced Banks, Exited BankUnited (BKU)

We have held a significant position in Banks since the beginning of this economic expansion, playing both the credit cycle and loan growth. However, given increased risk of lower rates, the slope of the yield curve compressing net interest margin and that we do not expect bank stocks to perform well in the next downturn, we trimmed our exposure to asset-sensitive banks. We sold out of BankUnited (BKU), because it has an ambitious loan growth strategy, which in a highly competitive slow-growth environment often means sacrificing credit discipline that could lead to higher risk down the road. We also trimmed Zions Bankcorp (ZION), a self-help thesis that has played out well, because appreciation reduced the reward-to-risk ratio.

Selectively Adding to Yield Stocks

We were underexposed to higher-yielding stocks that benefit from declining rates, for instance REITs and Utilities. This is not a macro bet on rates but rather a reflection of high valuations and relatively low return on capital. Where we find compelling opportunities, we are selectively increasing yield in the portfolio. Although we do not normally comment on position size changes, a good example of selectively adding yield is **Stag Industrial (STAG)**, which we increased concomitant with the reduction in banks. STAG is an industrial REIT that owns a diversified portfolio of single-tenant industrial properties, mostly light manufacturing, warehouses and distribution centers. In contrast to retailers, it benefits from the headwinds facing Brick and Mortar retailers, and the subsequent share-shift to online shopping because those purchases are mostly fulfilled from distribution centers (leased from STAG and others) displacing stores. It sports a 4.7% dividend yield and trades at 15.9x P/FFO versus peers trading at 22.4x despite approximately 200bp faster growth expected next year. The discount strikes us as counterintuitive, seemingly related to its conservative management team's valuation-oriented strategy, which is exemplified by its avoidance of the highest growth markets where cap rates are extremely low and the risk of overbuilding is greatest.

2Q 2019 Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
FTDR	Frontdoor Inc	28%	**TDC**	Teradata Corp	-18%
MLHR	Herman Miller Inc.	26%	**CRTO**	Criteo SA	-14%
ALOT	AstroNova Inc	20%	**ENR**	Energizer Holdings	-19%
DOX	Amdocs Ltd	15%	**SOI**	Solaris Oilfield	-10%
ZAYO	Zayo Group	16%	**COHR**	Coherent Inc	-9%

Top 5 Contributors

Frontdoor (FTDR) is a new position (discussed in New Positions Initiated section) that performed well this quarter. This formerly ignored spin-off began April with a series of positive analyst coverage initiations followed by an excellent 1Q19 earnings report in early May.

Quarterly results for **Herman Miller (MLHR)** surpassed expectations on both top and bottom lines. The results are consistent with our thesis that the company's extension into the high-end consumer market offers a self-help growth and margin opportunity not priced into the stock. Since 2014, when Herman Miller acquired retailer Design Within Reach, the business has emerged as a differentiated, design-focused brand. Further, the company continues to enjoy a strong position in commercial verticals and an enviable franchise in seating, including the iconic Aeron chair.

AstroNova (ALOT) jumped 20% in April, probably because the company presented to and met with investors at the end of March. The company is small and somewhat obscure but has a strong story to tell around new product launches driving both margins and growth. We like the way management thinks about investments, along with a strong track record of executing against its strategy. Apparently, others did too. Despite trading mostly sideways since reporting its first quarter results at the start of June, we thought it was an excellent quarter. Test and Measurement (including cockpit printers) continued to perform well and the acceleration in the Product Identification segment was encouraging with accelerating adoption of its newest labeling systems.

In May, **Amdocs (DOX)** reported solid results and raised full-year guidance. As discussed in our 1Q letter, earlier this year, the stock traded lower after Spruce Capital published a short-report on Amdocs. We disagreed with the conclusions and attribute them to a lack of understanding of the nature of Amdocs' business and its customer relationships. Since then, the stock has rebounded on quarterly results. We continue to view this stable business favorably and believe its billing solutions for service providers is undervalued.

Zayo (ZAYO) appreciated on news that the company would be acquired for $35 per share by private equity firms Digital Colony and EQT. We initiated a position in Zayo during the 4th quarter, after the stock sold off into the low $20s. While glad to see our thesis confirmed and the stock appreciate in such a short period, we believe the premium should have been higher.

Bottom 5 Detractors

Teradata (TDC) traded lower after 1Q results showed earnings in line but subscription revenue lower than expected. The story is familiar, as dozens of software companies transitioning from perpetual to subscription model have faced similar challenges. The uncertainty inherent in a new sales model coupled with reliance on new key metrics often triggers selling among investors. We believe Teradata is on solid footing and that the sell-off presents a significant buying opportunity that will prove rewarding for long-term shareholders.

Criteo (CRTO) lagged as little news came to stem the overwhelmingly negative sentiment following the *AdWeek* article released in late March regarding potential changes to Google search engine negatively affecting Criteo. As discussed in our 1Q letter, the *AdWeek* article speculated that Google is planning sweeping changes to its Chrome browser advertiser-facing tools. Historically, Criteo has exhibited the ability to adapt to changes to browser setting, and we believed Criteo would be able to work within those changes while still protecting privacy and personally identifiable information. Further, our belief was that Criteo's interests were aligned with Google's (making money from advertising), so any changes would not have a material effect on Criteo's business. Management has since confirmed our suspicion.

Quarterly results for **Energizer (ENR)** showed weaker-than-expected profitability, and new Nielsen data shows distribution losses for recently acquired Rayovac. The shortfall was exacerbated by its timing, as the company increased leverage to acquire the Rayovac battery and auto care businesses from Spectrum Brands. While wary of excessive levels of debt, we believe Energizer's integration of a large battery competitor and plans to de-lever the balance sheet will ultimately lead to equity accretion.

Solaris (SOI) fell 10% during the 2nd quarter, after rising 37% in the 1st quarter. Solaris offers productivity-enhancing solutions to the energy industry, so it's not terribly surprising to see near-term volatility in the stock price coincident with oil and gas commodity price fluctuations. Prices for West Texas Intermediate Crude fell from above $65 in April to the low $50s in June. Solaris fell from $19 in April to $15 at the end of June. However, fundamental demand for its product is growing on a secular basis, and its dependence on oil prices is thus somewhat moderated. With continued sales momentum and free cash flow on the rise, we think Solaris is an attractive investment at current prices.

After rising 34% in the first quarter, the price of **Coherent (COHR)** stock gave back some of its prior gains, falling just under 9%. Coherent has been a bellwether for US-China trade, as near-term growth in the microelectronics division likely hinges on the timing of China's investment in OLED screens. Despite the near-term volatility and the trade situation, we believe Coherent's 3- to 5-year outlook is bright.

Thanks again for your interest in Ballast. If you have any questions about our firm, our People, or our Process, please feel free to reach out.

Thanks,

Ragen Stienke

Important Notes and Disclosures

The investment decisions we make for clients' accounts are subject to various market, economic, and other risks, and there is no guarantee that those investment decisions will always be profitable. Clients are reminded that investing in any security entails risk of loss, which they should be willing to bear. The past performance of the firm or its principal is no guarantee of future results.

Some information contained in this communication was obtained from third-party sources. While these sources are believed to be accurate, that information has not been independently verified.

[1] The Ballast Portfolio represents the performance of a composite of accounts invested in the firm's model strategy that was launched on August 11, 2015. Gross Performance represents the returns of the composite after all expenses, but before deduction of management fees. An individual client's account would be subject to the deduction of management fees in accordance with the Ballast fee schedule. Net Performance represents returns net of all expenses and the highest management fee rate (1%) in the firm's fee schedule. The returns achieved by an individual client's account may vary from those reported for various reasons, including management fee rate, timing of cash flows, frequency of rebalancing of individual accounts, and an individual client's restrictions. In April 2019, Ballast transitioned from calculating performance based on a proprietary account to composite. The composite performance should be the sole source of information used when evaluating past performance. Past performance does not guarantee future results.

[2]The Russell 2500 Index is a market capitalization weighted index of the 2,500 smallest companies in the Russell 3000 universe of United States equities. Returns shown include the reinvestment of dividends and are based on data obtained from FTSE Russell.

[3]The Russell 2500 Value Index measures the performance of those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values. Returns shown include the reinvestment of dividends and are based on data obtained from FTSE Russell.