BALLAST
ASSET MANAGEMENT

THIRD QUARTER 2019 LETTER

For the third quarter of 2019, the Ballast Portfolio returned -2.9% before fees and -3.1% net of fees, compared to 0.1% for the Russell 2500 Value and -1.3% for the Russell 2500.

		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%	9.2%	-8.0%	10.1%
	Net	-8.0%	22.6%	12.4%	-3.2%	8.4%	-8.9%	9.0%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	15.4%	-4.4%	6.8%
Russell 2500		-6.9%	17.6%	16.8%	-10.0%	17.7%	-4.1%	9.5%

Performance (as of 9.30.2019) *2015 performance from 8.11.2015 through 12.31.2015

I once heard Peter Thiel give a speech, after which in the Q&A session he was asked about process. Paraphrasing from memory, he answered process was something people use when not capable of deep thinking. His point was that each situation is different, requiring one to think very hard about the specific circumstances involved. That's 100% accurate some of the time, but simply wrong most of the time. Investment research – to borrow a line from a much earlier tech giant, Thomas Edison – is 1% inspiration and 99% perspiration. Thiel's comment is spot on for the 1%, but for the other 99% process and teamwork are crucial to guarding against the cognitive and behavioral pitfalls impeding outstanding long-term results.

For those new to our letter, I was raised by the son of a rice farmer and cattle rancher. Many lessons learned in my life stem from that upbringing. One unique aspect of this childhood is the inherent cost of mistakes, both in terms of money and physical danger. My parents and grandparents taught me from a young age how to do things – general rules to live by and specific rules applied to certain situations (i.e., don't walk between a cow and her newborn calf).

Farm life often involved long hours of tedious work. For instance, during harvest I would drive a combine (machine that harvested the rice) around in circles for 8-10 hours per day, edging slightly nearer the center on each pass – kind of like mowing the grass – for weeks on end. Frankly, it did not require great independent decision-making. In fact, the monotony lulls the brain to sleep and prevents it. To combat that and preserve the ability to make correct snap decisions when something went wrong, we used a process to monitor the gauges during operation of the equipment and preplanned what to do when something went awry. For example, there is a gauge that measures the speed of the cylinder, which is the device that performs the threshing component – the most important function of a grain harvester. If the speed is too fast, it can crack the grain, which is bad. If too slow, it results in grain loss – equally bad. If it stops, for any number of reasons, and you do not immediately disengage operations, you can seriously damage components of the machine and will spend the next several hours pulling packed straw from multiple small openings behind hot metal doors to clear it. Ask me how I know.

By the way, this is the same thing pilots and doctors do, and one reason they use checklists. One of our checklists follows below. Importantly, having a great process does not ensure smooth sailing all of the time – stuff happens. A process helps to prevent a bad situation from turning into a disaster.

While I appreciate Thiel's sentiment around deep and independent thought, I also know from experience that if we rely solely on our own thought all the time, we are going to miss something and make mistakes. We need something that makes deep, independent thinking and great ideas repeatable. In short, I believe a process is something formulated over time using deep thought, reflects on lessons learned and improvements, and helps shield us from ourselves (i.e., emotion). While there is little physical danger in what we do at Ballast, the financial ramifications of our decision-making are serious. So, we use our process in order to turn investing into something that looks less like unique idiosyncratic insight and more like a repeatable manufacturing process.

Third Quarter Performance

The economic backdrop continues to be muddied by crosscurrents. Domestic manufacturing activity is stalled but the overall domestic economy remains slightly expansionary based on the latest ISM surveys. The global composite reads slightly expansionary with services and manufacturing in emerging markets ex-China offsetting weakness in China manufacturing and developed market manufacturing. The U.S. 10- to 2-year yield curve inverted but the NY Fed's "Probability of Recession within 12 Months" model (which is based on the yield curve) only ticked up from 33% to 35%. The yield on 10-year treasuries declined 35bp, the BBB spread was basically flat at 147bp, indicating some appetite for risk, but not excessive based on the 15bp widening in high-yield spreads and supply backup in the leveraged loan market. Most commodities, including industrially sensitive oil and copper, declined in 3Q19 with the notable exception of gold, which benefits from lower interest rates and tends to be viewed as a safe haven. U.S. Inflation expectations fell to the lowest level since 2016. The list of uncertainties and risks remains long, including:

- U.S.-China trade talks
- Brexit
- Presidential elections
- Inflation or deflation?
- Does treasury yield curve inversion mean a U.S. recession is inevitable?
- Will China's economy grow even slower or actually contract?
- With more than 50% of global central banks easing, can a global recession be avoided?
- Does the illiquidity-driven spike in repo rates indicate deeper issues with the financial system?
- Why do U.S. treasuries have a positive yield while $17tr of other sovereigns have negative yields?
- How large can U.S. budget deficits (treasury issuance) get without rates rising?
- What is the impact of historic income and wealth inequality?

New Positions Initiated

UFP Technologies (UFPT)

UFP Technologies (UFPT) is a contract manufacturer specializing in foam products for medical, defense, consumer and auto industries. The company is classified as a materials company, but healthcare accounts for 60% of sales. UFP serves 24 of the top 28 med device manufacturers, and helps companies like Becton-Dickinson, Merit Medical, and Don Joy make infection prevention devices, wound care devices, balloon catheters, titanium braces and many others. Their medical business offers both growth and a stable source of demand for the company.

To serve its healthcare customers, UFP manufactures from 14 FDA-approved clean rooms across the U.S. In many cases, they design and build custom manufacturing tools to achieve the specifications desired by customers, and because they're dealing with medical applications, they manufacture to very close tolerances with 100% in-line inspection.

UFP participates selectively in other markets for applications where they can earn a good return on their advanced capabilities. In defense, they supply the Army with lightweight load-carrying components made from ballistic nylon as well as specialty storage cases for various pieces of equipment, like armor plates for military aircraft. In autos, they are seeing favorable trends toward foam products to reduce weight from the vehicle while maintaining the structural integrity. A new durable, lightweight honeycomb product developed by one of their suppliers is fitted by UFP for auto OEMs. In aerospace, they've been qualified by Boeing to supply advanced burn- and smoke-resistant foam.

UFP works in close cooperation with their key suppliers, Zote Foams and FXI. UFP was given exclusive access to innovative foam products for certain market verticals in exchange for take or pay contracts with guaranteed modest volume increases. As such, the company works collaboratively with their suppliers to get these advanced technologies to specialized applications. While large areas of the foam industry have been commoditized by low-cost manufacturers, UFP brings value-added manufacturing solutions to customers, earning mid-teens EBITDA margins and high single-digit ROA. Yielding more than 7% on a free cash flow basis and growing mid-single digits organically, the stock has significant upside. At the same time, we see limited downside supported by stable medical demand from a diversified customer base, a portfolio of owned real estate assets, and balance sheet flexibility.

MGIC Corp (MTG)

MGIC is the largest private mortgage insurer (PMI), insuring lenders on mortgages with less than 20% down against losses to conform the mortgages with Fannie Mae and Freddie Mac underwriting standards, which lowers the borrowers' total cost to borrow.

It currently trades at ~1.1x Book Value Per Share, which is a massive discount to the 2-4x BVPS in 1992-2003 when it earned a normalized ROE of ~20%. The current multiple reflects the unprecedented deterioration of mortgage underwriting that culminated in the subprime mortgage crisis. It trended down to 1.2x at 5/31/2007 as awareness of housing insanity grew. In other words, it's trading at less than half the valuation it carried in prior “normal” housing markets and is at the same level as in the start of the housing bubble – despite substantially similar returns as in pre-bubble years and far better underwriting/book quality.

We think the current valuation reflects investor PTSD far more than any fundamental uncertainties. The housing industry has fundamentally changed. BVPS fell from $55 in 2007 to about $2 in 2013 with share price concurrently dropping from $65 to pennies. Then, credit standards, as typified by Liar Loans and NINJA mortgages, were completely insane with the predictable result of stratospheric frequency of loss. Then, the housing market was oversupplied, which led to falling home prices and greater severity of loss. Today, mortgage credit is still very tight, and housing is undersupplied at the national level. Pricing is competitively rational amongst the six PMIs and new business is anecdotally being written at high-teens ROEs. With the transition to analytic pricing engines, companies will be able to segment risk more finely, picking and choosing the risks that best meet their risk/reward criteria, potentially supporting some price increases.

Volume grows at a structural rate of population growth plus inflation, call it 2%-3%. However, growth is currently higher due to decreasing competition from the federal government. FHA and VA loans, which are the primary alternative to PMI, are ceding share to PMI. They constituted 55% of low down payment loans in 2018, but have been and are likely to continue to donate market share, boosting the industry growth rate to 5%-10% for the next three to five years. We think a further tailwind could arise if entry-level housing supply improves and millennials increasingly buy homes because first-time buyers are the principal PMI clientele.

New Insurance Written is cyclical with home sales, but current earnings are far more a function business written in the preceding decade. It is also sensitive to employment, with job loss being a leading cause of delinquencies and defaults, which trigger insurance payouts. However, the frequency of loss is likely to be much lower going forward given seasoning of older loans and much stricter lending standards on newer loans. Tight housing supply greatly mitigates the potential severity of losses. In addition, MTG has more recently started purchasing reinsurance, which transfers approximately 50% of its risk on about 50% of its book. All of which is to say it is far less risky than it used to be.

Given the income statement changes so slowly, fundamental risk over the next three years is much lower than trading risk. On a trading basis, with the existing book and sound underwriting environment, downside P/B of 0.9x seems exceptionally conservative were it not for investor PTSD. The 0.9x multiple is the average of the lowest two drawdowns outside the boom/bust, which we view as a rolling target, adjusting the risk price as BVPS increases. Also consider that a significant portion of management compensation is tied to achieving a BVPS CAGR of at least 16.4% for the next three years, which is almost a given absent a very nasty recession. In three years, BVPS would be 58% higher so the downside price would be $15.30 at 0.9x P/B, which is higher than the current price. Note that during pre-bubble recessions it traded around 1.8-2.0x, or 50% higher than it trades today.

Horizon Therapeutics (HZNP)

Horizon Therapeutics is a biopharmaceutical company focused on rare diseases, where it can obtain “orphan drug” status, which gives 7 years of exclusivity and quicker FDA approval. The company is led by Tim Walburt, who led the launch of Humira (largest drug in the world). His focus is on execution and commercialization, rather than traditional blue-sky R&D. Typically, Horizon acquires drugs/companies in promising Phase 1 or 2 trials and then commercializes them. Although this sounds a lot like big pharma's playbook, they don't compete for deals because orphan drugs' small market potential doesn't scale. The result is less risk, a higher hit rate and substantially lower R&D compared to peers, which shows up in the cash flow generation. The company has significantly delivered the balance sheet (1.2x net debt/EBITDA) since its last acquisition.

The majority of the company's revenue is protected from competition/generics through 2024/2025. Potential lost revenue from competition should be overwhelmed by new drug growth. It has significant near-term growth potential from existing drugs and medium-term opportunities from two drugs nearing FDA approval. This growth should also drive margins as the existing infrastructure is leveraged over more sales. It's currently operating in the mid-30% EBITDA range compared to the company's long-term target of 50%-plus, in-line with peers. Our target and risk prices model only gross margin expansion, which is less than what existing product growth ought to drive along with historical levels the company achieved.

We based our downside target on the lowest EV/Sales multiple that competitors have traded at (3x) which equates to a stock price of $18. Notably, several companies that traded down that low were ultimately acquired for >4x sales, including Celgene as recently as December 2018. For upside, we used 12x and 15x EV/EBITDA for 1- and 3-year price targets, respectively. Those multiples are in-line with peers with similar growth/development/patent portfolios, and also justified in absolute terms by the returns, balance sheet and margin opportunity of the company. Based on our estimates, the Reward-to-Risk ratio handily clears our 3:1 hurdle. In addition to margin upside, there is further optionality from the drugs in FDA approval process succeeding beyond the meager credit we have given the company.

CNX Midstream Partners (CNXM)

CNX Midstream is a midstream MLP with gathering and pipeline businesses servicing upstream Marcellus Shale production assets of Consol Energy (CNX). The company operates gathering pipelines, compression and dehydration facilities, as well as condensate gathering, collection, separation and stabilization facilities. CNX Midstream stands out amongst its MLP peers with appropriate leverage and assets positioned in the very low-cost portion of the gas supply curve that supports long-term growth.

Unlike traditional energy exposure, the company is leveraged to volume produced from their E&P partners, rather than the price of the commodity. CNXM generates revenue through long-term fixed-fee gathering agreements. These agreements are meant to limit the company's exposure to commodity prices and create a more predictable cash flow stream. In addition, as the general partner of CNXM, Consol Energy, is heavily incentivized to drop down additional assets to grow the value of CNXM because it represents a meaningful portion of Consol's net asset value.

The company has a dividend yield of 11%, with distribution growing at 15% per year all the while trading at a historically low multiple of less than 7x EBITDA. In our downside scenario, we contemplated a dividend yield that peers experienced during stressed energy price environments. Under that scenario and assuming a mid-teens dividend yield, we calculated downside in the $10-$11 range, or roughly 20%. For upside, we assumed the company would be able to maintain the stated 15% distribution growth forecast with a normalized yield of 6%, which implies the stock could more than double.

Exited Positions

Reduced bank exposure; Exited Wintrust Financial (WTFC) and Zion Bancorp (ZION)

We continued to reduce our exposure to banks. As we had anticipated in the second quarter, the risk of lower rates has come into fruition, and we focused on lowering our exposure to asset-sensitive banks. We trimmed First Financial (FFBC) and East West Bancorp (EWBC), and we exited out of Zion Bancorp (ZION) and Wintrust Financial (WTFC).

NetApp (NTAP)

NetApp has been an outstanding performer for us, appreciating almost 140% since 2016. We trimmed back the position substantially to take gains along the way, which protected us from the sell-off this quarter. Our original thesis played out, as NetApp's storage continues to remain relevant in hybrid cloud environments. However, we also didn't anticipate the negative results this quarter. The unexpected whiff sent shock waves through the rest of the tech sector, signaling an abrupt slowdown in tech capital spending. We exited the remaining position to curb our exposure to capital spending and reinvested in better opportunities.

Energizer (ENR)

Since acquiring the Battery and Auto Care businesses from Spectrum, Energizer has posted two consecutive top- and bottom-line misses. As net leverage increased from 1.8x at the end of 2018 to more than 5.3x on a pro forma basis, the company is increasingly relying on its ability to execute on its cost synergy targets. Energizer went on to acquire the Spectrum battery business but ended up walking out with the Auto Care business too – only to be surprised by heavy inventory levels in the channel forcing a reduction to FY20 revenue guidance. We recognize that a warm summer and fall may snap back demand favorably for the refrigerant business, but in our view, the downside and risk profile changed, so we chose to exit the position.

3Q 2019 Top and Bottom Performance Contributors

Top Performing Positions			Bottom Performing Positions		
	Name	Total Return		Name	Total Return
XPO	XPO Logistics Inc	25%	**ALOT**	AstroNova Inc	-38%
NCMI	National Cinemedia Inc	26%	**PINC**	Premier Inc	-27%
COHR	Coherent Inc	12%	**TDC**	Teradata Corp	-16%
FTDR	Frontdoor Inc	11%	**GDP**	Goodrich Petroleum Corp	-19%
DOX	Amdocs Ltd	7%	**TRIP**	TripAdvisor Inc	-17%

Top 5 Contributors

Top contributors included **XPO Logistics (XPO)**, which traded up more than 25% in the third quarter. XPO posted a second consecutive quarter of solid results. Although revenue was shy of expectations, margins significantly outperformed, boosting EPS, EBITDA, and Free Cash Flow above consensus expectations. Notably, in the last year, the company has opportunistically repurchased nearly a quarter of its outstanding shares.

In addition to reporting better than expected 2Q earnings, **National Cinemedia (NCMI)** announced a new preshow advertising structure with two of its largest exhibitor partners, Cinemark and Regal. The new structure allows for closer-to-feature advertising inventory, enhancing the value to advertisers and the participating theaters. Often overshadowed in the news, the movie theater remains a highly sought-after venue to reach audiences with cinematic advertising content on the big screen.

Coherent (COHR) has had a wild ride this year. Up 34% in the first quarter, down 9% in the second, and up 12% in the third. This company, more than any other in the portfolio, is sensitive to U.S.-China trade. While we do not love the volatility, our focus is on growth in their annealing laser technology and industrial businesses. As evidenced by Apple's iPhone 11 Pro in September, the switch to OLED screens for mobile devices and televisions bodes well for Coherent's growth in Asia.

Frontdoor (FTDR), also a top 5 contributor in 2Q, traded higher after reporting better than expected margins and raising full-year guidance. Since initiating the position earlier this year, we have been pleased to see the margin story play out successfully.

Strong year-to-date results have led to a recovery for **Amdocs (DOX)**, after Spruce Point's short-report triggered a sell-off earlier in the year. The company is well positioned to grow its billing software and managed services into the media vertical, and it will support AT&T's integration of Time-Warner. Amdocs offers best-in-class billing software and managed services and continues to invest strategically into their capabilities for service providers.

Bottom 5 Detractors

Astronova (ALOT) was down 37.5% after revenue and earnings missed expectations. The company's cockpit printer business faced headwinds from the grounding of the Boeing 737 Max. While the first order effect of Boeing production delays was anticipated, the second order effect meant retrofit opportunities were deferred, as more of the existing aircraft fleet was kept in service. While the timing is unclear, we believe the demand will be recouped in coming quarters, and we added to the position during the quarter.

Premier Inc. (PINC), like Amdocs earlier this year, was the subject of a Spruce Point short report posted on their website. Short sellers like Spruce Point serve an important role in market efficiency, but they also capitalize on manipulative short-term tactics. For example, a short-investor able to post a credible – not necessarily truthful – report can take quick gains before the sell-off fades or management addresses the issues raised. We have observed a pattern in several short reports; often starting with accounting anomalies, they tend to stretch facts into a draconian narrative, and most importantly, they target companies facing incidental uncertainty. The narrative plus uncertainty is often enough to spook complacent or fringe investors into selling. This recipe has rewarded short sellers in a reflexive fashion, so their reports consistently incite short-term price action, which we view as potential buying opportunities. That said, we take short reports on owned names seriously. We investigate the assertions to sharpen our analysis and then rely on our process.

Teradata (TDC) came under pressure in August after reporting quarterly results. Even if earnings were in-line, the market was punitive toward companies that missed top-line expectations. In Teradata's case, the top-line weakness came from perpetual license sales and consulting, while recurring revenue grew 12% and gross margins expanded 400bps. It was not a great quarter for tech companies generally, but Teradata continues to show progress on its transition from perpetual to subscription sales.

Like a good house in a bad neighborhood, **Goodrich Petroleum (GDP)** traded lower as the energy sector continues to fall out of favor. Goodrich grew production more than 125%, generated high-teens return on capital employed, maintains a healthy balance sheet, and spends substantially less cap-ex per dollar of EBITDA than peers with dramatically less financial leverage; but it trades at just 2.5x EBITDA.

Trip Advisor (TRIP) was down 17% after revenue and earnings missed expectations. The Hotels segment revenue fell precipitously, while the growing Experiences segment was up 28%. The negative price reaction was in response to slower top-line growth in the Hotel segment, but notably, the earnings for the Hotel segment were up 27%, as the company manages the business for cash.

Ballast Team Update

We are excited to announce that Joyce Schaer has as joined Ballast as head of marketing and new client development. Joyce has been a member of Ballast's Advisory Committee since the inception of the firm and a trusted resource as we have continued to plan for future growth. We are happy to have her join now on a full-time basis. Joyce and I previously worked together at Westwood Management where she was responsible for marketing a variety of investment strategies including the SMidCap Equity strategy. Joyce brings significant experience in marketing for both emerging and established firms. Most recently she was head of marketing for Oakview Capital Management and prior to Oakview, was the Chief Operating Officer and head of Investor Relations for Hirzel Capital Management, a Dallas-based hedge fund.

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.

Regards,

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 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.

[3]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.