BALLAST
ASSET MANAGEMENT

Real World, Real Businesses, Real Values

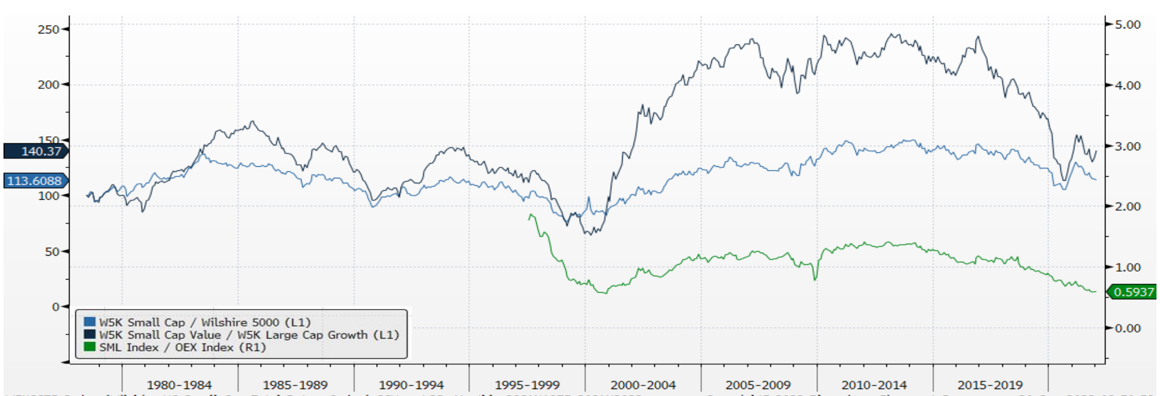
The Ballast composite portfolio returned 40.4% net of fees for 2021, which compares favorably with the Russell 2500 Value's 27.7% return. Fourth quarter returns were 4.9% for Ballast and 6.3% for the benchmark.

Performance*		Yearly Returns							Annualized Returns*		
		2015†	2016	2017	2018	2019	2020	2021	3 Yrs	5 Yrs	Inception
Ballast Portfolio[1]	Gross	-7.6%	23.8%	13.5%	-2.2%	16.1%	12.5%	41.7%	22.8%	15.5%	16.3%
	Net	-8.0%	22.5%	12.4%	-3.2%	15.0%	11.4%	40.4%	21.6%	14.4%	15.1%
Russell 2500 Value[2]		-5.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	27.7%	18.3%	9.8%	12.2%
Russell 2500[3]		-6.9%	17.6%	16.8%	-10.0%	27.7%	20.0%	18.1%	21.9%	13.7%	14.3%

* Annualized 3-Year, 5-Year and from Inception returns reported through 12/31/2021
† 2015 Performance from 10/1/2015 through 12/31/2015

Right now, it is neither too late nor riskier than usual to invest in small cap stocks. We believe it is still early innings for small value opportunity and know that our active management and reward/risk discipline is as rigorous and timely as ever. Despite extraordinarily strong results in 2021, we estimate the portfolio's reward/risk is more than 3:1 with significant upside relative to equities in general and small cap value. Here is why:

1. *We estimate the portfolio companies are more than 150% undervalued* relative to the Russell 2500 Value, with economic value 3 years hence about 2.5x the current market value. As usual, our businesses have strong commercial prospects, outstanding competitive positions, managements that act like owners, sensible balance sheets and attractive valuations.
2. *History favors small and value, even more so right now*. Small caps have slightly outperformed large cap since our records started, despite a decade of underperformance as shown below (light blue line). *Small cap value has outperformed large cap growth* (dark blue line) by 40% since 1978, despite even more severe underperformance than during the tech bubble. Small cap valuation (P/E for S&P 600 Small Cap divided by S&P 100 [basically the largest large cap growth]) is as cheap as it was two decades ago, just before the tech wreck (green line). Now, like then, liquidity and interest rate prospects argue against large cap growth extending its run.



Source: Bloomberg

3. *Active management can be crucial to earning the small cap value premium going forward*. While low-fee indexing is probably the average saver's best defense against gamified trading in large cap, active management can more than pay for itself in small value. First, decrepit methodologies no longer sort for value in small caps, at least not in the dictionary sense of the word. Second, asset managers compete on scale more than skill and so devote far more resources to short-term large cap trading than small cap investments. Third, informed and involved investors have far more access and impact at smaller companies.

4. *Inflation debates miss the bigger risk*. Whether money supply or production and logistics constraints or more expensive energy or aging of the global labor pool, these arguments all treat inflation risks like a math problem. In the real world, central bank and fiscal policies, consumer savings and consumption, business hiring and investment, geopolitics and the global financial system interact in unpredictable and unknowable ways. What we do know is that inflation favors real assets, like stocks, in the long term.
5. *We can consistently execute our reward/risk discipline with confidence amidst uncertainty* for two reasons. First, we have yet to find a practical short-term implementation that is as reliable in the long run. Second, we protect the short-term downside at a fundamental level – by owning good businesses, run by people that we trust to make good decisions and leverage small company agility advantage to outperform more complex, globe-spanning businesses.

Case Studies

We have discussed process for years now. In this letter, we wanted to give two real-world examples – one where it worked and one where it did not work – or at least the stock did not pan out the way we expected.

LINN Energy

LINN was an oil and gas company with assets in multiple basins throughout the U.S. that went bankrupt in 2016, caught between plummeting oil prices and an overextended balance sheet. We first bought LINN in September 2017 in the mid-$30 range, after it emerged from bankruptcy with a cleaner balance sheet and, importantly, a greater focus on capital discipline – both because the debt holders went on the board and management's compensation was tied to value creation. Calculating our ultimate return is complicated since we participated in its Dutch Auction share repurchase and then it split into two separate companies, neither of which now exists as an independent company. All in all, we lost roughly 33% on the investment.

Our initial thesis was simple – management was selling non-core assets to focus production on low-cost basins, and the asset sales would provide ample cash to grow the business and return capital to shareholders. Things went well the first year – the Dutch Auction cleared at $48 giving the stock price a nice early bump. Asset sales were done at premium valuations (1.5x proved developed production PV-10), which took the company to a net cash position and further improved our downside targets. Then in August 2018, the company completed a split into two entities: Riviera Resources to operate mature, low-declining wells and mid-stream assets, and Roan Resources, a growthy JV with Citizens, to expand in Scoop/Stack/Merge fields of Oklahoma, which was thought to potentially rival the Permian Basin. That is when things began to unravel, quickly.

Roan ran into pressure problems. The well results our analysis depended on were quite good for single wells, but as new wells were drilled, evidence accumulated showing that the test well results did not hold for the new “pad” drilling techniques that worked well in the Permian. Pad drilling uses one rig to drill multiple wells in different directions from the same surface site, or pad. The Permian is low cost in part because of the efficiency of batch drilling, batch fracking, and flipping the production knob to 11. It turns out the Scoop/Stack/Merge geology was similar but not the same – the underground pressure that pushed the oil up dropped dramatically when multiple wells were drilled. As a result, the well productivity dropped dramatically and way below expectations from previous traditional wells.

Riviera’s thesis relied on its midstream gathering assets (via Blue Mountain Energy) predicated on continued production growth in the Scoop/Stack/Merge. Then the bottom fell out of prices. Oil dropped from $70 in third quarter 2018 to the low $40s by the end of the year. Gas was initially more resilient, but eventually dropped from $3 to the $1.70 range over the near year and a half. When the dust settled, both companies were sold off leaving shareholders $1.52/share for Roan and $1.35/share for Riviera.

Fortunately, a competing E&P ran into the same Scoop/Stack/Merge pressure issues before Roan, which constituted a thesis violation, automatic exit and avoiding the eventual collapse. It was still a painful lesson. We are not petroleum engineers or geologists, and even those that are did not see it coming.

The important takeaway is this: We know we are not domain experts, and we know we will be wrong again, but when our investment thesis is violated, we sell the stock. We have nearly two decades of empirical data that shows when an initial thesis is violated, the stock continues to underperform for the next year or two, the vast majority of the time. It is this rule that prevents us from much more severe losses on a stock. While 33% is painful, the reality is, we were still able to manage the downside risk despite everything that could go wrong, going wrong.

ON Semiconductor

We purchased ON Semi the same day we started Ballast in August 2015 at roughly $10/share and sold it this past December for over $60, after it went out of our cap range.

ON manufactures specialized semiconductors for a variety of industries. At the time of our first purchase, the business was primarily focused on power management (think battery efficiency) for consumer electronics, but was expanding into Automotive, Industrial and Commercial verticals. They had recently completed an acquisition of a company called Aptina that expanded their capabilities in sensors for the auto industry (ADAS in vehicles for instance) and wireless charging (which was better than theoretical but far from mass production).

We first encountered the company in a routine research meeting. While we liked management and the new sensors were interesting, the stock’s valuation was a lot less compelling, so we passed. Later on, fearing near-term weakness in PCs and smartphones, the market dramatically marked the stock down, compressing EV/EBITDA from nearly 9x earlier in the year to roughly 6.5x. Little had changed fundamentally – the company was still growing, margins were still expanding and it was generating a healthy level of free cash flow, but analysts expected some near-term softness in revenue and earnings. Turns out, those analysts were correct about the revenues, which shrunk 3% in the fourth quarter of 2015 and 6% in the first quarter of 2016. At that point, ON traded at a market capitalization of roughly $4 billion compared to revenue just north of $3.5 billion, and yet the growth opportunity from increasing penetration of wireless charging on mobile phones and sensors on cars was only accelerating.

While we fully appreciated the near-term headwinds, we focused on the long-term growth opportunities. With each new version of smartphone and laptop PC release was increased computing power, and that required better power efficiency. ON was winning new business on the back of that trend. Further, we saw a clear sign of more and more sensors on the new models of cars. Keep in mind, this was well before features like adaptive cruise control, collision warning, lane departure and surround-view cameras were prevalent in vehicles. At best most vehicles had sensors that caused the vehicle to beep if you got too close to something when you were parking. However, many of these features and more were in development and being rolled out in newer models. Semiconductor content per vehicle averaged $300-$350/vehicle at the time. That has nearly doubled since then, and double that again for electric vehicles and hybrids.

While we do not claim to have nailed the numbers exactly, our fundamental research on features of new cars, the tailwind to industry growth was evident, and ON was perfectly positioned to take advantage. The market was purely concerned about near-term softness in two end markets, and therein lies part of our competitive advantage – we can take a longer-term perspective and use pullbacks in stocks based on short-term concerns to build positions that can compound over time.

2021 Top and Bottom Performance Contributors

Top Performing Positions			**Bottom Performing Positions**		
	Name	**Total Return**		**Name**	**Total Return**
GDP	Goodrich Petroleum	+127%	**COLL**	Collegium Pharmaceutical	-18%
TDC	Teradata	+89%	**FTDR**	FrontDoor	-27%
AVID	Avid Technology	+105%	**FL**	Foot Locker	-22%
COHR	Coherent	+80%	**CRMT**	America's Car-Mart	-7%
TPL	Texas Pacific Land Corp.	+73%	**SOI**	Solaris Oilfield Infra.	-16%

Top Contributors in 2021

Goodrich Petroleum is a natural gas levered E&P focused on drilling and production in the Haynesville basin. The company was acquired by Paloma Partners for $23 in December. Like its E&P peers, Goodrich suffered throughout much of 2020 due to stressed oil and gas commodity prices, along with a mass exodus of institutional investors from the sector. Part of that exodus was a result of historically poor free cash generation by the companies, due in part to low natural gas prices. These factors pushed Goodrich's stock to nearly $3 in March 2020. Having one of the cleanest balance sheets of any of its peers, along with good producing assets, a smart hedging policy and focus on cash generation enabled Goodrich to not just survive the downturn, but to thrive on the backside.

Teradata is a data analytics company originally founded in 1979. We originally invested in Teradata in May 2017. Through the end of 2019, the stock suffered headwinds from its transition to a subscription revenue model from its legacy perpetual model. During that transition, the company's revenue and earnings power appeared strained. Our fundamental analysis showed that appearance of financial stress was really just optical due to the contract transition. Toward the end of 2020, the company began to exhibit a reacceleration in revenue and earnings growth that continues to positively surprise the market. After being dead money for roughly 3 years, the stock jumped nearly 80% over two days after reporting earnings in February 2021 that validated our research. While the thesis took longer than we initially expected to play out, we believe this is the type of story that shows how having a longer-term investment horizon serves as a competitive advantage for Ballast.

Avid is a technology company that produces software and hardware serving the media industry. During the COVID-19 lockdown, the suspension of movie and song production, along with concert cancellations, negatively affected sales of many of Avid's products. With production coming back, increased demand for the company's software products (Pro Tools and Media Composer) and a shift to a recurring revenue model have materially boosted Avid's operating results. Evidence of management's success in capitalizing on each of these things became even more apparent when the company reported its first quarter earnings. While the stock has pulled back from its summer 2021 highs, we believe the fundamental thesis remains intact.

Coherent was acquired by II-VI in a $6 billion deal in the first quarter of 2021. Initially, Lumentum (LITE), announced intention to acquire Coherent for $5.7 billion, sending the stock 30% higher. Twenty days later, MKS Instruments came in with a $6 billion value, shortly followed by an unsolicited offer from II-VI. A series of bids between Lumentum and II-IV ultimately resulted in termination of the Lumentum deal (including payment of a $200 million+ break-up fee) and the acceptance of II-IV's offer for $220 cash and 0.91 II-IV shares for each share of Coherent.

Texas Pacific Land Corp. formerly known as Texas Pacific Land Trust, owns more than 900,000 acres of surface land and roughly 450,000 acres of royalty mineral rights in Texas, principally in the Delaware and Midland Permian basins. TPL does not drill but it does earns production royalties from E&P companies that produce oil and gas minerals from its properties. Although this revenue is tied to oil and gas prices, with zero capital tied up, the return on investment is extraordinary. It has also developed a frac water, reclamation and disposal business that is high return and relatively low overhead. Leasing surface rights for pipelines, easements and grazing provide additional revenues. Occasional land sales either release distributable cash or amount to parcel trades that optimize its footprint. Most of its property was acquired in 1888, as trustee for debt holders in resolution of the Texas and Pacific Railway Company's bankruptcy. We first purchased the stock in the depths of the oil price collapse in Q4 '19/Q1 '20 and sold half in the summer of 2021, after the stock doubled in conjunction with a tax-free conversion from a Trust to a Delaware C-corp and with continued production growth despite briefly negative oil prices in the prior year. With rising inflation expectations, increased investor demand for real assets and commodities (both of which also favored Texas Pacific's properties), we continue to hold a position in TPL.

Bottom Contributors in 2021

Collegium is a specialty pharmaceutical company focused on pain management. They offer a safer alternative to opioid-based pills. Collegium's formulary includes an extended release (ER) formulary that prevents abuse. While the industry as a whole has a stiff headwind from lawsuits and government focus on fighting the opioid crisis, the reality is, pain is real for millions of people, and we need alternative pain management drugs. The is significant data that shows Collegium's products do just that. Unfortunately, drugs are sold, not purchased, and COVID-19 made it difficult for Collegium's salespeople to visit doctors' offices and significantly reduced the number of patients going to visit their doctor. Doctors are hesitant to change a patient's prescription without seeing them, and need constant education on new alternatives available within the marketplace. While we were able to track weekly prescriptions, what we could not see is what channel those drugs were being sold through. Ultimately, the growth was reported to be through channels with much lower pricing (i.e., Medicare Part D) and therefore revenue and earnings disappointed. We sold the stock in December and will wait for the dust to settle before revisiting the story.

FrontDoor offers home service contracts, which work like bundled insurance and repair, for appliances and major systems, covering more than 2.2 million homes. We initiated a position in early 2Q19 following its spin-off as an independent company in 2018, with a three pronged thesis: (1) with more than 45% market share and roughly 4x the revenue of its next largest competitor, network density, operating leverage and scale offer significant competitive advantages, which should support above average return on capital, (2) It is a subscription business with roughly 70% recurring revenue and an 84% second year or later renewal rate that reduces business cycle sensitivity and which helps protect our downside—check, (3) moving to more granular pricing to match regional and dwelling size differentials will help margins, and (4) Upside: if the CEO successfully leverages his tech company background and fully transitions from analog business practices to digital, it becomes extremely difficult to compete with. All remain on track. The stock price issues appear to relate more to its sell-side coverage than the business itself. It is covered principally internet analysts that seem overly concerned with the slow pace of transitioning from analogue to digital and methodically developing new growth initiatives. We prefer faster revenue growth to slower, but it is growth in the return on investment that drives returns, so we do not lose sight of the improvements already achieved. Take gross profit margin for example, which averaged 46% for its first three quarters as a public company and 49.5% from 2Q2019. Last quarter, trailing twelve-month GPM was 50bp high than the prior year. Pricing gains have likely slowed, but with 9% ROA, a 10% free cash flow margin and Net Debt just 1.3x EBITDA, 8% revenue growth seems respectable for a defensive business with a 5% free cash flow yield on enterprise value.

Foot Locker is a specialty retailer focused primarily on sporting shoes and apparel. We initiated a new position on Foot Locker in the fourth quarter. The company has been around for decades and has a unique relationship with Nike and other shoe manufacturers who sell their premium products through Foot Locker and a handful of others. We believe the company has a competitive moat relative to the major online retailers (i.e., Amazon) because Nike does not sell their products through them – they do not want to tarnish/cheapen their brand. Further, Foot Locker improved its capital efficiency dramatically (mostly via inventory turns) over the last several years as they also right-sized their store base (closing less productive stores and brands). The company faced short-term headwinds from the Omicron variant just as things continued to fundamentally improve post the initial COVID lockdowns. However, we believe the valuation, returns and fundamental demand drivers put it on good footing as we enter 2022.

America's Car-Mart (CRMT) is an ethical, customer-centric "integrated auto finance company" that owns "buy here, pay here" car dealerships. It has a strong and sustainable competitive advantage reflected by its 12% book value CAGR that stretches back to the mid-2000s, not to mention that it repurchased more than half its initial market cap over the last decade paying less than book value. Nonetheless, its fairly unique economic model is widely misunderstood. Analysts that view CRMT as a car dealer were unhappy that the second quarter's gross profit margin rate declined under pressure from extremely tight used vehicle supply even though it actually made more dollars of profit per vehicle "sold." To offset the >20% jump in used vehicle prices, CRMT extended its average loan term about 25%. Analysts that see CRMT as a lender interpreted this as compromising credit discipline to grow faster. CRMT is conservatively accounting and reserving against the possibility of default rates increasing, but with ROE nearing 30% the last few quarters it is more than adequately compensated.

PulteGroup is a homebuilder with operations throughout the U.S., but with high concentration in the Southeast and Texas. In addition to capitalizing on an overall lack of housing capacity in its target markets, Pulte has a disciplined management team and focuses on generating exceptional returns and free cash generation, a stark contrast to peers and the homebuilding industry historically. Over the last decade, U.S. housing supply has grown extremely tight, dramatically overcorrecting credit-fueled excess supply at the start of the last decade. Moreover, if inflation runs structurally higher, the nominal equity value of its portfolio of inventory land, which is leveraged via debt and options, should increase much faster than the price level and further strengthen its position relative to competitors forced to buy at prevailing prices.

TripAdvisor operates as an online travel research company and enables booking of travel-related services. The COVID-19 lockdown materially adversely affected their business in 2020, and they continue to face some lingering effects of that. On the hopes of the lockdown loosening, the stock rebounded significantly during the fourth quarter of 2020. As concerns about the Delta version of COVID-19 continued to linger, along with travel restrictions remaining in place in Europe and Asia, the stock continued its downward drift. We believe that once travel stabilizes, TripAdvisor is in a great position to benefit from the recovering demand. In addition, the subscription service launched earlier this year should augment the recovery in its core businesses.

As always, our team is available to discuss performance in greater detail, as well as the changes we have made in response to 2020. We appreciate your continued investment and confidence in our team and strategy. Wishing you and your families continued good health during this unprecedented time.

Regards,

Ballast Asset Management

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.