BALLAST
ASSET MANAGEMENT

Real World, Real Businesses, Real Values

The Ballast composite portfolio returned 4.8% net of fees for the first quarter of 2023, which compares to the Russell 2000 Value's -0.7% return and the Russell 2500 Value at 1.4%.

Performance		Yearly Returns									Annualized Returns*		
		2015**	2016	2017	2018	2019	2020	2021	2022	2023 YTD	3 Yrs	5 Yrs	Inception
Ballast Portfolio[1]	Gross	0.9%	23.8%	13.5%	-2.2%	16.1%	12.5%	41.8%	-13.3%	5.1%	29.6%	9.8%	12.0%
	Net	0.7%	22.5%	12.4%	-3.2%	15.0%	11.4%	40.4%	-14.2%	4.8%	28.4%	8.7%	10.9%
Russell 2000 Value[2]		2.9%	31.7%	7.8%	-12.8%	22.4%	4.6%	28.2%	-14.5%	-0.7%	21.0%	4.5%	7.9%
Russell 2500 Value[3]		2.8%	25.2%	10.3%	-12.4%	23.5%	4.9%	27.7%	-13.1%	1.4%	21.8%	5.6%	8.2%

*Annualized 3-Year, 5-Year and (since Inception performance start date 10/01/15) returns reported through 3/31/23
**2015 Performance from 10/01/2015 through 12/31/2015

Outlook

We believe this economic environment increasingly calls for investing in idiosyncratic risk. There are an ever-growing number of warning signs that we are in or quickly approaching an earnings recession, particularly for economically sensitive companies. Fortunately, in the small cap space, the aggregate earnings multiple offers some protection against anticipated falling earnings. Regardless, we would prefer not to sail into the wind. Over the last several quarters, we have added to an already material position in businesses that should be largely insulated from an economic slowdown, and in some cases should actually benefit. This positioning does not mean we will avoid being wrong on some of these stocks, but it should mean that those errors stem from operational missteps or other company-specific factors rather than an overall economic malaise.

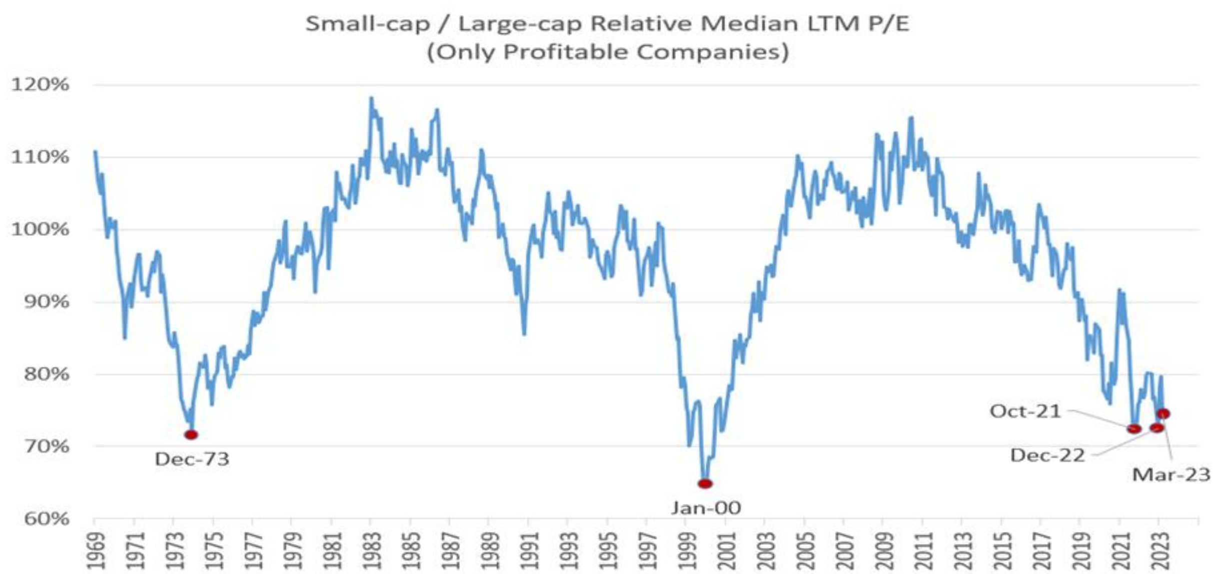
To be fair, some of our businesses will no doubt experience a headwind. However, we strive to make sure that balance sheets are impeccable, that management is dynamic and thoughtful enough to navigate rougher seas, and that specific reasons justify taking the risk of owning stocks in an economically deteriorating environment.

We also remain convicted that the quest to transition to renewable energy will be inherently inflationary to energy prices in the medium term. We own several businesses that should benefit from both sides of this – increased demand for components to build renewable energy infrastructure and higher prices for "traditional" energy commodities. In both cases we adhere to our strict valuation discipline, and in the latter case we focus on companies that fit in a couple buckets in case we are wrong:

1) Royalty businesses with extremely little/zero capital associated with production
2) Services companies with no financial leverage
3) Traditional E&Ps with hedges in place to help ensure profitability and/or rock-solid balance sheets

Why own any Small Cap Business if we are going into a recession? Great question, and one we get asked a lot. Candidly, we would not recommend owning any passive small cap funds in this environment for reasons we've written about for the last two years – indexes are full of Zombie companies that either have too much debt, do not make money or cannot reinvest in intangible assets. Lest we sound like any other active manager talking our own book, we will admit that there may absolutely be periods of time to own cheap Beta, but we remain convicted now is not that time.

With that said, there are a number of reasons we find this space particularly attractive at the moment. First, even after small cap value outperformed large cap growth last year, there remains a historically huge valuation gap. The chart below from Fury Research gives an updated picture of that. That valuation gap should provide protection for *profitable* small caps versus richly valued Growth stocks.



Source: Fury Research

In addition, many small cap companies allow for more precise risk-taking relative to multinationals. Most often we find that stems from specific products (like fire retardant used to battle an ever-growing number of wildfires, or ultrahigh-protein feed targeting aquaculture, or drought-resistant soybean and wheat seeds) that generally sell independent of which way the economic winds are blowing.

Also, small caps generally run the hardest coming out of a recession, and we believe allocators should be positioned for this eventual re-rating. When will that happen and what will be the catalyst? We have no idea. What we do know is that 1) economists determine when recessions started well after the fact and 2) the market discounts the change in direction 6-9 months prior to it happening. That makes perfect timing exceedingly difficult (if not impossible), which means we want to position for the uplift while protecting against potential downdrafts in the near-term.

Finally, this feels like the most predicted recession ever – both in terms of commentary and positioning. Cash levels amongst allocators appear exceedingly high, hedge funds have the largest net short position in the S&P 500 since the GFC, and even the Fed is now conceding that a "slight" recession this year is likely. This sentiment makes us believe we are much closer to the end of a correction than the beginning of a bear market in small caps.

Source: Bloomberg

What gives us extra confidence in our positioning? First, we have two former credit analysts on our investment team, which we believe gives us an enormous advantage in our ability to scrutinize Balance Sheets and Cash Flow. Second, each member of our investment team has over 25 years of experience doing this. We have all been punched in the proverbial mouth. During times of outsized uncertainty, we believe that experience and perspective become invaluable.

First Quarter Attribution

First quarter outperformance was driven by a combination of positioning and stock selection. A 30% underweight to Financials, along with stock selection within Technology and Healthcare were the three biggest contributors to the outperformance. Our performance within Financials was driven, in large part, by the fact that we only owned three banks heading into the SVB crisis, and our immediate sale of two of those. The strongest financial performers were Farmer Mac (AGM) and Everest Re (RE). Within Technology, Climb Global (CLMB) and Teradata (TDC) were the strongest performers, and in Healthcare Iradimed (IRMD) and UFP Technologies (UFPT) contributed most.

A combination of being overweight Materials and Energy, along with a drag from security selection in those sectors, both represented a drag on performance of nearly 100bps. Specifically, Northern Technologies (NTIC) and Perimeter Solutions (PRM) within Materials and Solaris Oilfield Service (SOI) and Siteo Royalties (STR) within Energy contributed most to the headwind. Finally, Olaplex (OLPX), a Consumer Staple, was a slight drag on performance.

Top Contributors			Bottom Detractors		
Ticker	**Name**	**Total Return**	**Ticker**	**Name**	**Total Return**
CLMB	Climb Global	70%	**CBNK**	Capital Bancorp	-29%
CVCO	CAVCO Industries	40%	**FCNCA**	First Citizens	-22%
BWA	BorgWarner	22%	**STR**	Sitio Royalties	-19%
TDC	Teradata	20%	**SOI**	Solaris Oil	-13%
AGM	Fed. Ag. Mortgage	19%	**NTIC**	Northern Technologies	-11%

Where We Are Finding Value

"Keep your eye on the ball, and hit 'em where they ain't"

— Willie Keeler, Hall of Fame baseball player

We often find value and opportunities where others are not looking. We continue to believe energy falls into this category. We also believe smaller cap value companies in general have been where "they ain't." We believe the significant and rapid shift by the Fed from Zero Interest Rate Policy (ZIRP) to a more "normal" rate environment will continue to ripple through investment allocations for years to come. Specifically, securities and companies that offer higher near-term cash flow, rather than long-duration expectations for growth.

This quarter, we added three new positions to the portfolio: Ecovyst (ECVT), Advanced Auto Parts (AAP) and Epsilon Energy (EPSN).

Ecovyst (ECVT) was a private equity roll-up of quasi specialty chemical businesses that went public in 2017, though private equity still owned most shares post-offering (70% of shares outstanding). Today, private equity is a minority shareholder (20%), and we believe Ecovyst maintains a solid business model (evidenced by its strong margins and returns) with steady revenue at an attractive valuation.

Management has been in the process of transitioning to being a more focused company, with higher margins and less cyclicality, yet the market remains skeptical. Like many of the IPOs from Private Equity sponsored businesses, most of the capital raised in the initial offering was allocated to a dividend, with little proceeds reinvested into the business, leaving the company with higher than ideal leverage at the time. Shedding lower returning/non-core businesses, along with cash generation, allowed the company to dramatically improve its leverage ratios (from Net Debt/EBITDA of 6x at their IPO to ~2.7x today).

The company has several good businesses, including a Sulfuric Acid Alkylation business and Catalyst business – both of which possess solid moats and are much less cyclical than some of the disposed business lines. The Sulfuric Acid business is in large part a contracted business with refiners who rely on Ecovyst to provide critical services and products to produce high octane gasoline, in addition to providing environmental benefits of recycling spent Sulfuric Acid (which saves the cost of disposal and is much more environmentally friendly). This provides ECVT scale to provide Sulfuric Acid to others – a business model that is not dissimilar from Air Products.

Given all the previous overhangs (balance sheet, returns, cyclicality and majority private equity owned) and the other less desirable businesses (that have now been sold), the stock trades much lower than its IPO price ($17.50 in 2017 versus ~$11.50 today). While both the business and multiple have shrunk (it traded at over 13x EBITDA at 12/31/2017 versus roughly 8.0x today), the quality of the business and balance sheet have improved significantly. EBITDA margins are now around 30% versus low to mid 20s, and ROA/ROE both more than doubled. We believe the company is now able to be much more active in returning capital to shareholders (primarily through share buybacks), which they have already started doing (bought back 16.5MM shares in 2022, or roughly 10% of the company). Our base-case Reward-to-Risk ratio at time of purchase was >5x.

Advanced Auto Parts (AAP) is a margin-driven self-help story in the very attractive aftermarket auto parts business. While its margins and sales growth have lagged peers, it also trades at a substantial discount. The company was making good progress in closing the margin gap (10% EBITDA margins in 2017 improved to 16.6% in 2021). That story stalled out in 2022 as cost pressures, supply chain challenges, misalignment of inventory and the COVID hangover impact all weighed on progress. AAP's takeover of leases from Pep Boys in California and the associated startup costs also pressured margins. As a result, the stock was cut by more than half from its peak at $244 to a low of $110 over the last year or so.

The company also switched to GAAP from "adjusted" earnings, which meant no longer making LIFO adjusts (which were material in recent years), and this caused a large drop in their margins relative to expectations. Finally, there are bad optics surrounding the "debt." Bloomberg includes lease liabilities in debt, which makes most retailers screen worse than other sectors leverage multiples, and AAP is no exception. As of the end of 2022, Bloomberg shows net debt of $3.7 BLN (including leases) versus $1 BLN in actual debt. While we recognize that leases are in fact liabilities, we do not believe it is the same as debt for three reasons. First, it is not appropriate to compare Debt with leases to EBITDA, because lease payments have already been subtracted, but debt servicing cost (interest and principal) are not. Second, someone else can take over a lease – maybe AAP would still lose money on the lease, but we believe it highly unlikely that the ultimate real liability would equal the notional value of the remaining lease terms. Third, if a store is profitable, the cost of the lease is being absorbed through operating income, not below the operating line.

We believe the number of stores where the long-term lease liability is equivalent to debt to be few and far between – it would be a store that is EBITDAR (R=Rent) negative and a location that could not be re-purposed. While AAP is not operating at the same level as its main competitors Auto Zone and O'Reilly, the business still generates decent returns and is in an attractive industry while trading at a massive discount (less than 8x EBITDA versus peers in the mid-teens). We believe that AAP has "self-help" opportunities that can close some of the margin gap (base case has EBITDA margins getting to 12% versus peers at 20%) and does not need multiple expansion to drive attractive returns (e.g., the company can continue to trade at a large discount to its peers and we have optionality on both the multiple and more significant margin improvements. Our base-case Reward-to-Risk ratio at time of purchase was >3x.

Epsilon Energy (EPSN) is a small cap, non-operating gas producer (meaning they participate in wells drilled on their leases and do not have control over the development of their assets). Its assets are in the sweet spot of the Marcellus Shale, the lowest-cost gas basin in the country. The recent sell-off in gas prices has caused the stock to trade down from its highs, resulting in almost 50% of the company's market cap being held in net cash. The company has put in place a program to buy 10% of the stock back this year after buying back 5% last year, in addition to the almost 5% dividend yield. While the non-op position leaves the company with less control, the ability to buy back stock with their cash on hand and Free Cash Flow provides an offset. Growth is a bit unpredictable, but the optionality (on gas prices and future development) is significant. The company has a rock-solid balance sheet ($45MM in net cash), providing downside support in the event of an extended and weak commodity environment. Our base-case Reward-to-Risk ratio at time of purchase was >10x.

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]Account returns are presented both gross and net of management fees. All account returns are net of transaction costs and gross of non-reclaimable withholdings taxes, if any, and reflect the reinvestment of dividends and other earnings. Monthly composite returns are calculated by weighting each account's monthly return by its relative market value. All returns are expressed in U.S. dollars. **Past performance does not guarantee future results.**

The gross performance results presented do not reflect the deduction of investment advisory fees. Actual returns will be reduced by such advisory fees and other expenses as described in the individual contract and, where applicable, Form ADV Part 2A.

Net performance results do not reflect the deduction of investment advisory fees actually charged to the accounts in the composite but do reflect the deduction of a model investment advisory fee of 1.00%, which is the maximum advisory fee rate in effect for the respective time period. Actual advisory fees may vary among clients invested in the strategy. Returns for each client will be reduced by such fees and expenses as described in the individual contract and, where applicable, in Form ADV Part 2A.

Ballast Asset Management, LP claims compliance with the Global Investment Performance Standards (GIPS®) and has been independently verified for the period October 1, 2015 through December 2020. Verification assesses whether (1) the firm has complied with all of the composite construction requirements of the GIPS Standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS Standards. The verification report is available upon request. Verification does not ensure the accuracy of any specific composite presentation. A list of composite descriptions is available upon request.

[2] The Russell 2000 Value Index measures the performance of the smallcap value segment of the U.S. equity universe. It includes those Russell 2000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years).

[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.

This presentation contains “forward-looking statements” which can be identified by the use of forward-looking terminology such as “may,” “will,” “should,” “expect,” “anticipate,” “target,” “project,” “estimate,” “intend,” “continue” or “believe” or the negatives thereof or other variations thereon or comparable terminology. Because such forward-looking statements involve risks and uncertainties, actual results of Ballast Asset Management may differ materially from any expectations, projections, market outlooks, estimates or predictions (collectively, “Predictions”) made or implicated in such forward-looking statements, and all Predictions contained herein are subject to certain assumptions. Other events which were unforeseen or otherwise not taken into account may occur; these events may significantly affect the returns or performance of any investment strategy. Any Predictions should not be construed to be indicative of the actual events which will occur.