



The Ballast composite portfolio returned -2.5% net of fees for the third quarter of 2023, which compares to the Russell 2000 Value's -3.0% return and the Russell 2500 Value at -3.7%. Year-to-date through the third quarter, Ballast returned 8.6% net of fees compared to the Russell 2000 Value's -0.5%.

Performance		Yearly Returns							Annualized Returns*		
		2017	2018	2019	2020	2021	2022	2023 YTD	3 Yrs	5 Yrs	Inception
Ballast Portfolio ¹	Gross	13.5%	-2.2%	16.1%	12.5%	41.8%	-13.3%	9.4%	19.8%	8.1%	11.8%
	Net	12.4%	-3.2%	15.0%	11.4%	40.4%	-14.2%	8.6%	18.7%	7.1%	10.7%
Russell 2000 Value ²		7.8%	-12.8%	22.4%	4.6%	28.2%	-14.5%	-0.5%	13.3%	2.6%	7.5%
Alpha		4.6%	9.6%	-7.4%	6.8%	12.2%	0.3%	8.1%	5.4%	4.5%	3.2%

*Annualized 3-Year, 5-Year and (since Inception performance start date 10/01/15) returns reported through 9/30/23

Outlook

Hope for the best, plan for the worst, and settle for whatever you get. That was a statement I remember my dad and many of his farmer/rancher peers saying a lot. I think the middle part of that sentence deserves the most focus this quarter – plan for the worst. One of the concepts in Nassim Taleb's book *Fooled by Randomness* that struck me most when I first read it over 20 years ago was how to view risk. Taleb explains that most folks are consumed with trying to determine the probability of something bad happening; comparing risk to how often an event might happen (for instance, a once in a hundred-year event). His perspective differs. He writes that rather than trying to calculate the probability of an event, one should focus on the magnitude of loss should that event happen. More eloquently said than my father, but the same idea. That idea is also the cornerstone of our investment process – quantifying the downside when we are wrong.

In times like today, when the number of global cross currents can seem overwhelming, this part of the process becomes the most important. We could write for pages on end about our opinions on inflation, government debt, global conflicts, the energy transition, the likelihood of recession, etc. That opinion would simply represent probability, not a magnitude of loss if/when we are wrong. So, we will focus on the latter, and leave the former for others to opine on.

We start with the Balance Sheet. Specifically, with the liability section (quick side note, two of our investment partners are former credit analysts). We've written before that debt represents a lack of options. This is why we avoid excessive debt like the plague – particularly for businesses with volatile/unpredictable business models (e.g., cyclicals). While debt, especially cheap debt, augments a company's return on equity (ROE) in the near term, it can become a heavy burden when the economic current turns against the business. We have written on the subject for two years now regarding the

number of Zombie businesses in existence today suffering from this (about 1/3 of the Russell 2000 Value index). We believe that chicken is coming home to roost.

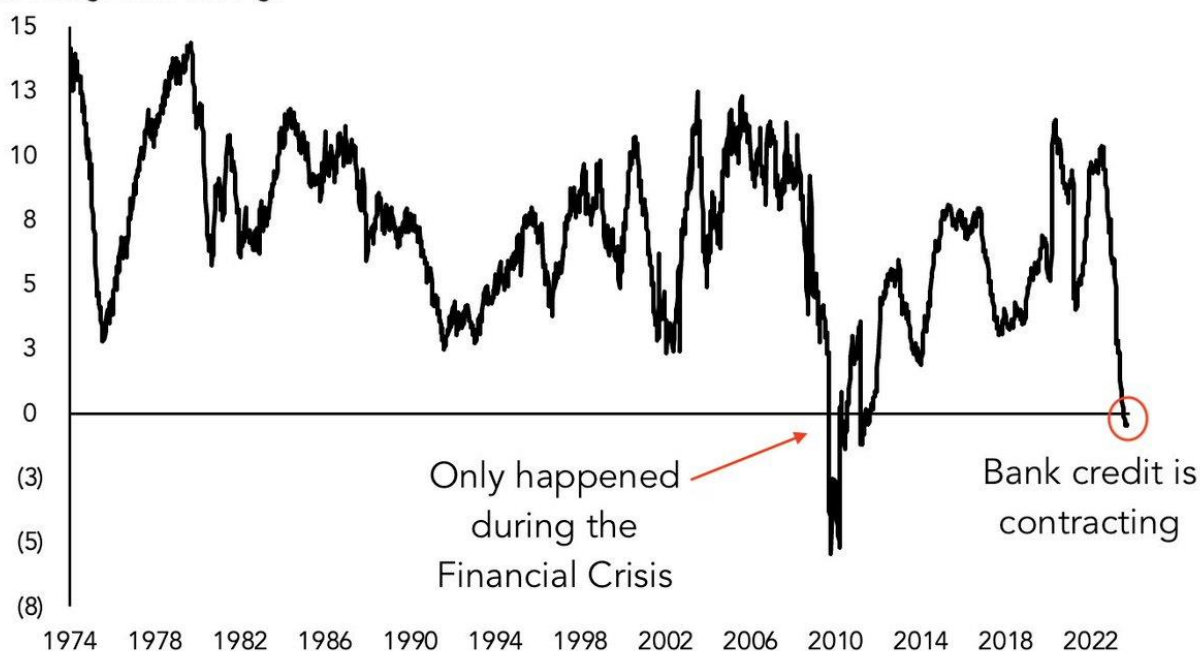
Importantly, we emphatically agree that ROE is an important metric to evaluate for a business. In fact, high returns are a requirement for inclusion in our portfolio. However, we require our business to generate high returns through *operational leverage*, not financial leverage. This is much more difficult to do. It requires skilled management teams, efficient operations, highly valued products/services and a culture with an almost religious perspective on capital allocation.

Credit Contraction is Here



Bank Credit; All Commercial Banks

% Change from Year Ago



Dates: 1974 Through 20th September 2023.
Source: Federal Reserve Board, Game of Trades.

Another fundamental part of evaluating the downside is determining whether a business is self-funding. Specifically, do they generate significant levels of cash flow (specifically, free cash flow), relative to their size and needs. This is particularly important after roughly a decade of free and cheap money. We firmly believe there are hundreds of businesses around today, simply because of that cheap money, that will not survive in a higher rate environment, especially if we go through a recession. In fairness, many businesses are not self-funding today because they are investing in projects that may have extraordinary return opportunities. The timing of higher rates and a potential recession within the next year are not their fault, but it is their problem.

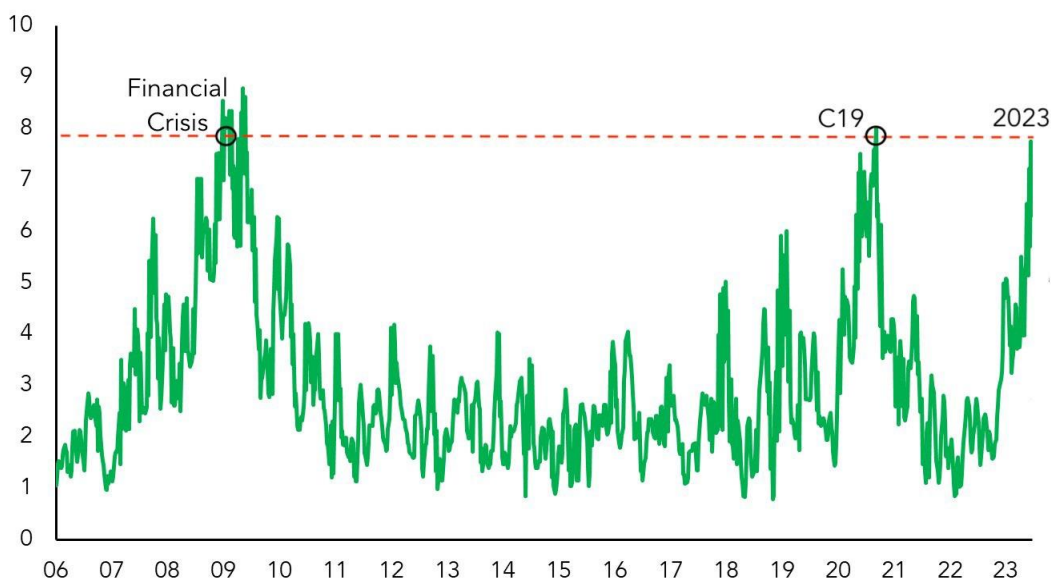
For these businesses, we believe one of two things needs to be true in order to invest in them: either that project completion needs to be imminent or they better already have all the capital they need to complete it. For the rest, we expect lots of asset purchases in the years to come at pennies on the dollar.

Investing in a Higher Interest Rate Environment

It finally feels like both the Fixed Income and Equity markets have come to grips with reality – that rates are likely to stay elevated for the foreseeable future. If that is the base case, we believe it bodes well for active management. Why? For a couple reasons. First, active managers can simply avoid many of the businesses that fit the Zombie description we wrote about above. Second, higher interest rates mean that every company’s cost of capital increases. We believe that will lead to the cream of better management’s rising to the top.

Bankruptcy Filings Moving Up in Recent Weeks

4-Week Moving Average of U.S. Bankruptcy Filings



Dates: 2006 Through June 21st 2023.

Source: Apollo, Game of Trades.

Filings are for companies with more than \$50 million in liabilities.

To illustrate, think about two sailboats racing against each other. When they sail with the wind, it is hard for the better ship and crew to truly differentiate themselves. When the ships turn and tack into the wind, that is when the superior boat and crew start pulling away. Overlaying this analogy in terms of a company’s cost of capital, similarities exist with companies. When capital is cheap/easy to obtain, nearly every capital allocation decision seems smart, even those with paltry returns. However, when the cost of capital goes up, so too does the hurdle rate on a company’s investment in order to generate a positive return. If you borrow money at/near zero interest, a 5% return on a project still looks great. If your borrowing cost goes up to 7% or even 10%, then the returns from those investments must be substantially higher, and not

every project can be improved to return more than the cost of capital. This is when the true prowess of management teams' ability to deploy capital is truly put on display, and when those companies and their respective stock prices have a better opportunity to pull away from the pack.

Finally, we believe a combination of Small Cap and Value should dramatically outperform large cap and growth in this environment. Why? Duration. This is the time for investors to start seeing significant cash flows from the businesses they own. When interest rates and the cost of capital are low, cash generation from the businesses one owns can be further out because there is less opportunity cost. When the opportunity cost goes up, the need for the company to show higher cash flows sooner does too. Furthermore, the longer the duration, the more unpredictable the outcome and the greater the risk to the probability of success. We also believe quality will be an important factor due to everything we wrote in the first sections.

The good news is that we continue to find extraordinary opportunities to invest resulting from a combination of a decade-long pullback in sell-side research coverage on small businesses, talented management teams with sensible capital allocation discipline, and volatility/dislocation of stock prices within otherwise stable/noncyclical business brought about by money flows from passive indices and broad sector allocation decisions. Each of these represents an opportunity for folks that are willing to get their hands dirty and truly dig into the underlying businesses, rather than simply evaluating the stocks that represent them. Candidly, this approach can take longer than relying strictly on quantitative analysis of financial statements or reading broadly disseminated research and opinions of others. However, over several periods throughout our nearly 20 years of managing this strategy, these are the types of environments when we believe the proverbial juice is worth the squeeze.

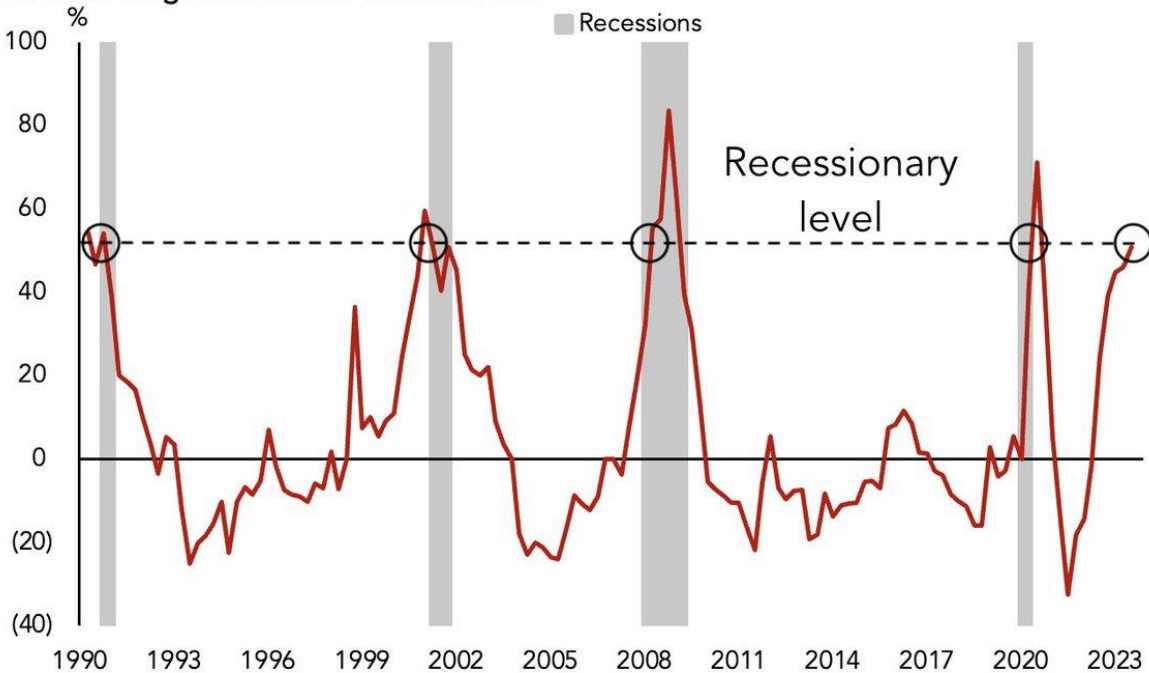
Quick Update on Regional Banks

We wrote earlier this year about banks, which now face two issues. The first is rising funding (deposit) costs pressuring their margins even as loan "growth" slows dramatically. Our concern is that we will see continued margin pressure along with lower overall loan levels (the assets), which would lead to declining earnings.

Domestic Banks Tightening Lending Standards



Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms



Dates: 1990 Through Q3 2023.

Source: Federal Reserve Board, National Bureau of Economic Research, Game of Trades.

The second risk comes in the form of traditional banking risk – credit. Of course, the magnitude of prospective losses depends on if/how deep of a recession we go into. While the Too Big to Fail banks are shrugging off funding costs (they do not have to raise deposit rates as fast because folks believe their money is safer there), they are starting to show signs of stress in credit – at least with their own fixed assets. For example, Goldman Sachs announced they wrote down their commercial real estate (CRE) exposure in office space by 50%. Guess what area has the highest exposure to CRE? Regional Banks.

In fairness, Regional Bank exposure within CRE is much broader than just office space. In fact, office space likely represents a small percentage of their loan books. However, on the same conference call Goldman mentioned that they also wrote down their non-office CRE by 15%. The KBW Regional Bank index trades at ~0.90x Book Value, which is nominally cheaper than “normal,” but after adjusting for NIM compression, leverage ratios brought about by unrecognized losses on the Held-to-Maturity investment portfolio and potentially significant credit losses on their loan books, we believe the banking story has a long way to play out before it starts to look interesting again.

Where We Are Finding Value

“Skate to where the puck is going”

—Wayne Gretzky

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, favoring 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: IPG Photonics (IPGP), Phinia Inc (PHIN) and Unit Corp (UNTC).

IPG Photonics (IPGP) is a leading developer of high-performance fiber lasers, its leading position helps leverage their integrated model to drive significant cost advantages versus their competitors. The slowdown in China and the restrictions on Russia have had a material impact on IPGP over the past few years. IPGP’s headwinds from China (China Sales were once over 40% and are now under 30%) appear to be receding as a large proportion of China lasers were used for cutting (in fact when sales were > 40% almost all lasers were used for cutting), today 2/3 of China is welding, which is a higher-value/higher-spec product with less competition. China should at minimum be less of a drag and could start growing again as the cutting business becomes almost immaterial. IPGP also did have some manufacturing operations in Russia, they have had to restructure their supply chain and increased costs associated with the restructuring is now being reflected in the financials and we believe that IPGP has optimization ahead to help lower costs from current levels. With the headwinds from China being less impactful and the supply chain restructuring in place – we believe that business will be able to return to growth and improved returns – these headwinds offered the opportunity to purchase IPGP at close to trough valuations. Notably IPGP has an overcapitalized balance sheet with over \$1 BLN in net cash (representing roughly 20% of the market cap) and will protect the downside in the event of an economic downturn. There are 3 material growth drivers for IPGP: (1) E-Mobility – which involves manufacturing processes in the battery and the motor of Electric Vehicles; (2) Light Weld – a new market, these products are 4x as productive as traditional welding and training people to use these products is relatively simple; and (3) Healthcare – this segment also has recurring/disposable revenues– right now the primary use case is for Kidney Stones and there are other applications IPGP is looking to expand. All 3 of these opportunities have better than company average margins, which should also be accretive to returns.

Phinia Inc (PHIN) was spun off from BorgWarner, which we also own, in July 2023 giving us a 30bp position. The stock initially traded at \$37 but quickly sold off into the mid-twenties where we subsequently increased the position to a more meaningful 1.5pp. BorgWarner spun the business because it is repositioning as an EV supplier and PHIN’s portfolio is centered around internal combustion engines. It has a competitive product portfolio of direct injection fuel systems, starter/alternators and electronics for both OEM and aftermarket.

Phinia looks like a buggy whip maker, but the reality is more nuanced. ICE may well be a sunset technology, but the stock was trading so cheap as to have virtually no downside on a discounted free cash flow basis even in the most optimistic EV adoption scenarios. At recent prices, the market is essentially saying PHIN has no future beyond 2028, despite its potential to generate substantial cash flows over the next 10 years or more, depending on how far and fast EVs penetrate the overall market for cars and trucks. Note that hydrogen or some other “clean fuel” extends the technological life of ICE for high-power, heavy-load, high-uptime, and off-road applications that are not amenable to electrification. CV and aftermarket already make up about 50% of sales.

Unit Corp (UNTC) is a unique small cap E&P business in that it has a drilling rig segment as well as traditional E&P. Notably UNTC emerged from bankruptcy in August of 2020. As part of the CH. 11 emergence, it was also forced to hedge a significant portion of its production (prices were low from COVID when they emerged) through 2023. Notably it did not realize the high commodity prices in 2022 and current commodity prices are significantly higher than what the company has realized. Unit also fits into the bucket of being an overcapitalized Energy business (Market Cap is approximately \$500MM while it has net cash of \$200MM = EV of \$300MM).

The Rig Segment (\$60MM + EBITDA) has high graded its Rig Fleet and now has only High Spec Rigs, where current day rates are still substantially below rates that would justify a supply response (current rates are \$33K a day versus \$50K+ a day needed to justify new builds). We believe that the underinvestment in rigs could provide a continued upward bias to rates particularly if oil prices remain above \$75. Cost to build one of their High Spec Rigs is roughly \$35MM, and their rig fleet on average is about 7.5 years old. UNTC has 14 rigs – replacement cost new for their rigs is estimated at \$490MM, which is in excess of their current EV (not given any value to oil and gas production assets). The market continues to move towards longer laterals and pad drilling which favors UNTC's High Spec Rigs.

The E&P Segment (\$100MM + EBITDA) does not have visible growth like the operators in the Permian or some of the other Shale Basins. Unit's assets are conventional Anadarko Basin production that have a relatively modest decline curve. This puts them in a good position to evaluate each prospect individually, while companies with a significant decline curve feel pressure to drill, because if they were to let their production run off the cost structure it would blow up on them and quite frankly they need all the personnel around to ramp a multi-rig development program when the cycle turns. We believe that there will be some drilling and consolidation opportunities given that Unit has roughly a 30% working interest on average in the acreage they operate that could allow for them to maintain production in a capitally efficient manner.

The company has a variable dividend policy, that said cash flow should be able to continue to support a \$10/year (20% Yield) at relatively low commodity prices and stable rig rates. At current prices the company will also likely be opportunistic in purchasing shares, particularly from converted debt holders that may be looking for an exit.

Regards,

Ballast Asset Management

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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.

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¹Account 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 US 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.

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

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