April 2021

Dear Friends and Clients,

The first quarter of 2021 saw a continuation of the strength in small/smid value stocks. As the nation recovers from the Covid induced supply shock to the economy, GDP has accelerated, yields on the 10-year treasury have risen and nascent signs of inflation have emerged. These indicators are all positives for the small cap value sector and we believe we are only at the beginning of outperformance for the space.

We are pleased with the performance of our Rewey Asset Management (RAM) small and midcap strategy versus the 16.82% return of our benchmark of the Russell 2500 Value index for 1Q21.[1,2]

Plenty of Good News for Stocks

This quarter offered many economic and administrative positives for investors to cheer in 1Q21. From a healthcare perspective, vaccination efforts moved into full stride with three approved vaccines in the U.S. and new Covid infections and related deaths dropped from post-holiday peaks. The new administration approved a new relief and stimulus package totaling $1.9 billion, which was signed into law March 11th. Additionally, the administration introduced a new infrastructure package on March 31st detailing a whopping $2.25 trillion in spending. Economic data also continued to strengthen with the Fed's Open Market Committee (FOMC) raising its forecast for 1Q21 GDP to 5.7%, vs. earlier expectations of 3.87%[3]. As states increased their cadence of reopening, employment strengthened too, with non-farm payrolls rising 916K in March 2021, the highest level since September 2020.[4]

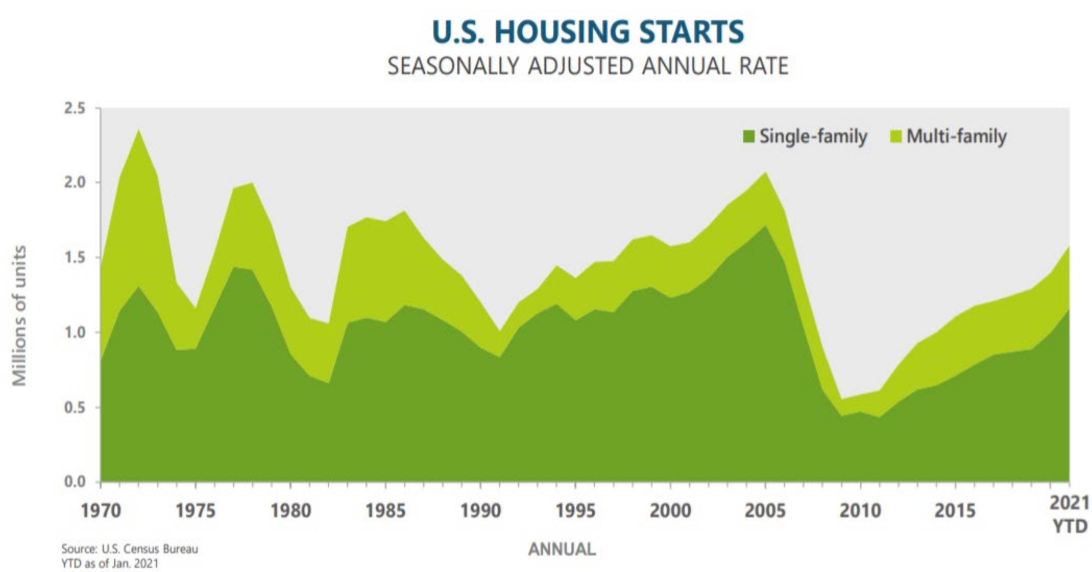
Small Cap and Value Outperforming

Economic and stimulus positives continue to support small cap and value. The Russell 2500 Value Index return of 16.82% eclipsed the 2.49% Russell 2500 Growth Index return and the 6.17% return for the S&P 500.[5] As we discussed in our market musing blogs (https://www.reweyassetmanagement.com/market-musings), rising treasury yields, embryonic inflation and signs of strengthening cyclical earnings provide a disproportionate benefit to value indices, which have a much heavier weighting in financial and industrial stocks. The yield on the 10-year Treasury rose sharply in 1Q21 from 0.91% on 12/31/20 to 1.74% on 3/31/21[6]. Manufacturing activity and prices rose, with the ISM Manufacturing Index rising to 64.7 in March, the highest level since December 1983, while the ISM Prices Paid index, a measure of inflation, rose to 86 in February and remained at a high 85.6 in March, the highest levels in over a decade.[7] Higher yields and inflation are a benefit to banks, which have been facing a flat yield curve that has pressured margins. (see https://www.reweyassetmanagement.com/post/a-boost-for-banks-in-

2021). Likewise, rising capacity utilization and higher inflation provide a dual benefit of volume and pricing power to many industrial companies. In contrast, generally higher interest rates and inflation are a negative for growth stocks that have low to negative near-term earnings levels and valuations primarily set utilizing 10-year discounted cash flow models. As the discount rate rises, the discounted value of the 10-year cash flow stream and terminal value are reduced, negatively impacting the calculated price targets.

Housing: An Example of Supply Constrained Price Inflation

We have held a bullish view on housing, and hold positions in the housing related names of Lennar Class B (LEN/B), Weyerhaeuser (WY), Interfor (ISFPF) and Eagle Materials (EXP). As seen in the chart below, housing starts are just now recovering to average levels from a multi-year downturn which began in 2005. The U.S. annualized sales rate for December 2020 was 1.32 million, and has remained strong into the new year, posting 1.04 million in February. The slight 2021 slowdown, according to builders, has been due to lack of inventory vs. lack of demand. Builders curtailed their activities into the Covid crisis in 1Q and 2Q 2020, and thus are now facing high demand with limited inventory. As a result, prices paid are rising, with CoreLogic reporting prices accelerated 11.2% year over year in January. A similar dynamic exists in the lumber market, with lumber surging to $1,009 per 1000 board feet on 3/31/21 vs. the Covid low of $278.50 on 3/31/20. Due to the strong demand, homebuilders are able to raise prices of new homes to offset these higher costs. In our view, this pocket of increasing inflation is typical of what we expect to see as the economy fully reopens from its supply shock closures, and consumers, flush with stimulus, rapidly move to resume their demand consumption patterns.[8,9,10]



Portfolio Highlights

We believe that our portfolio is very attractive from a valuation perspective. Four holdings are trading under book value, four additional holdings are trading at less than 1.5x book, and our composite portfolio is trading at an average of 1.97x book value.[11,12] It is also worth highlighting that four of our holdings have no sell-side coverage, and eight others have five or fewer covering analysts.[13] We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors, and help secure positions at attractive valuations.

At quarter-end, our cash level was at approximately 6.4%. Cash levels will fluctuate as part of our investment process, as we continue to be opportunistic to invest in new and existing positions and to harvest from those approaching our Assessed Fair Value (AFV) price targets.[14]

ABM Industries (ABM), a facilities services provider, was our top percentage gainer in the quarter. Shares rose on a strong FY1Q21 report that delivered results and guidance well ahead of expectations. When we added ABM a year ago, we liked its recurring revenue profile from cleaning and servicing buildings, schools, airports and other commercial facilities. While the post-Covid upswing in airport and airplane servicing revenue has yet deliver in full, the second part of our thesis, which was a higher and more intensive level of cleaning for buildings and schools, has delivered beyond our initial expectations. ABM's virus protection and EnhancedClean services are defining a new level of safety and cleanliness for facility reopenings. Not only do these services carry much higher margins than ABM's traditional core services, but ABM sees continuing strength in this area through at least year-end 2021. We continue to like ABM due to its cyclical re-opening leverage, its newly branded EnhancedClean momentum and its improved financial strength and debt reduction results.[15]

Kirkland Lake Gold (KL) was our top percentage detractor in the quarter. Kirkland Lake, like most gold producers, sold off in the first quarter in sympathy with lower gold prices which fell from roughly $1780 per ounce at year-end to $1600 per ounce at March 31st. Additionally, gold has become an anti-Bitcoin play for some investors. While we won't debate the merits of Bitcoin here, we see this either-or argument as spurious, as in our opinion the two asset classes are not opposites and not zero-sum. We see many positives for Kirkland Lake. The company has a defined 22-year reserve life, with further prospective upside from its properties in Canada and Australia, geographies that carry a low level of geopolitical risk. KL has a rock-solid financial profile to deliver on its growth plans from these assets, with $3.11 net cash per share, strong after-capex free cash flow ($2.69 per share in 2020 with expected growth in 2021 and 2022), and low all-in costs of $800 per ounce in 2020. Given these positives, we continued to build our position in KL on weakness through the quarter.[16,17]

Hurco Companies Inc. (HURC)

We initiated a position in Hurco Companies Incorporated (HURC), a world leader in the design, and production of interactive computer controls, software and computerized machine systems for the metal cutting and metal forming industries. We view Hurco as an overlooked small cap industrial gem that is positioned to gain share, increase earnings and drive strong cash flow as the global economy reawakens post the Covid induced recession. In our view, HURC's strong balance sheet, global exposure and brand diversity should allow for market growth and share gain on a global scale.

HURC certainly meets our first investment pillar of a strong financial profile, with a solid balance sheet, ample liquidity and solid cash flow. As of January 29th, 2021, its fiscal first quarter, the company had a net cash position of $66 million, or $10.11 per share, representing 34% of its per share price of $29.42 on that day. Additionally, HURC has no legacy environmental liabilities and no defined contribution retirement plan, but does maintain a DC (direct contribution) plan for employees. This financial strength allows Hurco to invest in software development, pursue acquisition opportunities and repurchase shares. Hurco repurchased $7 million in shares in FY20 and on 3/12/21 approved a new $7 million repurchase program, or another 3.3% of its market cap. Hurco has also paid a consistent and growing dividend since 2013, and on 3/12/21 again raised the quarterly dividend to $0.14 per share, or approximately a 1.73% yield. Last, because Hurco owns the vast majority of its intellectual property, mainly software code, in the U.S., HURC's value-added revenues and cash flows are generated in the U.S. meaning most of its cash is domiciled in the U.S. and easily accessible for investment and repurchases.

Hurco should grow revenues and expand margins in the near term as global manufacturing accelerates, and longer term from its strong global footprint. In its FY21 announcement, Hurco indicated that that sales and orders are already accelerating off of the bottom, "with all geographic regions experiencing some level of recovery." Orders were up 26%, outpacing strong revenue growth of 24%. Importantly, as the comparison is to the quarter ended 1/31/20, in our opinion, 2Q21-1Q22 should show strong comparable sales and margin growth against Covid impacted quarters. We believe revenue growth will rapidly improve margins through 2021 and into 2022, and management affirmed its opinion that the company remains well positioned to return to gross margins over 30% and operating margins over 10% in a non-recessionary post-Covid environment.

Longer term, we see Hurco's global manufacturing and sales reach enabling revenue growth and share gain from global capex growth, as well as low cost (and highly competitive) manufacturing opportunities. In 2020, 61% of Hurco's revenues were from non-U.S. locations, roughly 40% from Europe and 20% from Asia Pacific. We believe this global reach is a unique and durable advantage and especially rare for a small cap company. This footprint should allow HURC to participate in the emerging recovery in the U.S., as well as the enduring and large high-end machine tool market in Europe and rapidly growing markets in China and Asia/Pacific.

Last, HURC continues to look for global acquisition opportunities to deploy its cash position, building on its successful record of five acquisitions since 2013. Hurco's global sales, distribution and manufacturing base enables a unique ability to integrate a global based acquisition and quickly realize synergies. A unique strength of Hurco is that it has already made the capital-intensive investments in global infrastructure, and the added revenues and manufacturing density of acquisitions should allow Hurco significant cost cutting opportunities upon integration.

We see a compelling valuation opportunity in HURC shares. We have set our AFV (Appraised Fair Value) for HURC at $49, representing over 39% upside potential from 3/31 close, plus the current dividend yield of 1.7%. Our AFV is set primarily from 10x our estimate of calendar 2021 (not fiscal) EBITDA. Our AFV PT is below its all-time high of $50.50 set in May of 2018. We have taken what we consider to be a very conservative approach to HURC's recovery earnings as our FY21 estimate for EBITDA is $26.3 million, well below the peak level of $37.5 million in FY2018. We believe that HURC has the potential to grow revenues and earnings over the past 2018 highs, and thus see our price target as conservative and beatable over time. HURC's current valuation is only .99x book value, strengthening the downside protection case we see for HURC. HURC has no good-will on its balance sheet, less than $1.8 million in intangible assets and only $7.8 million, in capitalized software development costs. Thus, we see HURC's book value as very high quality.

Although not a critical part of our investment thesis, we also think HURC could be a tempting take-over candidate for numerous global machine tool manufacturers. Hurco's global footprint would overlap nicely with many larger competitors, allowing both expansion and cost consolidation opportunities. Hurco's $10.11 per share net cash position, in our opinion, is an open invitation for a take-out offer, allowing the acquirer to finance a significant portion of the target (Hurco) with its own cash. Moreover, all eight directors are only elected for 1-year terms and thus there are no staggard board take-over defenses in place, and no significant insider ownership voting blocks to thwart a transaction.[18]

Looking Forward

The small/smid value sector has continued its strong performance into 2021, and we believe this momentum should continue at least through the year. We have maintained our view that the Covid recession is a supply constrained slowdown vs. a demand driven recession, and that recovery should come quickly once a vaccine became available. While we have seen this scenario begin to play out as we envisioned, we think small and mid-caps should continue to show positive performance.

In our view small and mid-cap value stocks have lagged the broader averages since the advent of QE1 (Quantitative Easing phase 1) in 2009, as surging liquidity and consistently falling interest rates are a greater benefit to growth stocks, especially those with low or negative earnings. The massive liquidity injections by the Fed and Congress over the last 10-years have allowed weak cash flow and speculative companies ready access to financing options. Moreover, this easy liquidity has mitigated investor concerns regarding downside protection, as easy money equity and debt financings were readily available. We think downside protection weighed vs. upside potential should always matter to investors.

As we enter the 10th year of continued Fed driven liquidity, we see the end to this easy money paradigm now in sight, due to surging Federal deficits and incipient inflation that in our view, will continue to grow. We believe a Fed tightening and liquidity withdrawal is a question of when, not if. As always, we recommend investors look forward and adjust to these developments now, vs. chasing the herd of investors when these changes gain widespread attention. We think higher rates and moderate inflation will significantly benefit small/smid value equities, and believe prognostications of the value rotation ending already, with a shift back to growth, are mistaken.

Thank you for your continued trust and support. Stay safe and healthy. Please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

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1 ASN prohibits advertising of strategy returns to non-clients. Please contact us to discuss in more detail.
2 Russell 2500 Value Index performance levels are sourced from Bloomberg. The Russell 2500 Value index is an unmanaged group of securities considered to be representative of the small and mid-cap stock market in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.
3 GDP 1Q21 expectations from U.S. Federal Reserve Federal Open Market Committee (FOMC) forecast.
4 Change in non-farm payrolls from U.S. Bureau of Labor Statistics report released 4/2/2021.
5 Russell 2500 Value and Growth Index performance, and S&P 500 Index performance levels are sourced from Bloomberg. The Russell 2500 Value and Growth indices, and the S&P 500 indices are an unmanaged group of securities considered to be representative of the small and mid-cap stock market, and large cap market respectively, in general. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index.

6 U.S. 10-Year Treasury Yield Information sourced from Bloomberg.
7 ISM Manufacturing and Prices Paid reports sourced from the Institute for Supply Management as reported by Bloomberg.
8 U.S New Privately Owned Housing Unit seasonally adjusted data source from the U.S. Census Bureau, via Bloomberg.
9 U.S. single family housing pricing sourced from S&P Core Logic Case-Schiller Index as reported by Bloomberg.
10 Random Lengths Lumber Futures as quoted on the Chicago Mercantile Exchange, reported by Bloomberg.
11,14 All portfolio discussion is based off our model portfolio. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes and names held.
12 Book value portfolio estimates exclude Graftech International, due to a negative equity position that would distort the comparison by lowering the value of the portfolio multiple.
13 Covering active sell-side analyst data sourced from Bloomberg.
15 ABM quarterly performance information sourced from Black Diamond/ASN performance reports. Other ABM commentary sourced from company 10Q, 10K filings and company presentations and Rewey Asset Management proprietary analysis.
16 KL quarterly performance information sourced from Black Diamond/ASN performance reports. KL corporate and financial information, including dividend announcement information from KL Quarterly and Annual Filings, company press releases, company presentation materials, company website and Rewey Asset Management proprietary analysis.
17 Gold price per ounce information sourced from Bloomberg quotes on SPDR Gold Shares (U.S.).
18 All financial ratios, statistics, and projections discussed in the Hurco Companies Inc. (HURC) commentary are sourced from HURC's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, HURC company webpage, RAM discussions with HURC management and Rewey Asset Management proprietary financial analysis. Historical share price information sourced from Bloomberg.