July 2021

Dear Friends and Clients,

The second quarter of 2021 saw a continuation of the year-to-date rally in value stocks, albeit slightly below the performance of the growth style. In 2Q21 the Russell 2500 value index gained 5.00% and the Russell 2500 growth index gained 6.04%. We believe value is still in the early innings of a sustainable recovery versus growth styles. On year-to-date basis, the Russell 2500 value index has returned 22.66% vs. 8.67% for the Russell 2500 growth index. Despite the slight underperformance of the value style in 2Q21, we are pleased with the performance of our Rewey Asset Management (RAM) small and midcap strategy versus the return of the Russell 2500 value index for the first half of the year.[1,2]

As the nation's economy recovers and reopens from the Covid induced supply shock, GDP has continued to accelerate, the Federal Reserve remains in an unprecedented stimulative mode, and the government continues to pass leglislation aimed at rapidly growing the economy. These factors are are all positives for the small/mid cap value sector.

America Re-Awakens

The Covid pandemic brought about an economic supply shock that was inherently different than other economic downcycles that were caused by weakening consumer demand. Mandated business shutdowns caused many goods and services from toilet paper to hair cuts to be immediately out of stock, despite continued strong demand. As many Covid restrictions were lifted, commerce accelerated dramatically, with surging demand in goods and services, particularly housing and air travel. Notably, on July 2, the Transportation Security Administration screened 2.2 million air travelers, exceeding pre-pandemic levels of 2019 for the first time.[3]

Economic data shows the U.S. economy is powering forward. 1Q21 GDP surged to 6.6%, U.S. vehicle sales posted an 18.51 million annual selling rate in April and pending home sales surged 8.0% in May. The surge in non farm payrolls of 850 thousand in June show that Americans are going back to work at an increasing pace.[4,5,6]

Stronger Growth = Higher Inflation

Acknowledging the quickening recovery, the Federal Reserve raised its 2021 real GDP growth projection from 6.5% to 7.0% at its June meeting. This torrid pace of activity is leading to out-of-stock supply shortages and driving inflation higher. June auto sales moderated to a 15.36 million pace as automakers could not secure critical parts, primarily microchips, and were forced to idle production lines. Housing starts too flattened to 1.57 million in May, as shortages from lumber to labor inhibited building activity.

With supply constrained, prices are rising. Year over year CPI was reported at 5% for May, the highest level since 2008, while U.S. Y/Y PPI was a scorching 6.6% for May. Hourly earnings soared to up 3.6% year over year in June.[7-12]

Our Outlook for Value Outperformance is Not Transitory

As we discuss in our Market Musing blog, "The Fed Taper: When Not If" https://www.reweyassetmanagement.com/post/the-fed-taper-when-not-if, we believe rising inflation and surging government debt levels will push the Fed to cut back its bond buying activity and raise interest rates sooner than it forecasts. In summary, the Fed is buying $120 billion in bonds per month, its balance sheet has surged to $8 trillion from $800 million in 2009, and the U.S. Federal Debt has soared to $28.2 trillion. Further, the projected deficit of $2.3 trillion for 2021 would only add to this debt mountain.

We find it hard to envision a long-term scenario where skyrocketing U.S. debt and building credit market dislocations will not drive-up interest rates to attract buyers of U.S. treasuries, or a scenario where inflation rapidly cools while the Fed continues to pump stimulus into the accelerating economic recovery. Moreover, we believe as inflation continues to rise, the Fed will face increasing political pressure to act, as the negative tax-like impact of inflation hits lower income Americans the hardest.

Portfolio Highlights

We believe our portfolio is both well positioned against rising inflation and very attractive from a valuation perspective. Four holdings are trading under book value, six additional holdings are trading at less than 1.6x book, and our composite portfolio is trading at an average of 1.97x book value.[13] It is also worth highlighting that three of our holdings have no sell-side coverage, and ten others have five or fewer covering analysts.[14] 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 4.3%. 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.[15]

Mayville Engineering Co., Inc., (MEC) was our top performing stock in 2Q21. MEC is a $400 million market cap industrial company based in Mayville, WI, specializing in metal fabrication and prototyping. We see MEC as an undiscoverd gem, with strong leverage to an industrial recovery and 65% employee ownership through an ESOP structure. Shares rose in the quarter post a strong 1Q21 result. MEC saw record sales and net income, and a raised its outlook for full-year 2021 results. Additionally, MEC announced a strategic relationship with a new customer in the fitness industry. The initial three year agreement will have MEC investing around $40 million of capital for a new plant in Michigan and hire 300 employees. This investment not only opens up a new vertical in the fitness industry for MEC, but is projected to produce a 3-year return on investment of 30%. Despite the strong performance in the quarter, we continue to see good upside returns for MEC as the economic recovery continues.[16]

ABM industries which was our top performer in 1Q21, pulled back modestly and was our largest detractor in 2Q21. ABM is a $2.9 billion facilities servcing contractor, serving diverse industries including schools, offices and airports. We are a little confounded with the pull back, as most of the weakness was post their FY2Q21 earnings result on June 8th, where the company posted strong operating income growth across its industry verticles, raised its EPS targets for 2021 for the second time this year, dramatically improved its debt/ebitda ratio to 1.7x from 3.7x a year ago, gave an upbeat management summary for the remainder of the year and repurchased its own stock for the first time since 1Q20. We think ABM will continue to benefit from renewed economic activity in 2021, particularly in its Aviation segment which is 11% of revenues and from enhanced Covid related cleaning protcols that will likely continue into future contracts on a recurring basis. We did increase our holdings of ABM on this share price weakness, after trimming near record price levels earlier in the year.[17]

Still Finding Ideas

We have had a few clients ask us if we are still able to find new companies in which to invest, given the strong year over year moves in the market. Our answer is definitively yes, mainly because we don't own the market. Given our concentrated focus and what we believe to be over 4600 publicly traded companies in our potential universe, we believe there are always attractive ideas for investment. It is our job to do the work and find them. Even if the broader averages are strong, underlying stock specific volatility can create purchase opportunities for individual companies. Indeed, our WIP (work-in-process) list remains full as we enter 3Q21.[18]

Moreover, quite often our good ideas get better on their own, as we believe is the case for Weyerhauser (WY), one of our largest holdings. On June 21, JP Morgan Asset Management acquired Campbell Global, which owns 1.7 million timber acres globally to initiate a position in the carbon offset market, which pays timberholders cash for the carbon capture activity associated with growing trees. Essentially, firms will pay tree holders for carbon credit in their quest to become carbon neutral. While we ascribe no value to carbon offset markets in our valuation target for WY, we note it owns 11 million acres of timberland in the U.S. and will likely emerge as a leader any carbon capture market. As WY already owns these trees, the incremental margin on this business will essentially be 100%.[19,20]

In 2Q21 we added three new ideas (we describe Heritage Insurance below), and we sold two names to zero, as our price targets were reached and we did not see a further attractive risk vs. reward tradeoff in the positions. Moreover, we bought an additional name, Ferro Corp. (FOE) on April 29 and sold it to zero on May 11th, as the company was acquired for cash and we do not believe there will be competing offers. From our perspective, despite our 28.6% gain, we view this transaction as more of a take-away vs. a take-out, since we had only built the postion to an initial 1.5%.[21]

Heritage Insurance Holdings, Inc. (HRTG)

In the second quarter, we initiated a position in Heritage Insurance Holdings, Inc. (HRTG), a $241 million market cap property and casualty insurance underwriter based in Clearwater, FL. Heritage writes residential policies in 16 states, and commercial policies in Florida, New York and New Jersey. We see Heritage as an undiscovered gem, with a strong balance sheet, a consistent track record of revenue growth and a book value compound average growth rate (CAGR) of nearly 12% over the last 5-years.

We were presented with the opportunity to purchase Heritage as its shares sold off sharply from its 52-week high of $14.05 to our average purchase cost of $8.48 per share, approximately 55% of 1Q21 book value. Shares were pressured by a 1Q21 earnings report that showed a much higher than normal loss provision. This provision was driven several small storms that aggregated to $10 million in claims but did not hit HRTG's reinsurance layers individually. Additionally, HRTG is still dealing with illegitimate claims for roof repairs in the Florida market, which have plagued the industry.

We do not believe the small individual claims of 1Q21 are an underwriting issue, and believe investor negativity around this loss is overdone. Also, FL's legislature has passed reforms to combat fraudulent claim activity. Effective July 1, 2021, contractors can no longer solicit damage claims from homeowners with gifts, and lawyers are no longer mandatorily reimbursed 100% of legal fees for disputed claims. Proactively, HRTG has aggressively raised premium rates in FL, like most other FL underwriters, and it has aggressively cut back its exposure to the three counties that account for most of these suspect claims. With actions to cut exposure, raise rates and limit fraudulent claims activity, we think the future negative financial impact to Heritage of this activity will be greatly diminished.

Looking forward, we believe Heritage fits all three of our investment criteria very well. It has a very strong financial profile. Since 2017, it has lowered its debt to total capital level from 35% to 22%. It has an investment grade rating from Kroll, and has net cash of $283 million, versus its June 30th market capitalization of $240 million. Impressively, Heritage's 5-year book value growth CAGR of nearly 12% is after the impact of an annual dividend of $0.24 (2.8% 6/30/21 yield) and consistent share repurchases (930 thousand shares for $10 million in 2020). Excluding HRTG's cumulative share repurchases of $75.3

million since 2016, its trailing 5-year book value growth CAGR would be almost 15.2%! In 4Q20, HRTG's board increased its repurchase authorization to $50 million.

We see strong potential for revenue and earnings growth in HRTG, driven by rate increases and both organic and acquired geographic growth. From its roots as a FL only personal residential insurer, HRTG has rapidly expanded its writing to 16 states. In 2016 it acquired Zephyr insurance (Hawaii). In 2017 acquired NBIC (NY, NJ, CT, RI & MA). It has also expanded organically in 9 other states, primarily on the east coast plus California. Florida now represents only 31% of insured value and 52% of premiums in force. Heritage has a strong distribution network of over 3000 independent agents, plus partnerships with larger diversified insurance companies including Liberty Mutual, GEICO and The Hartford. Policy growth was over 10% in 1Q21. HRTG, like other FL writers, has the ability to acquire policies from FL Citizens (the default state provider) at its discretion, which could allow for incremental policy growth. Additionally, HRTG is aggressively raising prices, as are peers in a hardening pricing market. In 1Q21, HRTG's FL prices rose 14%, and HRTG expects to raise rates in all states in 2021. Anecdotally, we have heard of 40%-100% industry price hikes in FL and double-digit price hikes in other states, as the residential insurance market appears to be rapidly hardening.

From a valuation standpoint, we find Heritage compelling. We think the 1Q21 sell-off was an over-reaction to an asynchronous loss event that should not repeat. Given HRTG's strong financial profile, this loss was only an earnings event, and not an event that challenged its capital position. At 6/30/21's closing price of $8.58, HRTG was trading at 56% of book value, substantially below its 3 closet peers trading between .68x and .95x book. Heritage has the financial strength to continue to pay its $0.24 dividend (2.8% yield) and execute on its $50 million share repurchase program, and/or continue to pursue acquisition opportunities. We have set our AFV price target at $13, approximately 85% of book value and just over 11x expected 2022 earnings, which represents 51.5% upside from 2Q21 closing levels. We view this price target as conservative, given HRTG's past record of profitable growth and shareholder friendly repurchases and acquisitions.

Although it is not part of our investment case, we see HRTG as activist/take-over vulnerable. The strength of HRTG's platform and substantially discounted share value is likely to attract attention of larger and growth hungry competitors. As the 4th largest FL writer, and 19th largest writer nationally, HRTG could easily make a nice bolt on acquisition. Although we see management as capable and aligned with holders, owning 9% of the shares outstanding, we do not see this holding level as enough to block a takeover attempt. Indeed, on 7/1/21, Bloomberg ranked HRTG as the 12th most likely company it sees as drawing activist interest over the next twelve months.[22,23]

Looking Forward

The small/smid value sector continued its healthy performance in 2Q21, and we believe this momentum should continue at least through the year. The strengthening economic recovery, continued Fed and government stimulus and burgeoning inflation all favor the small/smid value sector at a macro level. Additionally, we believe our concentrated portfolio of companies presents compelling valuation opportunities with identified investment mileposts and catalysts that should help to increase per share valuations over our three to five year investment horizon.

While many market strategists have opined that the outperformance of small and value vs. large and growth has played out and will now moderate or even reverse, we believe this view is mistaken. The structural paradigm of economic growth and government stimulus remain in place. Over the next few months, the economy is highly likely to strengthen and at some point we believe treasury rates will have to rise due to the dual impact of inflation and surging debt levels. Most importantly, we do not need to be exactly right on when this will happen. Time is our ally, and to us the question is when will rates increase, not if. We like the set up of risking time instead of capital, and we see the potential return profile of our portfolio heavily skewed to the upside vs. downside risk level.

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.

-Chip

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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 TSA Spokesperson Lisa Farbstein, via Twitter 7/3/2021

4 US Q/Q GDP growth rate for 1Q21 sourced from the U.S. Bureau of Economic Analysis

5,8 U.S. SAAR monthly auto sales rates sourced from Wards Automotive

6 Change in June non-farm payrolls from U.S. Bureau of Labor Statistics

7 Fed GDP outlook sourced from Fed June 2021 Summary of Economic Projections https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20210616.pdf

9 May Housing Starts sourced from U.S. Census Bureau

10 U.S. CPI Urban Consumers year-over-year reported by Bureau of Labor Statistics

11 U.S. PPI Final Demand Y/Y SA reported by Bureau of Labor Statistics, both source via Bloomberg.
12 June Average Hourly Earnings sourced from US Bureau of Labor Statistics
13, 15 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. 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.
14 Covering active sell-side analyst data sourced from Bloomberg.
16 MEC quarterly performance information sourced from Black Diamond/ASN performance reports. Other MEC commentary sourced from company earnings releases, 10Q, 10K filings and company presentations and Rewey Asset Management proprietary analysis.
17 ABM quarterly performance information sourced from Black Diamond/ASN performance reports. Other ABM commentary sourced from company earnings releases, 10Q, 10K filings and company presentations and Rewey Asset Management proprietary analysis.
18 Rewey Asset Management proprietary analysis estimates over 4600 companies with market capitalization between $100 million and $10 billion, as sourced from Bloomberg screen and discussed in our RAM investor presentation.
19 WY comments sourced from company presentations and Rewey Asset Management proprietary analysis.
20 JPM purchase of Campbell Global comments sourced from 6/21 press release https://www.prnewswire.com/news-releases/jp-morgan-asset-management-acquires-campbell-global-a-leading-player-in-forest-management-and-timberland-investing-301316396.html
21 FOE commentary sourced from Black Diamond/ASN performance reports and company 5/11/21 press release https://www.businesswire.com/news/home/20210511005674/en/Ferro-Corporation-to-Be-Acquired-by-Prince-International-Corporation-for-22.00-Per-Share-in-2.1-Billion-All-cash-Transaction-Reports-First-Quarter-Results
22 All financial ratios, statistics, and projections discussed in the Heritage Insurance (HRTG) commentary are sourced from HRTG's 10-K and 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, HRTG company webpage, RAM discussions with HRTG management and Rewey Asset Management proprietary financial analysis and Rewey Asset Management industry due diligence. Historical share price information sourced from Bloomberg.
23 Bloomberg activist article 7/1/21 sourced from paid Bloomberg subscription. Public link to article requires a subscription https://news.bloomberglaw.com/esg/geo-group-pg-e-rank-highest-in-bloomberg-activism-model?utm_source=rss&utm_medium=CTNW&utm_campaign=0000017a-654e-d0db-abfe-fd6fbf2a0002

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