NorthPointe Capital
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NorthPointe Capital, LLC
Small Cap Value
3Q2017

General Market Commentary for the Third Quarter of 2017

Continuing the trend seen in the previous quarter, most broad stock market indices traded in a tight range during the first two months of the third quarter. Markets then rallied in September to end the quarter at or near all-time highs. Small cap stocks were slightly more volatile, as the Russell 2000® Index experienced a modest correction in the first half of August before advancing nearly 10% to outperform the large cap indices. Investor sentiment remains strong. The hurricanes in Texas and Florida did little to sour investment returns; indeed, stocks staged a "hurricane relief" rally when the storms did not inflict as much damage as was earlier feared. Investors drove markets higher on potential tax reform while seemingly paying no attention to missiles launched out of North Korea. It continues to be a momentum driven market, with little attention being paid to valuation, and a lot of attention on earnings and price momentum. It is beginning to feel eerily reminiscent of the 1998-2000 Dot.com bubble. This time it is darling tech and Biotech stocks leading the way. History has a way of repeating itself so many investors are starting to look at the markets from the post Dot.com period to anticipate new market leadership. Value investing may soon become the tour de force.

Small Cap stocks outperformed large caps as the Russell 2000® Index gained 5.67% compared to the 4.48% gain in the Russell 1000® Index. Growth stocks continued their outperformance of value stocks due to the high weight of Biotech and Emerging Pharma stocks. Additionally, the Industrial and Financials sectors within the value index had a lower return than the corresponding sectors in the growth index.

Portfolio Commentary

For the quarter ending September 29, 2017, your NorthPointe Small Cap Value portfolio was up 1.00% versus a return of 5.11% for the Russell 2000 Value® Index. Despite a difficult period, the strategy, over time, has proven to have performance resiliency, and we are confident that the portfolio is poised to respond appropriately.

The lackluster performance for the quarter was primarily driven by two main factors. The first factor, and most important one is that stock selection was negatively impacted across the board by what we feel is a very narrow market driven only by what has near-term earnings, growth and price momentum. It's a short-term focused market, one we have seen before. The momentum to the downside was even more pronounced for companies that did not meet the overall market expectations or reported disappointing short-term news. This was the case in Financials with names like Meta Financial (CASH) which announced they had lost a large customer in H&R Block. By the beginning of the fourth quarter, the company announced they had largely replaced the business with new customers, but the third quarter damage was done. We also had disappointing news from Bank of the Ozarks (OZRK) who lost their head of Real Estate Lending, which is their largest contributor to loan growth and profitability. As a result, we sold the remaining holdings of both CASH and OZRK due to our investment thesis being severely constrained.

Secondly, the best absolute performing sector for the quarter once again was Healthcare, yet, our stocks did not keep pace with the performance of the group. Specifically, Capital Senior Living (CSU) was down 17% in the quarter due to near-term occupancy issues, exacerbated by hurricane Harvey. We believe the underlying real estate is worth 25-50% more than the current stock price, and this has been cited in the past from activist investors as a reason for their holdings. Our confidence remains high with a majority of the portfolio as these businesses continues to execute and meet our expectations. To be sure, we had plenty of winners in the portfolio, but typically our top ten performers outperform our bottom ten by a wide margin. This was not the case in the third quarter. The momentum to the downside was even more pronounced for companies that did not meet the overall market expectations.

Flotek (FTK) is a company that disappointed in the third quarter, but where we believe the stock price move was an overreaction to the representative value. After a good start to the year, completions activity in the second quarter was slow and FTK's largest customer, Pioneer Resources, had significant delays in the completions for the quarter. Given Flotek's geographical exposure, Hurricane Harvey and Irma did not help in the third quarter and it led to FTK being one of the worst performers. The valuation on the company is ridiculously cheap, trading at less than 5X EV/EBITDA. We expect to be patient on the recovery as the last three quarter have seen sequential revenue improvements for the company. We are confident EBITDA will improve and will serve as a catalyst to the stock.

Another significant detractor in the third quarter was Neophotonics (NPTN). The company has equity of $215 million and debt of only $10 million. They have $79 million of cash on the balance sheet, and their products have been touted as best-in-class for the 100G network build throughout the world. China represents 50% of the company's revenues and China has been going through an inventory correction. Now that it seems that inventory is back at normal levels while some would argue below normal levels, orders are starting to flow from the government to NPTN's customers. We expect 2018 will be a bright recovery year. The stock trades at .5X revenues, a historic low for any tech company that is not financially distressed. NPTN represents tremendous value waiting to be unlocked.

One of the stocks that did not meet our thesis, and has subsequently been sold, is Team Inc (TISI). Team specializes in maintenance services principally to the energy and chemical refining sector. Last year, the company completed and acquisition of Furmanite which operated in the same arena as Team, but with a complimentary suite of services that Team found attractive. In addition, Furmanite had been an industry disruptor, often competing more on price than reliability and service excellence. Team understood there were significant cost-saving opportunities for the combined entity and the opportunity to enhance the value proposition by bundling the sales opportunity. We expected that the refineries, which had delayed this necessary maintenance capex due to the energy downturn, would return in the second half of 2017 to a more normal maintenance schedule. This did not materialize, despite the uptick in refining profitability and growth. But more importantly, the company announced a large restructuring in the third quarter, signaling to us that our thesis was incorrect and that a long workout lay ahead for the company. We have moved on according to our discipline and process.

Portfolio Positioning

From our perspective, the portfolio has rarely been better positioned to outperform than it is today. On 2018 earnings, the portfolio trades at 14.1x earnings versus 16.7x for the Russell 2000 Value® Index. In addition, the portfolio, as it traditionally has, is expected to grow in line with the index, but has had better historical growth and profitability than the index. Finally, the debt load of our portfolio is in line with the overall debt load of the market, signaling we are not leveraging the portfolio for returns. In short, we love the portfolio today.

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As we have discussed before, in a rising rate environment, an increasing discount rate on our DCF model is most punishing to those companies whose earnings are well off into the future. Currently, on average, only 20% of our individual valuation targets come from the net present value of future growth. In other words, that means that, on average, 80% of the upside we see in the stocks is based off the net present value of the current assets and return on invested capital. While the market may from time to time shift in its preference for high growth vs stability of current cash flows, we are confident over time that the companies we own are generating substantial shareholder value from their current position in the market. In addition, we believe that our companies can reinvest in their existing businesses with similar returns without having to look elsewhere to reinvest their cash flows.

It has been a tough year, both in relative and absolute returns, but in our twenty-five-year history of managing portfolios, we have learned three important lessons, all related to the process we have deployed over that time-frame. Tough performance periods require these actions:

- Adhere to the Sell Discipline - Sell the Losers when the thesis is broken (removing dead weight) and re-evaluate when stocks approach their targets.
- Reaffirm the Intact-Thesis, under-performing stocks to either gain conviction, have patience or move on.
- Buy Fresh, New Names to Reinvigorate Performance (allocate capital to timely, catalyst driven stocks with value).

We have been following this discipline all year, and especially in the third quarter. While difficult markets can last longer than we think, we also believe in our process and our understanding of intrinsic value over time. We expect, solid performance results will follow and have no reason to expect otherwise.

Sincerely yours,

Jeffrey C. Petherick, CFA
Partner

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The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.