

Opportunities in Micro Cap

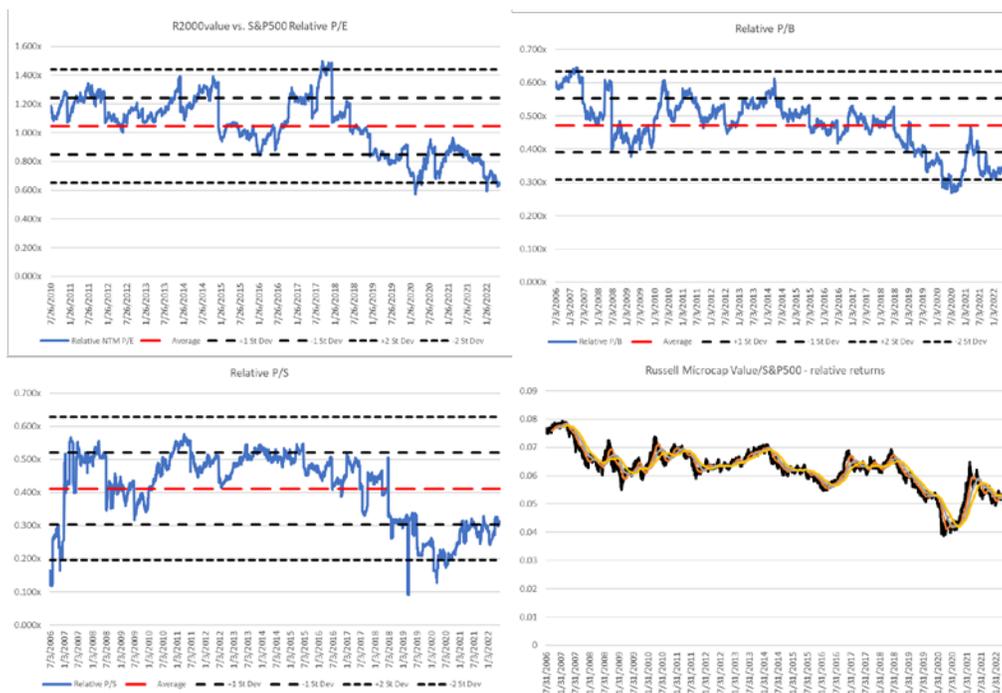
Looking across U.S. indices, we believe today's market is primed to see micro cap value equities outperform relative to growth and large cap peers. Why? First, on a relative basis, micro cap value stocks are trading near historically low levels – levels that typically precede periods of relative outperformance for micro cap value. Second, and despite the valuation discount, relative fundamentals for micro cap value stocks have improved versus their larger peers and consensus expectations for micro cap stocks are well below those built in for the large caps. Lastly, balance sheets have strengthened significantly for all market cap segmentations though on a relative basis, we believe micro cap value stocks have improved much more than their large cap peers.

Valuations Favor Micro Cap Value

The relative valuation between micro cap value stocks and the S&P is at historically low levels.

Relative to the S&P 500 (“the market”), micro cap (and small cap) value stocks are trading near historically low levels when looking at (1) price-to-earnings (P/E), (2) price-to-book (P/B), and (3) price-to-sales ratios (P/S). Typically, such large valuation discrepancies precede periods of good relative returns for small & micro cap value stocks vs. the market. Recognizing valuation multiples are an imperfect method for comparing assets, earnings, and growth in earnings/FCF, when the three relative multiples below are near historically low levels, we believe the odds are tipped in favor of small cap value.

Anecdotally, the price-to-book ratio comparison appears to be one of the better indicators for pinpointing relative value between small cap value stocks and the market. Historically, overweighting small cap value stocks when the relative P/B ratio was below average (~0.4x) and inflecting has led to periods of positive relative returns – and today appears to be one of those periods.



Source: Bloomberg; Monarch Partners Asset Management

Additional food for thought on valuation across the market: *that last two times the 10-year treasury yield was >3% the Russell 2000 value index was trading at a higher NTM P/E multiple while the Russell 2000 Growth index, the S&P 500 index, and the Nasdaq Composite were trading at multiples meaningfully below current levels. (see below)*

Russell 2000 Value Index NTM P/E vs. 10-year Treasury Yield...

- Today (June 15, 2022) trading at 13.3x NTM EPS estimates
- In October 2018 the index was trading at 14.9x NTM EPS estimates
- And, in December 2013, the index was trading at 19.3x NTM EPS estimates



Source: Bloomberg; Monarch Partners Asset Management

Russell 2000 Growth Index NTM P/E vs. 10-year Treasury Yield...

- Today (June 15, 2022), the small cap growth index is trading at 31.1x NTM EPS estimates
- In October 2018 the index was trading at 31.7x NTM EPS estimates
- And, in December 2013, the index was trading at 27.9x NTM EPS estimates



Source: Bloomberg; Monarch Partners Asset Management

S&P500 NTM P/E vs. 10-year Treasury Yield...

- Today (June 15, 2022), the S&P is trading at 17.3x NTM EPS estimates
- In October 2018 the index was trading at 15.5x NTM EPS estimates
- And, in December 2013, the index was trading at 15.5x NTM EPS estimates



Source: Bloomberg; Monarch Partners Asset Management

Nasdaq Composite NTM P/E vs. 10-year Treasury Yield...

- Today (June 15, 2022), the Nasdaq is trading at 23.2x NTM EPS estimates
- In October 2018, the index was trading at 19.6x NTM EPS estimates
- And, in December 2013, the index was trading at 20.2x NTM EPS estimates



Source: Bloomberg; Monarch Partners Asset Management

Today valuations for micro cap and small cap value stocks are the cheapest they've been in a long time. Typically, this bodes well for future relative returns.

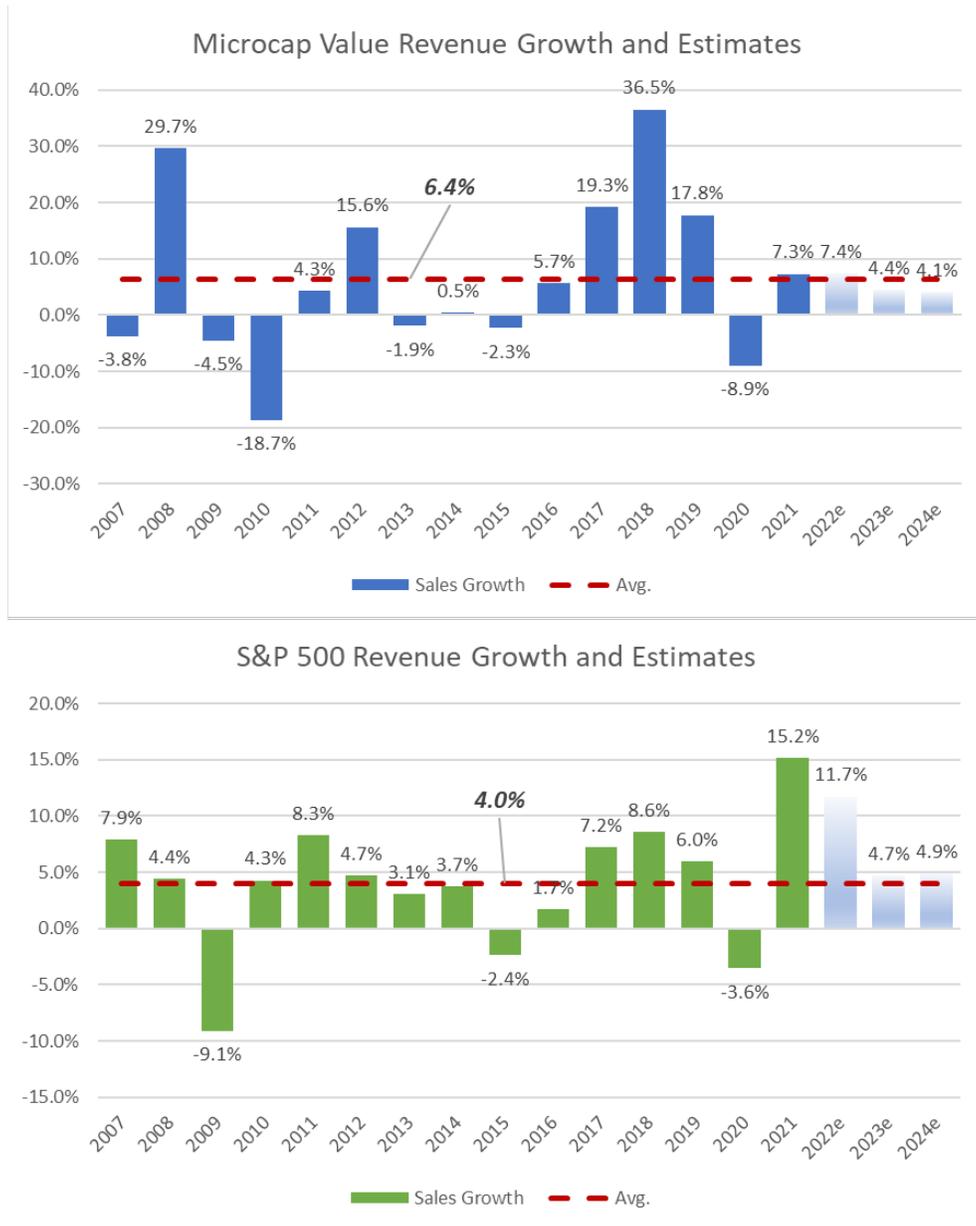
Income Statement Comparison

Valuation is just one of the factors we look at when evaluating the relative attractiveness of one set of equities versus another. It's also important for us to evaluate whether companies are over- or under-earning relative to history and what consensus expectations look like relative to our expectations.

Since before the 2008-2009 Financial Crisis, micro cap value stocks have, unsurprisingly, generated better sales growth, on average, when compared to the S&P 500. From 2007 through 2021 micro cap value sales grew, on average, 6.4% vs. the S&P500 at 4.0%. This makes sense as smaller companies with lower base sales levels have more opportunity to grow above GDP. Conversely, the S&P 500 – given the maturity of the companies that make up the index – will be, over time, much closer to GDP growth. Over a cycle, this will likely remain the case.

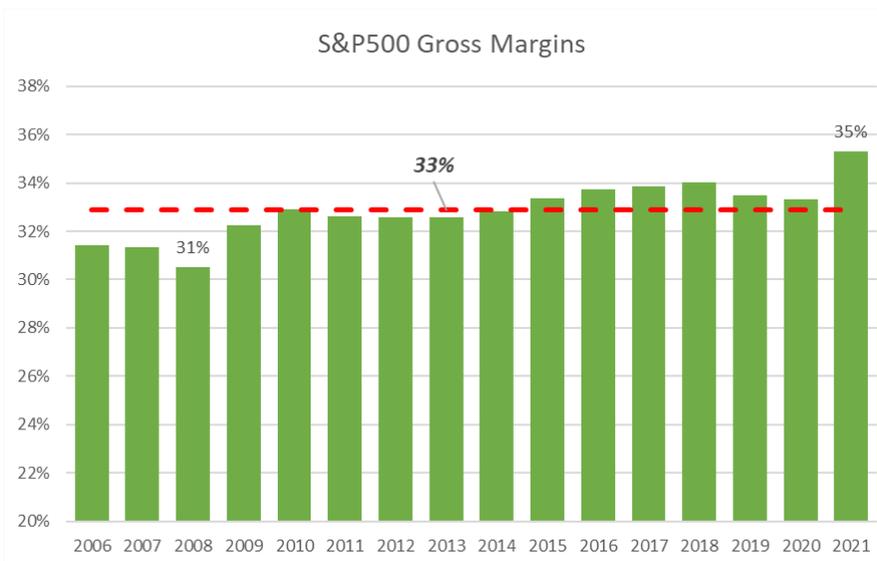
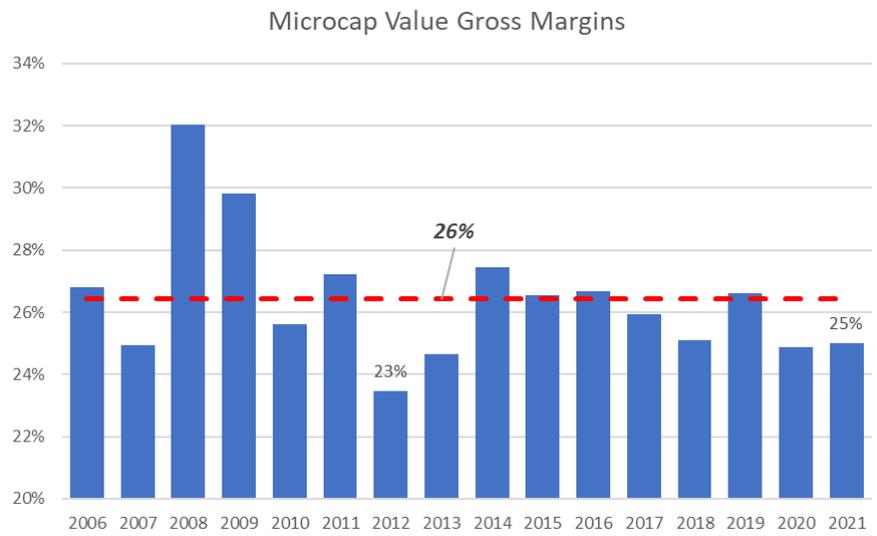
For micro cap value stocks, consensus sales estimates for 2022 are slightly above the long-term average and dip below for 2023-2024 which brings the next 3 year average close to the long-term average (inclusive of 2022e). For the S&P 500, sales estimates are well above the long-term average in 2022 (at +11.7%) and remain above the long-term average for both 2023-2024. Though we see downside risk to

consensus estimates for both this year and next, consensus estimates for the S&P 500 appear very optimistic relative to micro cap value.



Source: Bloomberg; Monarch Partners Asset Management

When contemplating relative margins, the S&P 500 index is operating at historically high levels while the micro cap value index is closer to the lows seen over the past 15 years. To us, this suggests large caps are far out-earning relative to micro cap value stocks and are more at risk of significant margin degradation relative to their micro cap peers.

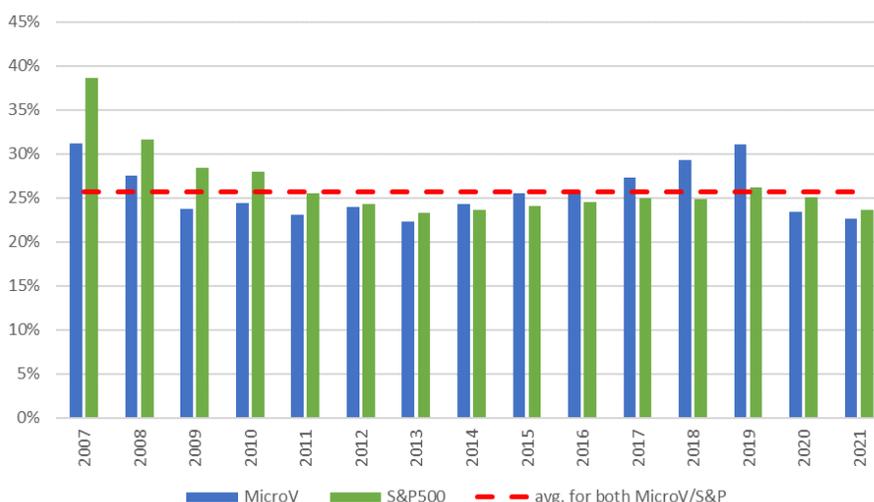


Source: Bloomberg; Monarch Partners Asset Management

Balance Sheet Comparison

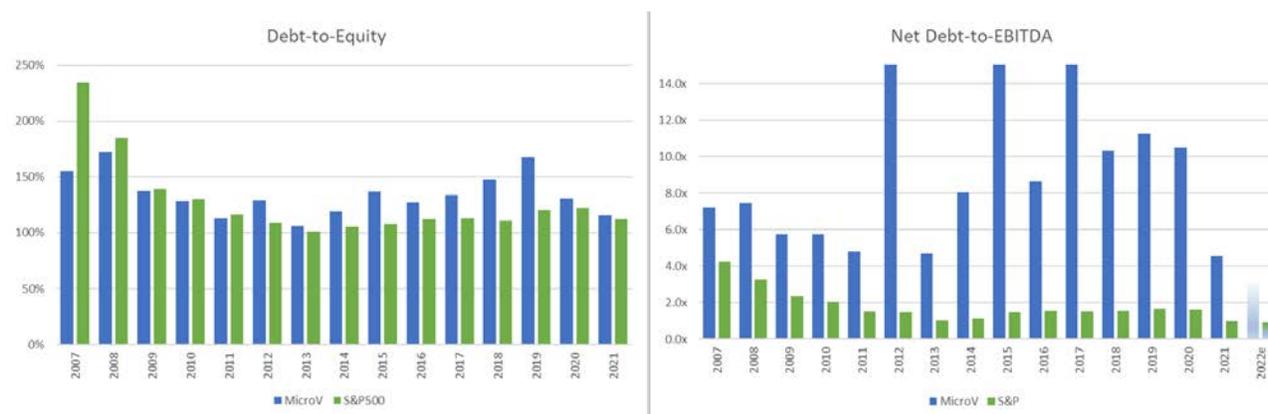
Over the past several years, balance sheets for both large cap and micro cap value stocks have improved significantly. On a relative basis, micro cap value balance sheets have improved much more over the past several years. This should make micro cap stocks more attractive acquisition targets and reduce the risk of bankruptcy should the economic environment deteriorate significantly. For both large cap and micro cap value, debt-to-asset values are below historical averages with micro cap value at 23% ending 2021 and the S&P500 at 24% (both have averaged 26% since 2007).

Debt-to-Assets



Source: Bloomberg; Monarch Partners Asset Management

Debt-to-equity and net debt-to-EBITDA show a starker relative improvement in micro cap value stocks balance sheets vs. their large cap peers. Since 2007, debt-to-equity has averaged ~135% for micro cap value stocks though ended 2021 well below that number at 116%. That's only 400bps above the average debt-to-equity ratio for the S&P 500 (112%) which has averaged ~128% since 2007. Similarly, the spread in net-to-EBITDA between micro cap and large cap is near historic lows and is estimated to be its lowest ever by YE2022.

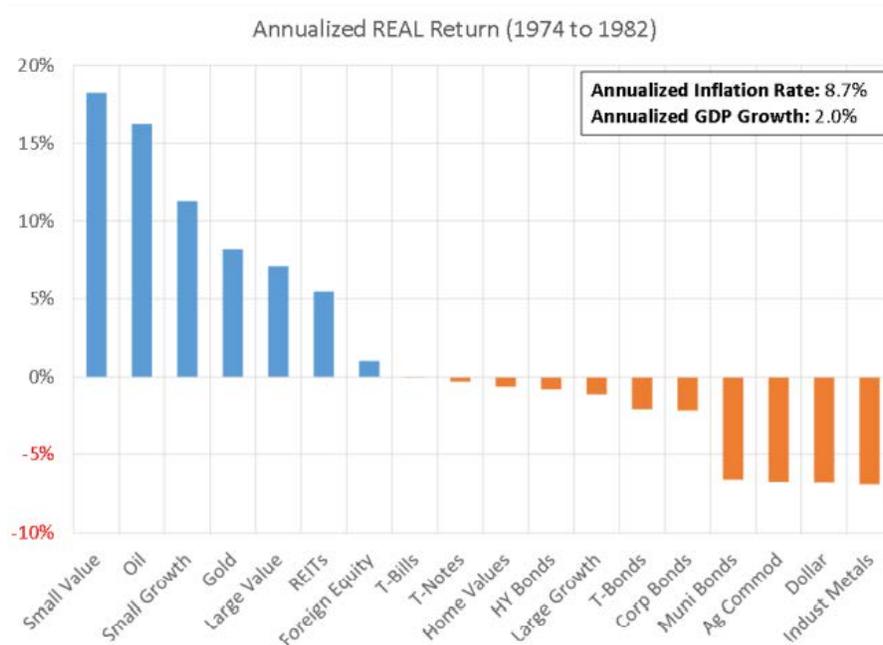


Source: Bloomberg; Monarch Partners Asset Management

Some Additional Thoughts on the Current Environment and Micro cap Value

On a relative basis, how do small cap stocks perform in stagflationary environments? Recent research from Furey Research Partners shows that, historically, small cap value stocks perform particularly well in

an environment characterized by stagflation – stickier/higher than expected inflation and no growth. On a sector basis, utilities, financials, energy and materials tend to outperform.



Source: Furey Research Partners

What are our biggest concerns? Historically, when heading into a recession it has been far better to own larger, more stable companies given their larger asset base, market position, and asset base. Should we enter a recession, we don't think this time would be any different than in times past. However, given the historical valuation disconnected between micro cap and large cap stocks, this would offer an even better entry point relative to the current discount.

Monarch Partners' Micro Cap Investment Process

Monarch Partners is a boutique asset manager that specializes in investing in small and emerging companies. We come from diverse backgrounds and have decades of experience at large asset managers.

Our investment process is to find micro cap companies with improving fundamentals, visible catalysts, and attractive relative valuation. We use a bottom-up approach to identify under-covered and under-appreciated companies with market caps typically between \$100 million and \$2 billion. By conducting deep research and meetings with management over the years, we identify companies that have attractive positions in industry niches and improving financial profiles.

We further filter the opportunity set by focusing on companies that trade at attractive multiples versus historical ranges and peers. Lastly, we identify visible catalysts that would generate potential multiple re-ratings as company fundamentals improve. Our \$200 million Micro Cap Value fund has built a 6-year track record, and our objective is to generate attractive outperformance over a market cycle.

Historical performance is not indicative of future performance. The investment return and principal value of a Monarch Partners Account will fluctuate and may be worth more or less than the original cost when liquidated. The investment environment and market conditions during the Prior Performance Period may be markedly different in the future and investment returns will fluctuate in value. There can be no assurance that any Monarch Partners Account will achieve positive returns in future periods.

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Benchmarks: The **Russell 2000 Value Index** measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect value characteristics. **Russell 2000 Growth[®] Index** measures the performance of the small cap companies located in the United States that also exhibit a growth probability. The **S&P 500[®] Index** is the Standard & Poor's Composite Index and is widely regarded as a single gauge of large cap U.S. equities. It is market cap weighted and includes 500 leading companies, capturing approximately 80% coverage of available market capitalization. The **Nasdaq Composite** is an index that includes almost all companies listed on the Nasdaq exchange. The composite is a capitalization-weighted index.

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