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The following represents a portion of the Kippington Capital H1 2020 Letter to Partners.

Market Insight

The US has continued its battle against the coronavirus with large portions of the country reopening. This has aided in bringing down weekly unemployment figures, but unfortunately the country has persisted in reporting over 1 million new unemployment claims each week. And, in the rush to reopen the economy and allow people to work again, mistakes were made such as certain states' decisions not to mandate masks in high-traffic places such as grocery stores or shopping centers. So accompanying the reopening are new highs in daily cases of the virus leading several states to either pause or even reverse their reopening plans. Equity markets have slowed their previously jet-fueled rise that lasted from the end of March through late May. And though they continue to trudge higher, it is not without volatility now as investors realize that businesses will have to contend with extreme uncertainty until there is a preventative for the virus.

US small-caps continue to lag behind large-caps in their short-term share price performance by a sizable margin. As of June 30th, the Russell 2000 lost 13% vs the Russell 1000's loss of just 2.8%. As I discussed last month, this is due in large part to the fact that small-caps were carrying a high amount of leverage both historically and relative to their large-cap peers (Chart 1).

The economic impacts from COVID-19 caught small-caps particularly off-guard, and they now face top line pressures from a drop in aggregate demand and increased operating costs.

However, though their leverage was relatively higher at the onset of the coronavirus economic crisis, interest coverage is close to the average indicating there is a possibility that small-caps pull out of this downturn successfully (Chart 2).

Chart 1: Russell 2000 vs S&P 500 Net Debt/EBITDA (ex-financials)

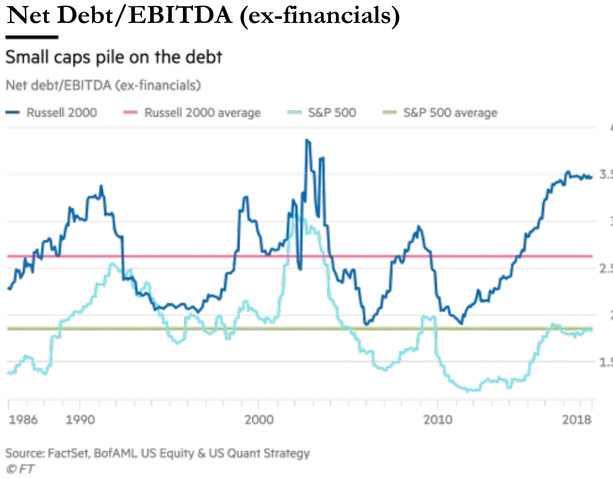
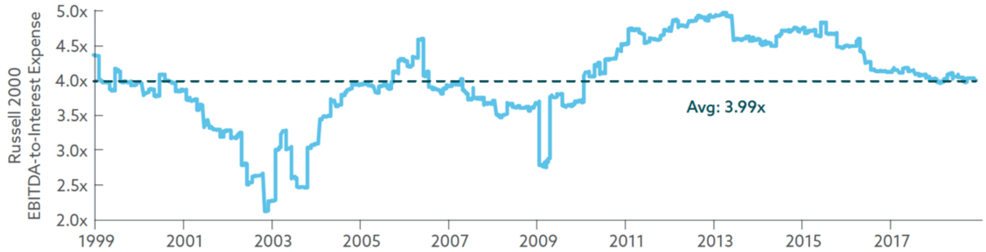


Chart 2: Russell 2000 EBITDA / Interest Expense



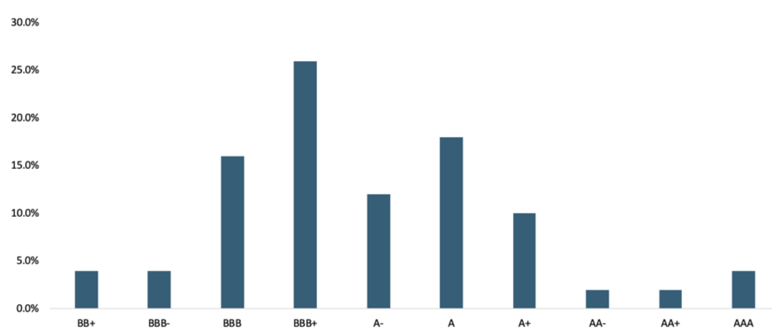
Source: Factset, PPM America

Forward Insight

According to Bank of America, small-caps have a weighted average debt maturity of five years compared with nine years for large-caps. What's more, only 10% of larger companies' debt is high-yield whereas fully 70% of smaller companies' debt is considered in that potentially riskier category. Looking forward, small-cap companies will need to refinance through their lenders or access the debt capital markets sooner than their large-cap competitors, and they will require an environment accepting of high-yield paper.

It's unclear as to whether this environment will present itself. The Federal Reserve has initiated purchases of corporate debt for its Secondary Market Corporate Credit Facility (SMCCF), and while many anticipated that it would primarily purchase paper close to the bottom of investment grade, the Fed elected to steer towards the middle. SMCCF purchasing is based off a Fed-created index of 794 companies with differing weightings. Out of the 50 largest weightings - which account for 40% of the index - 56% are rated between BBB+ and A. What's more, ratings of BBB+ and higher account for 74% of the firms in the group (Chart 3).

Chart 3: Credit Ratings for Top 50 Weightings in SMCCF Index

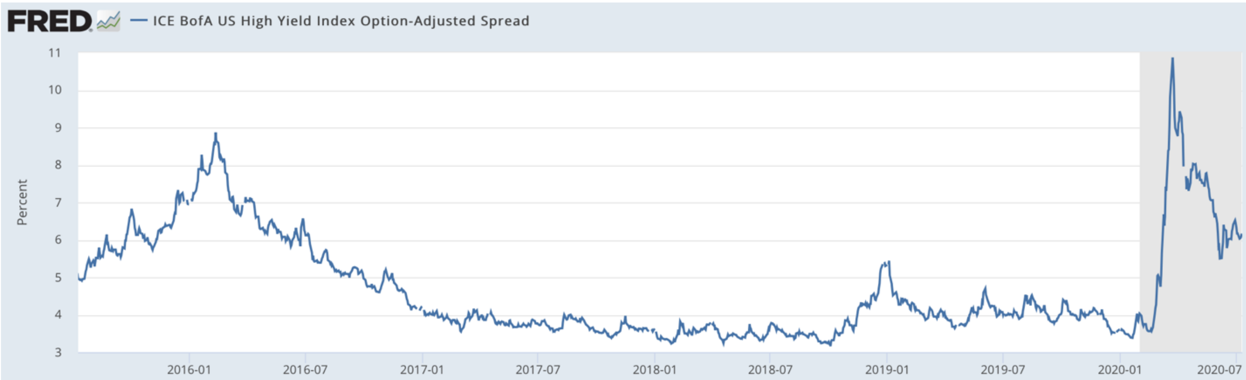


Source: Kippington Capital Management

This is quite a contrast to the smaller constituents of the Russell 2000, the average credit rating of whom is B+, firmly inside non-investment grade territory.

The high-yield bond market has recovered substantially from earlier this year, but spreads have held steady at 2016 levels. The Bank of America HY Index spread sits right around 6% vs the 3.5% - 4% firms have been pampered with for the past 3 years (Chart 4).

Chart 4: ICE BofA US High Yield Index Option-Adjusted Spread



Source: Federal Reserve Bank of St. Louis FRED, ICE Data Indices, LLC

Should the economic environment prove friendly to firms looking to refinance high-yield debt in the next several years, domestic small-caps will likely reap the benefit of the rising tide lifting all ships. However, should lenders take a more conservative stance and high-yield spreads move towards a mid-point of where they are now and the almost-11% level hit in March, smaller companies will have a difficult go of it. In that event, those small-caps with fortified balance sheets and consistent cash flows will see the most success in the following years.

As always, I welcome the opportunity to address any topics discussed herein as well as specific issues or portfolio objectives you may have. You can reach me directly at (847) 648 - 2667 or by email at conor@kippingtoncapital.com.

Best regards,

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