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Kippington Capital Management June Insights

Portfolio Insight

Small caps fully participated in the equity rebound with the Russell 2000 gaining 6.51% in May. With May's strong performance, the Russell index has now bounced an incredible 41.06% off its low point made on March 18th and is just 18% from its high of the year on January 16th. This strong performance enabled Kippington to take advantage of substantial price increases and trim two (2) positions.

1. **Boot Barn Holdings, Inc. ($BOOT),** the largest western wear retailer in the US with 259 stores and a formidable e-commerce presence, has increased 105% from its low of $10.46 just two and a half months ago and now trades at a much fairer valuation. Boot Barn was a fully-sized position, and coupled with its recent appreciation, became a relatively large component of our portfolio.

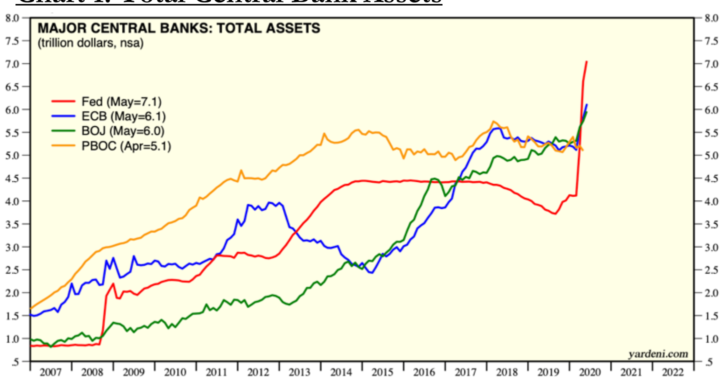
2. **Chase Corporation ($CCF),** a specialty chemical company that produces sealants and tapes for a variety of industries, saw its shares increase 81% from its low this year. Chase shares also now trade at a valuation with a much smaller margin of safety.

The trimming of these investments was the result of a disciplined evaluation process, similar to when we decide to make an initial investment. The Kippington investment process is primarily focused on qualitative factors, and in the case of the above companies, their positive qualitative traits remained intact. However, valuation and margin of safety are also key points in the process, and if the margin of safety materially changes due to a change in price, the sizing of the position should change accordingly.

Market Insight

I've previously discussed the economic effects of COVID-19, and there is no prior event that serves as a lens through which to view the economic situation the US is in. While the full impact of COVID-19 has yet to be determined, the same can be said of the stimulus actions of the world's central banks. The US Federal Reserve's balance sheet has almost doubled in the span of three months to just over $7.15 trillion (Chart 1).

<u>**Chart 1: Total Central Bank Assets**</u>



Source: Yardeni Research, Inc.

Due at least in some part to the Fed's actions, initial unemployment claims numbers dropped precipitously with 3.18mm in the first May report to "just" 1.88mm reported at the end of the month. The unemployment rate is at a historic high of 13.3%, but is already down 1.4% from the April number. There's speculation that the unemployment rate will follow jobless claims and decline substantially in the coming months as the country continues to reopen for business.

Forward Insight

As the country re-opens on a locality-by-locality basis, the effects of the virus will likely be unevenly felt across the US economy. Large businesses are generally more entrenched in their industries - after all, that's how they became large businesses. Typically they have the human and financial resources to make necessary adjustments to business models or infrastructure (though they may be slower to do so). However, small-capitalization businesses entered this crisis much less well-prepared than their larger peers and will bear a disproportionate brunt of the crisis for two reasons:

a) Small-caps are carrying a historically high debt load (Chart 2). This greatly limits their wiggle room if they experience substantial revenue declines or find they must incur additional costs to do business in a different way. Unfortunately, many will experience both top and bottom-line pressures.
b) The percentage of small-caps reporting GAAP net losses (even before this crisis) is also at a historically significant point (Chart 3). These companies generally have a larger reliance on the friendliness of financial markets to maintain their operations and may find the environment a bit more challenging to raise equity and attractive debt.

For these reasons, it seems clear why, even with the recovery over the past two months, the Russell 2000 has delivered a total return YTD of -16% vs the S&P's -5%. Fortunately, we do not "index" the small cap sector. We execute a disciplined process that analyzes the entire small-cap universe to select the very few companies that meet a stringent set of criteria we feel reflect "small-cap value". Among the key points Kippington seeks in portfolio companies are:

a) Strong competitive advantages
b) Cleaner balance sheets
c) Long runways ahead to deploy incremental capital

Chart 2: Russell 2000 vs S&P 500 Net Debt/EBITDA (ex-financials)

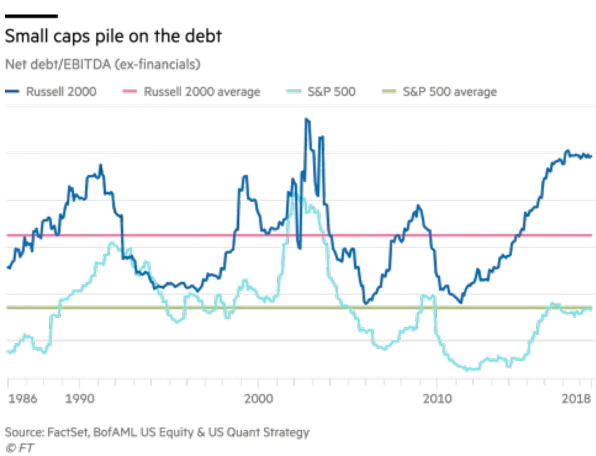
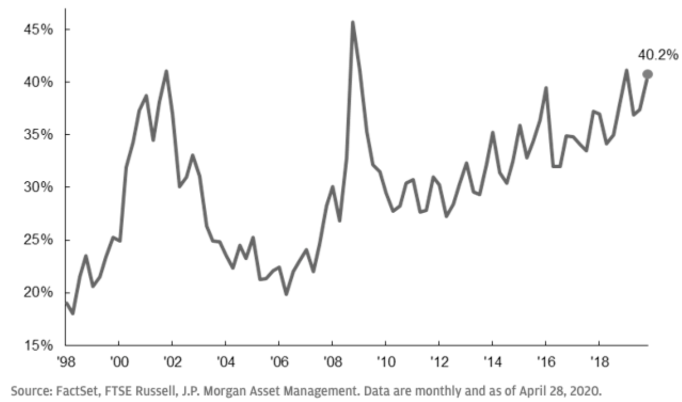


Chart 3: Percentage of Russell 2000 Reporting Net Losses (%)



Small-cap value stocks tend to outperform their large-cap brethren when the US economy emerges from a recession. In fact, after the dot-com bust as well as the 2008 financial crisis, the 5-year annualized return for small-cap value was over 6% higher than for large-caps (Table 1). We believe this recovery period will be no different. As the US pulls out of its current economic trough, the businesses with significant competitive advantages, strong balance sheets, and small capital bases will be positioned to experience the strongest growth and recovery.

Table 1: Returns in Recent Recession Departures

From October 2002

	Large Cap	Small Cap Value
One Year	24.4%	42.2%
Three Years	16.7%	30.1%
Five Years	15.5%	21.7%

From April 2009

	Large Cap	Small Cap Value
One Year	49.8%	88.5%
Three Years	23.4%	29.0%
Five Years	21.2%	27.4%

S&P 500 and Fama French Small Cap Value
3 and 5 year numbers are annualized

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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