PENN CAPITAL

Overview

The Bloomberg 2000 Index rose 4.5% in 2Q23 and is now up 7.6% year-to-date ("YTD") defying the bearish consensus driven by a resilient consumer, cooling inflation and a pause in the Federal Reserve's ("Fed") campaign of interest rate increases. Large caps were even more impressive with the S&P 500 Index up 8.7% in 2Q23 ("2Q") and 16.9% YTD. This relative outperformance was predominantly driven by seven mega cap stocks: Apple, Microsoft, Amazon, Alphabet, Nvidia, Meta and Tesla. Excluding the 23% rally in those seven names, the S&P 500 Index would have only risen 4.1% in 2Q, modestly lagging small caps (Source: Furey Research Partners).

During 2Q, the best performing sectors in the Bloomberg 2000 Index were Healthcare, Industrials and Information Technology ("IT") while the worst performing sectors included Utilities, Financials and Consumer Staples. The 10-year US Treasury yield increased from 3.43% to 3.81% during 2Q. Small cap growth stocks outperformed small cap value stocks as regional banks continued to struggle. The spread-to-worst on the J.P. Morgan US High Yield Index declined from 499 bps to 434 bps, almost fully recovering to the pre-regional banking crisis lows of February and early March of this year.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 2Q as top contributors included the Industrials, Real Estate and Financials sectors. Within Industrials, our holdings performed well as the economy continued to show resilience with stronger new home sales and strong employment data in the back half of the quarter. A company that was negatively impacted by a slow snow plow season rebounded as demand for their lawn service segment continued to show growth as the season transitioned. Our overweight position in multi-family real estate outperformed within the sector as offices continued to struggle as the threat of lower occupancy impacts the group. Many questions still loom regarding the true demand for office space as leases begin to expire in the coming years. Within Financials, our underweight to regional banks served the portfolio well as small banks continued to struggle as deposit costs soared and depositors moved funds to higher paying alternatives which simultaneously caused margin compression and higher loan to deposit ratios. These factors rattled investor confidence as several deposit runoff scenarios resulted in bank failures during the first half of the year.

Top detractors included the Healthcare, IT and Utilities sectors. Within Healthcare, a holding was negatively impacted by two of their major divisions. The market sold off companies with Medicaid exposure with Medicaid redetermination looming, and its transportation segment was heavily dependent on the Medicaid community. The Centers for Medicare & Medicaid Services ("CMS") also offered their first proposal for lower rates within the personal care division which has been a focus for growth in another division of the company. Typically, CMS offers its most aggressive rate cut plan which usually takes some time to negotiate the ultimate fair rate over time. Within IT, a company was negatively impacted as it transitioned to a recurring software company from a device sale company as margins were impacted by availability and surging prices for tech components required to produce their products which negatively impacted sector performance during the quarter. Our overweight position to Utilities suffered as strong housing and employment data boosted rates at the end of 2Q which negatively impacted companies with interest rate exposure.

Small to Micro Cap Equity

The Small to Micro Cap Equity strategy outperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 2Q. Top contributors to performance were the IT, Energy and Materials sectors. Within IT, a developer of specialized web browsers announced plans to integrate AI-generated content into its browsers. In the Energy sector, a provider of oil field services and equipment is driving significant EBITDA growth due to accelerating international demand and its focus on high-margin services. Positive free cash flow is being deployed to pay down debt and drive down balance sheet leverage. Within Materials, a provider of construction materials is benefitting from strong infrastructure spending, which combined with pent-up demand in other residential and commercial end markets will drive favorable cement pricing.

Small to Micro Cap Equity (cont.)

Top detractors to performance were the Consumer Discretionary, Healthcare and Financials sectors. In the Consumer Discretionary sector, a franchisor of boutique fitness studios saw its shares drop sharply in the wake of a negative research report from a short seller. We believe the report lacked credibility although we do expect it will take some time to rebuild investor confidence. Within Healthcare, a provider of technology solutions for healthcare payors and patients traded lower due to concerns that Medicaid redetermination will negatively impact results; the strategy exited the position due to the overhang. In the Financial sector, a New England-focused regional bank is facing pressure on net interest margins as funding costs increase amid intense deposit competition. Pace of buybacks is moderating given the uncertain macroeconomic outlook.

Small Cap Equity

The Small Cap Equity strategy outperformed its benchmark, the Bloomberg 2000 Index, during 2Q. Top contributors to performance were the Materials, Energy and Industrials sectors. In the Materials sector, a provider of construction materials benefitted from strong infrastructure spending, which combined with pent-up demand in other residential and commercial end markets, drove favorable cement pricing. Within Energy, a provider of oil field services and equipment is driving significant EBITDA growth due to accelerating international demand and its focus on high-margin services. Positive free cash flow is being deployed to pay down debt and lower balance sheet leverage. In the Industrials sector, a provider of logistics services continues to execute on its terminal expansion plan while reducing leverage as investors hope for a second half tonnage recovery and hired an industry veteran as their new COO.

Top detractors in the quarter included the Consumer Discretionary, Healthcare and IT sectors. Within Consumer Discretionary, a franchisor of boutique fitness studios saw its shares drop sharply in the wake of a negative research report from a short seller. We believe the report lacked credibility although we expect it will take time to rebuild investor confidence. In the Healthcare sector, a provider of technology solutions for healthcare payors and patients traded lower due to concerns that Medicaid redetermination will negatively impact results; we exited the position due to the overhang. Within IT, an application performance management software company underperformed when a rumored private equity takeover did not materialize.

Small Cap Value Equity

The Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 2Q as top contributors included the Financials, Real Estate and Industrial sectors. Within Financials, our underweight to regional banks served the portfolio well as small banks continued to struggle as deposit costs soared and depositors moved funds to higher paying alternatives which simultaneously caused margin compression and higher loan-to-deposit ratios. These factors rattled investor confidence as several deposit runoff scenarios resulted in bank failures during the first half of the year. Our overweight position in multi-family real estate outperformed within the sector as offices continued to struggle as the threat of lower occupancy impacts the group. Many questions still loom as to what true demand will be for office space as leases begin to expire in the coming years. Our industrial exposure performed well as the economy continued to show resilience with stronger new home sales and strong employment data in the back half of the quarter. Our exposure to an online auto sale company for dealers also showed improvement as used car prices dropped during the quarter and transaction volume started to improve for used cars.

Top detractors to performance were the IT, Materials and Utilities sectors. A technology company was negatively impacted as it transitioned to a recurring software company from a device sale company as margins were impacted by availability and surging prices for tech components required to produce their products which negatively impacted sector performance. The Materials sector was negatively impacted by lower commodity prices as China's growth recovery from Covid stalled rather quickly. The Utilities sector was negatively impacted by a higher rate outlook as the economy continued to show strength during the quarter which lead to more defensive groups underperforming. Although rates rallied aggressively into the end of the quarter on a stronger growth outlook than was anticipated, we expect rates to peak in 3Q23 as we have seen commodity prices peak and companies have started to see orders slow as supply chains across all industries are finally back to normal which implies that inflation has peaked for most goods.

Small to Mid Cap Equity

The Small to Mid Cap Equity strategy underperformed its benchmark, the Bloomberg 2500 Index, during 2Q. Top detractors included the Consumer Discretionary, IT and Healthcare sectors. In the Consumer Discretionary sector, a regional gaming company underperformed due to recession fears and investor concerns regarding its competitive position and path to profitability in their digital businesses. Within IT, an application performance management software company underperformed when a rumored private equity takeover did not materialize. In the Healthcare sector, a provider of over-the-counter healthcare products underperformed amid headwinds from an infant formula recall and increased FDA scrutiny of that industry leading to production costs, additionally, their CEO announced plans to retire.

Top contributors to performance in the quarter were the Materials, Energy and Financials sectors. Within Materials, a producer and distributor of lithium compounds outperformed as investors grew more optimistic regarding a pending merger as well as the outlook for EV auto sales. In the Energy sector, a provider of oil field services and equipment is driving significant EBITDA growth due to accelerating international demand and its focus on high-margin services. Positive free cash flow is being deployed to pay down debt and drive down balance sheet leverage. Within Financials, a leading provider of term life insurance, mutual funds, annuities and other financial products improved earnings reflecting a boost from higher interest rates, share repurchase, lower Covid claims and a smaller loss in senior health.

Mid Cap Equity

The Mid Cap Equity strategy outperformed its benchmark, the Bloomberg Mid Cap Index during 2Q. In the Materials sector, a producer of aggregates for the construction industry outperformed due to robust infrastructure spending and green shoots in the residential segment which supports a favorable pricing outlook. In the Industrials sector, a provider of logistics services continues to execute on its terminal expansion plan while reducing leverage as investors hope for a second half tonnage recovery and hired an industry veteran as their new COO. In the Healthcare sector, a hospital operator is experiencing a recovery in patient volumes post-pandemic and notably improved labor trends with contract labor utilization and spending declining.

In Consumer Discretionary, a regional gaming company underperformed due to recession fears and investor concerns regarding its competitive position and path to profitability in their digital businesses. Additionally, a franchisor of low cost gyms underperformed as unit development is being temporarily constrained by higher interest rates, increased construction costs and ongoing HVAC supply chain issues. Within Industrials, a maker of airplane components came under pressure after learning of a manufacturing problem with two of their fittings. This will result in delivery delays and higher costs as the company works to correct the issue.

Outlook

Despite the variable, lagged and cumulative effects of 18 months of Fed tightening, the US economy remains on solid footing and the odds of a soft or no landing scenario have increased. Job growth remains positive, unemployment is low and corporate layoff announcements have slowed considerably. New home construction is re-accelerating amid a lack of competitive supply from existing homes as many homeowners are reluctant to give up historically low mortgage rates. Auto sales are picking up as supply chains have improved post-pandemic and prices for new and used vehicles normalize.

The shift in consumer demand from goods to services early last year left many retailers and manufacturers with excess inventories. That process has mostly run its course and should not be a significant economic drag going forward. Inflation continues to improve sequentially and consumer inflation expectations are nearing pre-pandemic levels. As of this writing, the headline Consumer Price Index (“CPI”) for June is expected to come in at 3.0%, down from 4.0% in May and well below last year’s peak of 9.1%. This would represent the lowest CPI reading since March 2021 (2.6%). While the Fed may elect to raise rates following its “hawkish pause”, we do not believe the Fed needs to push the economy into a deep downturn to win its war on inflation. Nonetheless, we believe consumers and businesses are healthy enough to take a few more doses of medicine if need be.

Outlook (cont.)

The high yield credit market continues to demonstrate strength with spreads closing the quarter near pre-banking crisis levels. New issuance activity has increased with many deals oversubscribed and pricing tight or being upsized versus initial expectations. Overall financial leverage is low, interest coverage is high, and the percentage of the high yield market that is rated BB is at or near all-time highs.

Investor sentiment remains disproportionately negative with institutional and retail money market fund assets at all-time highs and meaningfully above pandemic era peaks. Small cap equity valuations trade at a significant discount to long term averages, reflecting an overly pessimistic macro view and small caps remain historically cheap relative to large caps. The top 5 stocks in the S&P 500 Index represent 24% of its weighting, an extreme not experienced since 1973 (Source: Furey Research Partners). We believe that a normalization of inflation and interest rates will ultimately favor shorter duration, attractively valued small cap companies that are generating positive earnings and free cash flow. We will continue to use our differentiated, fully integrated credit and equity research process to identify companies that are improving their capital structures for the benefit of shareholders.

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Specialists in Capital Structure Investing®

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa.

Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing.

We are a boutique investment management firm based in Philadelphia, PA. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
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