Teton Advisors

KEELEY
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# Small Cap Select Value

Third Quarter 2018 Commentary

Past performance does not guarantee future results. The performance data quoted represents past performance and current returns may be lower or higher. The investment return and principal will fluctuate so that an investor's portfolio, when liquidated, may be worth less than the original cost/balance. As with any investment, there is a potential risk of loss. Smaller and medium-sized company stocks are more volatile and less liquid than larger, more established company securities.

## Performance

For the quarter ended September 30, 2018, the Small Cap Select Value Strategy appreciated 0.09% gross of fees (-0.12% net of fees) versus a gain of 3.58% for the Russell 2000 Index and a gain of 1.60% for the Russell 2000 Value Index. Year to date, the Strategy appreciated 6.08% gross of fees (5.42% net of fees) versus gains of 11.51% and 7.14% for the respective indices.

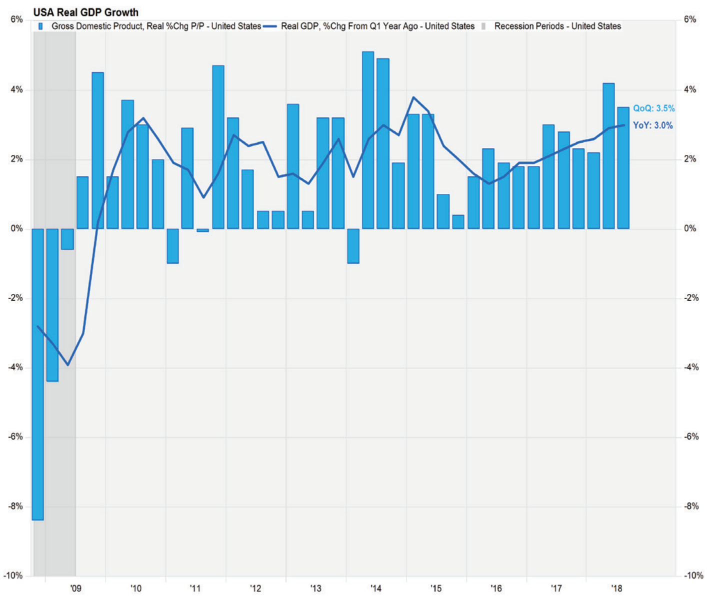
## Macroeconomic Review

As we move towards the end of the calendar year, the economy continues to signal domestic strength. Chief among these positive statistics is the unemployment rate, which has declined to 3.7%, the lowest level since the Vietnam War. Yet, despite tight employment conditions where many companies cite talent acquisition as a strategic concern, hourly earnings growth and inflation remain at modest levels, not suggesting a state of economic overheating. Corporate tax reform has boosted earnings growth and contributed to a general willingness for business investment. Likewise, the ISM Non-Manufacturing Index, which also encompasses orders and business activity, marked the highest expansionary reading since mid 2005.

**Market Performance**

| As of September 30, 2018 | 3 Months | YTD | 1-Year |
|---|---|---|---|
| S&P 500 Index | 7.7% | 10.6% | 17.9% |
| Russell 3000 Value Index | 5.4% | 4.2% | 9.5% |
| Russell 3000 Index | 7.1% | 10.6% | 17.6% |
| Russell 2500 Value Index | 2.7% | 5.7% | 10.2% |
| Russell Midcap Value Index | 3.3% | 3.1% | 8.8% |
| Russell 2000 Index | 3.6% | 11.5% | 15.2% |
| Russell 2000 Value Index | 1.6% | 7.1% | 9.3% |
| Bloomberg Barclays Agg. Bond Index | 0.0% | -1.6% | -1.2% |

**USA Real GDP Growth (Q4 2008 - Q3 2018)**




Source: U.S. Bureau of Economic Analysis, Factset. Grey represents recession periods.

Stock indices, however, ended the quarter on the retreat after marking all-time highs earlier this summer. The impact was far more pronounced for small capitalization stocks, at nearly two to one in the last week of the quarter, as those indices returned to where they began the summer months, generally inline with their 200-day moving average. Reflecting to the start of the year, the Trump Administration's opening of a two-front trade war—China and North America—prompted investors to reallocate towards domestically-focused small caps, perceived as insulated, with each escalation of rhetoric in relation to scope and level of penalties against Chinese goods. We were supportive of the insulation thesis and felt it a reason to remain bullish. Yet in the final days of the quarter, the Trump Administration rather quickly resolved the war on one front as NAFTA was restyled the US-Mexico-Canada Agreement (USMCA). Largely perceived by investors and companies as having "dodged a bullet", the new agreement allows for minimal disruption to existing supply chains and implements reasonable protections, rather than the punitive repudiations implied by earlier rhetoric. With this achievement, and its contemplation as a template for China, small caps lost their perceived competitive advantage over larger, global brethren. We do remain concerned about the prickly sparring with China, predominantly over trade issues, recognizing both the exposure of technology supply chains and the threat to US consumers through higher price levels. We continue to proactively anticipate potential exposure among our holdings.

Within the portfolio, our gains have recently slowed after a strong start to the year that outpaced the market. Considering the sudden headwinds—the unwinding of the small cap relative trade and weakening investor sentiment for semiconductor stocks—the portfolio held nearly flat on a net basis for the quarter. Predictably, technology represented nearly all of our detractors and this was centered in a pair of names, which are detailed below. After a strong two-year run, a pullback in technology stocks is not unexpected. Counter-intuitively, we believe this scenario could provide an opportunity to employ our consistent strategy of acquiring high-quality companies whose stocks decline towards our downside targets, setting up attractive risk/reward scenarios. Though still perceived as exhibiting the steep cyclicality of the 1990s, we would note that these "new industrials" have demonstrated superior margins and sustainable business models.

Offsetting much of the portfolio weakness, our primary contributors were from our industrial and energy names. Within industrials, the gains were concentrated in a non-traditional "industrial" company, business services firm FTI Consulting (detailed below; +21% portfolio total return for the quarter). In energy, our best performers were exploration and production companies with top-tier, seasoned management teams. Centennial Resource Development, Inc. had anticipated pipeline bottlenecks in the Permian and preemptively secured takeaway capacity for it's top tier wells. While Magnolia Oil & Gas Corp. (+31%) operates in the Eagle Ford and is intensely focused upon cash returns, already carrying cash margins above its target of fifty percent. As global oil supplies unexpectedly tighten, either due to sanctions or intense economic disarray in certain countries, we expect commodity prices to remain high and both our production and service holdings should continue to benefit.

Lastly, our cash balances are higher than usual, attributable to the surging acquisition activity within the portfolio. We have marked 11 takeouts year-to-date through the end of the third quarter, some having been large positions. We expect to opportunistically take advantage of market volatility to continue to employ our strategy of redeploying proceeds into high-quality names at value prices.

## Leading Contributors

**Bottomline Technologies, Inc (EPAY)** is software vendor with a trio of subscription-based products for business payments. As a long term holding of ours, we have been optimistic on the significantly underpenetrated market opportunity for Paymode-X, which moves purchasers and vendors from a paper-based invoicing system to digital transactions. The company is on the verge of gaining critical mass with this product, now hosting over 385 thousand vendors on the platform, transacting over $200 billion of payments annually. We believe that fundamentals have further room to grow, also aided by an updated digital banking platform. Yet, we acknowledge that the current valuation that reflects much of the opportunity.

**FTI Consulting, Inc. (FCN)** is a business advisory firm touching all parts of the business cycle, from restructuring to litigation to merger advisory. The company significantly beat earnings estimates in the quarter, winning many large jobs and exhibiting the best operating leverage in five years. Having been long term shareholders, we have experienced the cyclicality of the underlying business and its sensitivity to headcount. We took the opportunity of the strong move in the stock to cut back this top position, trusting management's assessment that current business levels imposed an unsustainable strain on staff, necessitating imminent hiring plans (thus, near term margin compression).

**Pandora Media Inc (P)** is a personalized online music platform, akin to a digital version of terrestrial radio, providing content to over 73 million active users. A strategic investment by Sirius XM Holdings Inc. in 2017 established a floor valuation on the the stock during a difficult transition period of working to improve monetization of the giant user base. Last month, Sirius chose to acquire Pandora via a stock-based transaction, always considered a likely outcome, albeit the timeline was significantly accelerated. The deal provides Sirius a source of growth and a broader portion of the car-based audio market, now encompassing both subscription and advertising-based listening.

## Leading Detractors

**Diebold Nixdorf, Inc (DBD)** builds hardware-based transaction systems, from ATMs to retail checkout terminals. Having been major shareholders at another investment firm over a decade ago, we returned to look at the company when investors became sorely disappointed by the slow pace of restructuring gains promised with the Wincor Nixdorf AG merger. We reasoned that turnarounds take time for large, equipment-based firms and the stock appeared reasonably valued. Since that point, a lull in end market activity prior to the Windows 7-driven upgrade cycle, as that platform was to be retired, only aggravated the financial situation. When new management took over, a reset of targets and acknowledged operational inefficiencies indicated a trajectory towards debt covenant violation. Overnight, the company was plunged into a liquidity crisis as holdout Wincor shareholders suddenly demanded to be made whole on the acquisition of two years prior. Though a tenuous process, the company has since established extended covenant releases and secured funding to remain in business. As the business is approaching the seasonally strong part of the year, we believe this can give an opportunity for investors to see the viability of the firm. We also note the curious double incentive in this case: banks are both customers and creditors. Likewise, as with the case of legacy mainframes in the computing industry, the ATM will remain a necessary point of physical cash transactions, needs to be protected and integrated, and continues to replace live tellers as a cost savings. Overall, this painful process has reminded us why we so rarely become involved with stocks that could be considered "deep value."

**Infinera Corporation (INFN)** designs and builds network equipment for optical transport, which is the high-speed transmission of data in the form of light waves. After an exceptional start to the year, where the stock doubled in short order as strong orders illustrated the leverage potential of the business, the stock sagged in the second quarter as investors then dismissed this as a one-time event. In the current quarter, at a bargain valuation, the company unexpectedly acquired Coriant, serving to both double revenues and remove a price competitor. Though none of the debt burden came with the acquisition, investors have responded sourly towards the deal, citing the “failed” 2015 acquisition of Transmode (which, we would note, was not a drag but lacked achieving the hoped-for goals). While we expect the integration will take a few quarters to engender renewed confidence, we cannot ignore the severe risk/reward imbalance. The stock currently trades at its downside target, with minimal cost synergies assumed. To the upside is the significant earnings potential from vertical integration and cost savings—by order of magnitude, more than ten points of margin potential with earnings power nearly double what could have been achieved prior. Despite their large size, we view the target savings as reasonable given Coriant’s sustained status as a distressed debt situation reliant upon commercial components and price aggressive to move volume.

**Extreme Networks, Inc. (EXTR)** provides network equipment for wireless and wireline networks. The company has grown revenues by more than fifty percent following two fortuitous acquisitions: Avaya out of bankruptcy proceedings and Brocade IP Networking, disgorged from the larger Avago/Broadcom acquisition. Yet shareholders and analysts turned angry as management’s forecasting ability proved sloppier than investors had grown adjusted to. As true contribution appears clouded while the company right-sizes levels of business at both divisions, the stock has collapsed to our downside target. We believe the acquisitions—acquired at very modest valuations—have strengthened the firm, propelling it into a larger customer set who considers potential vendors only sized above a billion in revenue (a level it was, and many peers are, far below). Still, the stock is likely to remain in the “penalty box” through the end of the year, before being considered by investors. We had reduced the position size of this long term holding near its peak valuation but retained enough of a portion that has placed it among our worst performer list in the quarter.

## Outlook

We are cognizant of forward-looking concerns as to the durability of the economic expansion and continue to monitor both our holdings and new opportunities presented by the market. Overall, we believe that we have demonstrated excellent risk adjusted returns within the portfolio across a complete market cycle and endeavor to continue to do so.

In conclusion, thank you for your investing alongside us in the Small Cap Select Value Strategy. We appreciate your confidence and trust.

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## Third Quarter Contributors and Detractors

**Third Quarter Contributors**

| Top Contributors | Total Return (%) | Contribution to Return (%) |
|---|---|---|
| Bottomline Technologies (de), Inc. | 45.92 | 0.81 |
| FTI Consulting, Inc. | 21.02 | 0.68 |
| Omnicell, Inc. | 37.08 | 0.50 |
| Pandora Media, Inc. | 20.69 | 0.34 |
| Centennial Resource Development, Inc. Class A | 20.99 | 0.32 |

**Third Quarter Detractors**

| Largest Detractors | Total Return (%) | Contribution to Return (%) |
|---|---|---|
| Diebold Nixdorf Incorporated | -62.34 | -1.12 |
| Infinera Corporation | -26.49 | -0.65 |
| Entegris, Inc. | -14.43 | -0.33 |
| Extreme Networks, Inc. | -31.16 | -0.33 |
| NetScout Systems, Inc. | -14.98 | -0.28 |

Source: Factset

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*Past performance is no guarantee of future results. As with all investments, there is a risk of loss. Any performance and/or attribution information contained herein are based on a representative account of the specific strategy discussed.*

*Market Performance presented solely for informational purposes. The S&P 500 Index is designed to act as a barometer for the overall U.S. stock market and consists of 500 stocks that are chosen on the basis of market size, liquidity, and industry grouping. The S&P 500 is a market value weighted index with each stock's weight in the index proportionate to its market value.*

*The Russell 2000® Value Index is an unmanaged index that measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 2000® Index is an unmanaged index that measures the performance of the smallest 2,000 companies by market capitalization of the Russell 3000® Index.*

*The Russell 2500® Value Index is an unmanaged index that measures the performance of the small to mid-cap value segment of the U.S. equity universe and includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 2500® Index is an unmanaged index that measures the performance of the 2500 smallest companies by market capitalization of the Russell 3000® Index.*

*The Russell Midcap® Value Index is an unmanaged index that measures the performance of the mid-cap value segment of the U.S. equity universe and includes those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell Midcap® Index is an unmanaged index that measures the performance of the 800 smallest companies by market capitalization of the Russell 1000® Index.*

*The Russell 1000® Index is an unmanaged index that measures the performance of the 1,000 largest companies by market capitalization of the Russell 3000® Index.*

*The Russell 3000® Value Index is an unmanaged index that measures the performance of the broad value segment of the U.S. equity universe and includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.*

*The Russell 3000® Index is an unmanaged index that measures the performance of the 3,000 largest U.S. companies by market capitalization.*

*The Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. A direct investment into any of these indices is not possible.*

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*Teton Advisors, Inc. is the registered investment adviser to this strategy.*