

July 20, 2018

Investing Environment

It's hard to believe that we are already halfway through 2018. The second quarter earnings season has already begun, and very soon strategists and economists will release their forecasts for the rest of the year.

The summer months have kept everyone on their toes, from escalating trade wars to the World Cup finals. Who could have predicted that Croatia, an underdog with a \$50 billion economy, would be playing France, a \$2.4 trillion economy, at the finals. In the end, France won the cup, but it seems like Croatia may have won over the world.

Just as Croatia surprised us with a totally unexpected World Cup performance, investors are wondering which other unpredictable events might impact global economic growth in the short term. The "wall of worry" continues to build, but in the meantime, not much has really changed. We are still discussing tweets, trade wars, tariffs, rates and a hazy geopolitical forecast.

Will US Federal Reserve interest rate tightening be compounded by global trade wars and lead to a recession? Are these just headline wrinkles that fundamentals will overcome? These are some of the questions keeping investors up at night.

In Europe, Italian politics were once again in the headlines. Although the uncertainty in Italy has settled, the short-term ramifications for markets are still uncertain.

Despite the ongoing geopolitical drama around the world, economic numbers have been reassuring, especially in the US. While some economic data out of Europe has been soft, the numbers don't warrant concern at this point. PMI's in emerging markets were also soft mainly due to sequential declines in Russia, China and Brazil.

Back to Global Small Cap

During the second quarter of 2018, the MSCI World Small Cap Index outperformed the MSCI World Large Cap Index. The MSCI Emerging Markets Index underperformed both the MSCI World Small Cap and the MSCI World Large Cap Index.

In the MSCI World Small Cap Index, energy was the strongest performing sector, delivering a positive return of 20.1%. At the opposite end of the spectrum, industrials was the worst performing sector, returning 1.8% for the quarter.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

Performance Highlights

For the second quarter, our Global Small Cap composite underperformed the MSCI World Small Cap Index but has outperformed the MSCI World Small Cap Index year to date.

One of the highlights for the quarter was IWG plc. The company is better known as Regus, the world's largest provider of workspace solutions. It offers workstations, office support services and communication services through approximately 3,000 business centres in 100 different countries. In addition to utilizing office facilities, customers can take advantage of numerous professional support services such as catering, mail delivery, office supplies and more.

So what drove the stock up? The company recently announced that it had received attention from several potential takeover bidders. This level of interest suggests that IWG could benefit from a competitive auction, which should drive up the value of the company. IWG's global leadership position, cost-effective back office and cash-generative nature are now being recognized by the market. Over the past three years, IWG has managed to increase its revenue by 11% per annum, outperforming many industrial servicing companies. Moreover, the company generated 19% EBITDA growth per annum over the same period. IWG is also expanding its "Space" offering, a co-working brand similar to WeWork.

Another top contributor for the quarter was Verifone Holding, a facilitator of payment transactions via point-of-sale terminals. The company ranks as the first or second largest player in most markets. Verifone introduced multiple new products this year, divested of certain non-core assets and is working to increase the percentage of revenue it derives from services.

So what drove the stock up? The company was acquired by an investor group led by Francisco Partners for \$2.58 billion in cash. During its 31-year history, Verifone has been both privately and publically owned.

One of our top detractors for the quarter was Greencross. Founded in 1994, Greencross is the largest pet care specialist in Australia, providing both retail and veterinary services.

Greencross has 247 retail stores operating under the brand names Petbarn and City Farmers in Australia and Animates in New Zealand. The company also operates an online platform. In addition to its retail business, Greencross offers a wide range of pet services such as grooming, dog washing, obedience training and pet adoption.

Greencross also owns and operates Australia's largest network of veterinary practices. Its more than 150 clinics include general practices, specialty and emergency centers, pathology labs and pet crematoria.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

The Australia and New Zealand pet care industry has an addressable market of AU\$9 billion and a compound annual growth rate of 4%. Greencross is the largest player in Australian market, twice the size of its closest competitor. One of the company's growth strategies is its co-location model, which situates retail stores in close proximity to veterinary clinics.

So what drove the stock down? In May 2018, the company provided a trading update and guidance that EBITDA would be 12% lower than expected, predominantly due to weakness in the Australian veterinary business and labour cost related to IT projects. Greencross also expected some non-cash impairment charges which would have a negative impact on earnings. New CEO Simon Hickey announced an immediate review of the company's operating cost base, with targeted reductions of AU\$10-13 million in annual operating expenses.

New Position

During the second quarter, we identified a number of new and promising investment opportunities. We are excited to introduce you to one of them — a biotech company called Evotec AG.

Evotec is a German biotechnology research outsourcing company with key assets in novel drugs. Services include target identification for drug development and small batch productions. The company's business model is to provide scientific expertise via yearly or project-based contracts or by taking royalty-bearing stakes in novel compounds. It operates five research facilities in Germany, the UK, France, Italy and the US. Evotec also has over 80 co-owned projects, including more than 50 discovery, 25 pre-clinical and 10 clinical. Its major partners are Bayer, Sanofi, Pfizer and Celgene. Evotec has as strong development pipeline which is expected to generate double-digit royalties.

Other New Buys and Sells

We also initiated a position in Cotivity Holdings and Korn Ferry International. We will provide more details on these companies in upcoming weekly commentaries.

In terms of sells, our preferred way to exit an investment is either via acquisition or when a holding's market cap reaches the upper limit of the index. These methods typically validate our investment thesis. In the second quarter, we exited Verifone as it was acquired, and we sold Cyberagent because it reached the upper limit of the benchmark. We also exited Orbcomm as the company raised additional equity, and we didn't see a clear strategy for margin expansion.

What is Our Ear-to-the-Ground Approach Telling Us?

The Global Alpha team was on four continents during the second quarter, doing on-the-ground research and attending conferences. We met with the management teams of existing holdings, their competitors and potential new investment candidates.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

Rising raw material costs, wage inflation and a shortage of qualified labour are key concerns and topics of discussions in our meetings with management.

Looking ahead, valuations in the US are high, especially in the tech sector, and there is a risk of multiple contraction. To put this into perspective, the top four S&P 500 stocks (Amazon, Microsoft, Apple and Netflix) have been responsible for 84% of the S&P 500 gains so far this year. If the five FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) were excluded, the S&P 500 return for the first half of 2018 would have been -0.7%. On the other hand, companies in other developed markets are trading at cheaper valuations when compared to their US peers.

Within equity markets, we think small cap names offer greater opportunities when compared to their large cap peers given their attractive relative valuations, expectations for higher profit growth and the current M&A environment.

We appreciate your continued confidence in us.

The Global Alpha Team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.