QUARTERLY COMMENTARY

September 30, 2022

Investors usually look forward to the summer as the markets tend to be quieter. Not this year: macro and economics news have been flowing left and right, leaving investment managers with much to digest. Global Alpha is not macro driven in its investment process but let us share some of the news that caught our attention.

Japanese citizens have been navigating a more turbulent environment than they have been accustomed to. The main headline has been the assassination of former Prime Minister Abe Shinzo, one of the most prominent figures of modern Japanese politics, in a country where violent crimes are the lowest in the world. However, the more impactful news to our strategies have been on the economic front. The Japanese government intervened on the foreign exchange markets for the first time in almost 25 years to prop up the weakening yen, which hit an historical low of 145. Their central bank had previously announced their intent to keep rates low, going against the worldwide trend to raise rapidly. Given that the ex-food and energy inflation is still in the low single digits, it appears unlikely that they will need to drastically change course.

Europe is kept busy with the Ukraine/Russia conflict and more specifically the incoming winter and potential energy crisis. The strategic ambiguity strategy that Russia had so far been applying to the Nord Stream 1 pipeline was made clearer: energy supply is to be used as leverage. Even on an ex-energy basis, inflation is still excessively high in the Eurozone which prompted the European Central Bank to raise rates in July for the first time in a decade and again in September for a total increase of 1.5%. Further measures to alleviate the pressure on consumers, such as a Euro-wide windfall tax on energy companies, are being put forward in addition to country specific initiatives. The probability of at least a mild recession in Europe, which in spring appeared as a minor risk, is now a near certainty.

The UK had a busy couple of months where they elected Liz Truss as their new leader following Boris Johnson's resignation, experienced some of the worst inflation in the developed world, and saw their longest reigning queen die. Nonetheless, the FSTE100 index saw one of the better relative performances during the period, as it appears much of the negative sentiment has been priced in by investors who have been dealing with Brexit and political uncertainty for the better part of a decade at this point. It is worth noting that the UK small cap index did not see the same resilience and is now priced at highly discounted multiples.

US monetary and economic policies are still the most scrutinized. The Jackson Hole symposium in August reinforced the message that the Fed has been communicating for months: inflation is the priority, and they will not budge on their plan to continue raising rates until they see improvements. The effects of the aggressive hikes are quickly being felt: house sales in America have been falling sharply, mortgage applications are at their lowest level since 2000, and markets are trending downward across the world.

Overall consumer sentiment is steadily trending downward, despite a surprisingly resilience labor market and strong US dollar.

China, which is not within our investment universe but quite impactful, is dealing with its own set of issues. Economic growth is weak resulting from a mix of COVID lockdowns, property downturn that is not showing signs of improvements, and risk-averse consumers that are reluctant to take any kind of leverage. It is unlikely that any significant policy shift will be implemented before the CCP National Congress takes place in October as Xi Jinping will attempt to present the existing policies as a success.

Heatwaves worldwide have been creating and outsized demand for electricity consumption. In Japan, the government had to ask roughly 37 million people to reduce their electricity consumption to avoid blackouts after its worst heatwave since 1875 and following the earthquake in March where multiple power plants were shut down. The extreme heatwave in Europe has been well documented already and multiple unfortunate records have been smashed. Even the US saw 28 states issue extreme heat warnings. It might just be an outlier year, but the likelier option is that this will be closer to the new normal and, needless to say, that the current energy infrastructure is ill-equipped to deal with it.

BACK TO GLOBAL SMALL CAP

During the third quarter, the MSCI World Small Cap Index outperformed both the MSCI World Large Cap Index and the MSCI Emerging Markets Index.

Within the MSCI World Small Cap Index, Energy, which represents 5% of the index, was the strongest performing sector, delivering a return of 9.4%. At the opposite end of the spectrum, Real Estate was the worst performing sector, returning -6.3% for the quarter, with an index weight of 9%.

PERFORMANCE HIGHLIGHTS

For the third quarter, our Global Small Cap composite delivered a return of -0.8% gross, underperforming the MSCI World Small Cap Index by 1.7% gross.

Our top performer for the quarter was Ormat Technologies Inc. (ORA IS). Based in Israel, Ormat is one of the largest geothermal power producers in the US and the only pure-play provider of products and services to the geothermal power industry. It designs, constructs, owns and operates geothermal and recovered energy generation power plants.

Geothermal energy is a small but quickly growing segment of the global sustainable energy market and Ormat stands out as a leading owner and operator of high-quality assets. As such, the company is poised to benefit disproportionately from the increasing size of the market.

So what drove the stock up?

Ormat reported very strong top and bottom line results. The company further reaffirmed its annual targets giving confidence to investors in the current unpredictable economic environment. Besides strong execution, Ormat shares also benefitted from being added to the S&P Dow Jones MidCap 400 Index in early July, which lead to high demand to the share from index trackers. Increased possibility of President Biden's infrastructure development plan passing in the United States, could help the green energy field through massive government support.

Another top contributor this last quarter was MOTORCAR PARTS OF AMERICA INC. (MPAA US). As the name suggests, the company manufactures, remanufactures, and distributes automotive aftermarket parts for retail outlets and those servicing the professional repair market throughout the US and Canada. Through its seven manufacturing and distribution facilities, the company maintains a catalogue of over 175,000 pieces and 9,000 SKU.

The average vehicle age has increased during the past decade and now stands at more than 11 years in North America. The miles travelled by these vehicles also continued to increase during that time. Combined with the company focus on remanufacturing pieces to reduce carbon footprint and greenhouse gas, which can reduce material and energy consumption by up to 91%, the company is well positioned to benefit from the increased environmental awareness while providing exposure to the auto sector.

What drove the stock up?

MotorCar Parts delivered a strong quarter especially in their brake business, which is still ramping up. Strong demand is supporting double digit revenue in most product lines giving management confidence in reiterating full year guidance. The company has been increasing prices, helping pass through inflation, which will further help margin expansion. We anticipate higher FCF conversion in the next few quarters which will further help multiple expansion.

Our top detractor for the quarter was IWG Plc (IWG LN). Better known as Regus, they are the world's largest provider of workspace solutions. They offer workstations, office support services and communication services through approximately 3,300 business centers, in 120 different countries, and serve over 2.5 million people. IWG has a global leadership position, a cost-effective back office and is highly cash generative.

Since the pandemic, the company took actions by closing non-performing centers and by renegotiating more favourable lease terms with their landlords. The management is successfully shifting its business model towards a more capital light growth strategy. In fact, half of the network should be made up of franchise and partnership deals by year-end.

What drove the stock down?

The poor price reaction this quarter was explained by the cyclicality characteristic of the company and by the likelihood of a potential recession. While higher inflation has benefited revenues this year, it has also had an impact on cost. As more workers return to the office, occupancy rate and ancillary revenue should recover to pre-2020 levels and we remain positive on IWG's growth opportunities.

NEW POSITION

We did not initiate any new position or exit any existing position during the quarter.

WHAT IS OUR EAR-TO-THE-GROUND APPROACH TELLING US?

Global Alpha is busy travelling to conferences. The equity markets industry consensus coming out of COVID 19 is that live conferences are required by institutional investors. Therefore, we expect a mix of remote and live conferences to become the norm. We also expect an increasing amount of non-deal road shows by corporations to our offices. We however expect broker analyst live road shows to decline post COVID as banks and brokerage firms concentrate on remote interactions with their analysts. The team is also preparing reverse road shows where plants and corporate head offices become part of a travelling route.

As companies reported earnings during the summer, it became clear that the comparison to last year's earnings were challenging and that expectations had to be reset. Many corporations that saw double or triple digits growth in 2021 are either seeing no growth or some decline in sales. The goal is now to understand which companies will continue their downward trend and which will be able to build on the growth they saw during the pandemic.

In this macro environment, we continue to put our focus on our holdings balance sheet, favouring companies with little debt and strong cash flow generation, as well a well-defined secular trend that will drive growth for years to come. We do not make material sector or country adjustments to the portfolio because of these expectations and maintain a diversified list of holding companies with defensible business models that are trading at a discount to their intrinsic value. Our portfolio remains well diversified across the many countries, currencies and industries that compose our benchmarks.

The Global Alpha team

About Global Alpha Capital Management Ltd.

Global Alpha Capital Management Ltd. (Global Alpha) is an independent and privately owned investment management firm focused exclusively on global and International small cap portfolio management. The team believes that portfolios built from the bottom up using a global thematic perspective and a risk-controlled, low turnover approach are key to generating consistent added value for clients over time.

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Performance figures are stated in Canadian dollars. Performance figures are stated after trading fees and before management fees and operating expenses. Operating expenses include items such as custodial fees for segregated accounts and for pooled vehicles would include charges for valuation, audit, tax and legal expenses. Such additional operating expenses would reduce the actual returns experienced by investors in segregated accounts and pooled vehicles. Further information about the Global Small Cap Composite is available by contacting the firm.