QUARTERLY COMMENTARY

December 31, 2022

We are now done with the third year of this decade and the differences with the past decade could not be more acute. Inflation seemed like a permanently solved issue in the 2010s, geopolitical conflicts were mild in comparison and many other things taken for granted 10 years ago no longer apply now.

Through this economic and political volatility, there are reasons to believe the era of active asset management is making a comeback. Bonds are looking more attractive as an asset class and there is more leeway for bond managers to differentiate themselves. In the equity space, especially small cap, most of the markets outside the US are trading at depressed valuations on cheap currencies. Higher rates are showing the crack in the "wishful thinking" unsustainable business models and thus rewarding the quality management on a comparative basis. Let's take a look.

Europeans have had a tough year on both the political and economic front. Inflation across the Eurozone accelerated at the fastest pace since the Euro's inception. The UK's own inflation rate is now at a 41 year high of 11.1%. The tight labor markets in the various European countries have led to multiple labour disputes including the highest number of working days lost to strikes in the UK. France is not far behind either. As a result of all the uncertainty, corporate earnings are being revised down aggressively.

Nonetheless, some positive data points allow us to be slightly optimistic on Europe. First, the EU reacted surprisingly well to the 2022 energy crisis and gas storage levels have proven remarkably resilient. Between August and November, Europe was able to reduce its gas consumption by 20% which is well above the government's target of 15%. Weather has been lenient so far reducing the need for heating and as such, December 2023 futures contracts for LNG are now sitting around €70/MWh versus the €345 seen in August. Clearly, it's not all doom and gloom and we are already seeing multiple stock picking opportunities.

In Asia, we still see China driving the show. Much has already been written about the great Chinese reopening and the relaxation of its zero COVID policy. With Xi Jinping's term renewal last October there are reasons to believe that, although the big themes of his reign will remain the same, small shifts such as the removal of COVID restrictions can be expected going forward.

On the Japanese front, the Yen has been quite the headache. The discrepancy between Japan's artificially low rates and the rest of the world finally caught up and the Japanese currency reached multi-year lows in Q4. With inflation ramping up, even if still low by global standards, there are reasons to question whether the Japanese Central Bank will be able to keep its highly accommodative policies. It is worth noting that Japanese firms with global exposure performed wonderfully in Q4 as the weak Yen drove earnings in local currency to all time highs. It is also expected that tourism, especially from China, will provide a boost to the local economy in 2023.

Finally in the US, much of the same topics we discussed in previous commentaries still apply. Labour markets are still showing a stubborn resilience to the breakneck pace of rate increases, with labour demand still outpacing supply by over $5 million. The tech layoffs situation has yet to materialize to the rest of the economy and we are now seeing the "real economy" catch-up after three years of tech dominance. Investors reacted positively to signs that inflation is now coming down from its peak, but we question the level of optimism given how far we are from the Fed's long-term target. While this last earnings season was somewhat on the negative side, it seems supported by low valuations in small cap.

Global Alpha is not a macro manager, but we definitely have much to keep up with on the economic and political front in 2023.

BACK TO GLOBAL SMALL CAP

During the fourth 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, Materials, which represents 7.6% of the index, was the strongest performing sector, delivering a return of 15.4%. At the opposite end of the spectrum, Health Care was the worst performing sector, returning 1.6% for the quarter, with an index weight of 10.6%.

PERFORMANCE HIGHLIGHTS

For the fourth quarter, our Global Small Cap composite delivered a return of 8.9% gross (8.6% net), underperforming the MSCI World Small Cap Index by 1.9% gross (-2.1% net).

Our top performer for the quarter was Rothschild (ROTH FP). Founded in 1838 by the famous family, Rothschild is one of the world's largest independent financial advisory groups. The company provide M&A, strategy and financing advice, as well as investment and wealth management. With a foothold in over 40 countries through more than 50 offices and 3,500 employees, it is still more than 60% family owned. As a boutique firm, it also benefits from the secular trend of increasing number of advisors on individual deals and managements shying away from the bad press of going with larger banks. In 2019, boutique firms accounted for 22% of advisory deal value versus only 9% in 2000 and its share is expected to keep increasing over the next decade.

Within its global financial advisory business, Rothschild employs more than 1,100 advisors, and derives two-third of its revenue from pure M&A, with the balance from capital markets financing. Rothschild ranks number six in revenue globally and first in Europe for its investment banking business.

What drove the stock up?

The share price rallied in October, as did most Eurozone shares, as the market interpreted an ECB statement that the Eurozone economy may be heading for recession as a sign that the pace of rate rises could soon ease, thus supporting the appetite for shares. The company delivered a strong Q3 earnings report with revenues up 30% year on year. Global advisory performed well due to strong levels of deal completion. Wealth Management benefitted from an increase in management fees after strong AUM growth in 2021 and value accretion on certain private equity positions boosted Merchant Banking performance.

The company noted that 2023 is expected to be more challenging. Later in the quarter, Rothschild agreed to divest its North American asset management business, something it has been seeking to do for a while. The deal is expected to be completed early in the first quarter of 2023.

Another top contributor for this last quarter was Eagle Materials (EXP US). Founded in 1963 as a subsidiary of Centex and then spun off in 2014, Eagle Materials is a producer of building materials based in Dallas, Texas. The company operates to primary business lines: Portland cement and gypsum wallboard.

Eagle Materials is well known in the industry as a low-cost producer that is well diversified across the US heartland and sunbelt with its 70 production facilities.

What drove the stock up?

The company reported strong earnings with revenue up 19% and EBITDA increases 22%. Both cement and wallboard business saw strong pricing environment. The cement business of which 50% is supported by infrastructure saw strong demand. Given the sold-out market pricing is increasing with EXP announcing $15/ton Jan 2023 price increase, which has been matched by competitors. While the wallboard business is inherently cyclical, the lack of availability of synthetic gypsum is adding constrains to wallboard supply, which may limit the downside to prices. We are confident in the stock going into 2023.

Our top detractor for the quarter was Omnicell Inc (OMCL US). Headquartered in California, Omnicell is one of the leaders in automated dispensing cabinets for pharmacies and hospitals. Their products are appliances with a significant degree of software content that helps track, store, acquire, dispense & administer medications and supply in hospital settings. It is present in roughly 50% of the US hospitals and 80% of the retail pharmacy sector.

Medical management, and more specifically medication, is a complex and resource intensive aspect of health care given the high level of customization required for each client. Omnicell's solution provides added value on two fronts: reducing the resource required to provide the service and reducing the risk of human error.

What drove the stock down?

The company missed third quarter (2022) estimates and lowered guidance for the fourth quarter. The top line miss was largely attributable to headwinds from health system budget freezes and customer labor availability challenges. Investors were frustrated as none of the issues were highlighted at the recent analyst day in September. Given the weakness, investors began to question management visibility into future growth. Management team is taking the right steps by evaluating expense reduction actions to offset the reduced revenue expectations, while plans for investments in growth remain intact.

NEW POSITION

We finished the quarter with a new position in SalMar inc (SALM NO). The world second largest producer of Atlantic salmon, it boasts a 11% market share of the global salmon market. SalMar is known as a high quality and high margin producer compared to its peer that consistently sees its core operations run close to 100% utilization rate. Its primary operations are in northern Europe.

We received SalMar shares as part of its acquisition of Norway Royal Salmon in November. The switch provides us with a more diversified and vertically integrated exposure to the salmon space, which we were looking to maintain with the sale of Norway Royal Salmon.

OTHER NEW BUYS AND SELLS

During the quarter we also initiated new positions in Brunswick Corp, Gentherm, Menicon, NOW Inc, and Orora. We will profile these names in future commentaries.

During the quarter we exited Carriage Services, Primo Water, Emergent Biosolutions, Advance Residence Inv Corporation, Norway Royal Salmon, Autogrill, Cognyte Software, and Cerence Inc.

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

Global Alpha had its year-end market review in December and discussed expectations for 2023. Globally, we see the year being driven by some of the same themes that defined 2022.

First, we expect higher rates to stay high for longer. Markets are looking for any potential signs of rate stabilization and potential reductions despite the Fed and other central banks constantly trying to show they won't fold. Even the Bank of Japan has been showing cracks that its historically accommodative policy might be unsustainable and that it might need to close the gap between its overnight rate and that of its western peers. This expectation implies a global economic slowdown in 2023, which is commonly agreed, but the extent of the slowdown is still unclear.

Second, we expect some investor optimism from the reopening in Asia and more specifically China, although the process will be messy. There are already multiple reports on the scale of the COVID pandemic happening in China, with some countries announcing that as much as 50% of incoming Chinese travellers are estimated to have COVID. Nonetheless, the removal of the zero-COVID policy was long overdue. Japan has also been relaxing its policy for incoming travellers and we expect that the low Yen will drive tourists' interest.

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 expect this new volatile environment to be beneficial to active asset managers as opportunities to add value will accelerate.

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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