QUARTERLY COMMENTARY

June 30, 2023

Artificial Intelligence, or AI, has continued to grow with developments in technology and more funding flooding the sector. In fact, AI has been viewed as a possible solution to combat the slowdown in global GDP. Promising to be a unique productivity tool, AI has attracted attention as a catalyst for global economic growth, particularly as expectations for China's and Russia's economies have dwindled. AI's impact has been significant enough to shift some investors' focus from dividend-paying stocks to AI-based stocks. During these times of macroeconomic uncertainty, investors have seen more opportunities for gains in AI stocks.

However, despite the positive outlook on the AI sector, global venture funding continues to decline. Quarter over quarter, global venture funding is down 18%, and year over year it has fallen by 49%. If not for the AI sector, which has made up almost a fifth of total global venture funding this year, these percentages would be even higher. Global funding overall has been on the decline for the past four to five quarters, fueled by uncertainty in the macroeconomic landscape and inflation rates. Companies are hesitant to spend capital and engage in other business operations, which has not helped global economic growth.

In the US, labour markets remain strong and resilient. Private payrolls increased significantly, and continuing claims are low, indicating that workers have been able to quickly find new employment after being laid off. Layoffs have decreased by 31% compared to the first quarter. Regarding monetary policy, the US Federal Reserve decided to keep interest rates unchanged in June. However, given the positive labour market news, this is unlikely a signal of peak interest rates. In the stock market, the trend from the first quarter continued, with big rallies seen in large-cap stocks like Apple, Tesla, Meta and Nvidia while the rest of the market remained relatively flat. Another strong spot in the US economy during this quarter was the construction market due to increased construction spending, employment and easing supply chain issues.

At face value, Europe's market underperformed compared to the excitement around large-cap tech stocks seen in the US. However, excluding the "big 7" companies driving S&P 500 Index performance, Europe no longer underperforms. The European market has been cautiously following the US labour market and monetary policies, which have been headwinds for a market lacking the AI craze and large tech companies to invest in. Looking at country specifics, Germany's economy has struggled to recover in Q2, with industrial production falling 0.2% month over month in May. This indicates ongoing challenges in the country's industrial sector, worsened by weak global demand from China. In the UK, inflation showed little sign of slowing, reaching 8.7% in April, higher than the expected 8.2%. Inflation seems to be more persistent in the UK compared to other high-income economies, and the Bank of England's efforts to curb inflation have impacted the housing market.

In Japan, the macroeconomic market has been relatively stable, with the Bank of Japan leaving its monetary policy unchanged in April. The central bank's new governor is electing to support fragile economic growth through accommodative policies and expects inflation to moderately recover in the second half of 2023. Japan's re-opening post COVID has led to accelerated retail sales due to pent-up demand, and the service sector is gaining momentum with borders reopening and strong consumer spending. Inbound tourism has also played a significant role in driving the economy, with the number of foreign nationals staying in accommodation facilities in Japan exceeding 10 million in April for the first time since January 2020 according to the Japan Times. A similar recovery story can be seen in Hong Kong, where China's reopening has driven economic growth through inbound tourism and domestic demand.

BACK TO GLOBAL SMALL CAP

During the second quarter, the MSCI World Small Cap Index underperformed the MSCI World Large Cap Index but outperformed the MSCI Emerging Markets Index.

Within the MSCI World Small Cap Index, information technology, which represents 12.0% of the Index, was the strongest-performing sector, delivering a 6.7% return. Communication services was the worst-performing sector, returning -2.2% for the quarter, with an Index weight of 3.0%.

GLOBAL ALPHA PERFORMANCE HIGHLIGHTS

Over the same timeframe, our Global Small Cap composite delivered a 0.1% gross return (-0.1% net), underperforming the MSCI World Small Cap Index by 3.1% gross (3.3% net).

Radnet Inc. (RDNT US) was our top performer for the quarter. Founded in 1984, this radiology firm operates imaging centres and is the largest provider of outpatient imaging services in the US.

So, what drove the stock up?

Coming into 2023, the company was already seen as a winner of the softening labour market, with expectations of increased margins, volume and cyclical tailwinds. However, the real driving force was the development in its AI segment, which was initially presented by management as an additional productivity tool, despite being loss-making at the time. Now, it is on the verge of becoming a breakeven business capable of drastically improving margins and scalability. This development also supports the introduction of new services like the Early Breast Cancer Detection Program (EBCD). We remain positive on Radnet as a long-term holding with plenty of upside.

Another top contributor last quarter was **Eagle Materials** (EXP US), a manufacturer of construction materials used in residential, commercial and infrastructure applications. The company produces cement, wallboard, paperboard, concrete and other aggregates. We like Eagle Materials due to its status as one of the low-cost producers, providing it a competitive advantage. The company is uniquely positioned to leverage its distribution and sales network to secure new business. It also stands to benefit from the long-term trend of increased demand for housing, which further bolsters its growth prospects.

WHAT DROVE THE STOCK UP?

Cement pricing once again demonstrated strength due to limited supply and the potential tailwind from the infrastructure bill. As a result, the segment was expected to be a significant driver of earnings growth. Concerns, however, lingered around the wallboard segment, given the slowdown in residential housing. Nevertheless, the company was able to beat expectations thanks to pricing performance. Additionally, the company maintained a solid balance sheet, supporting a 9% free cash flow yield.

Our top detractor for the quarter was **PRA Group** (PRAA US) headquartered in Norfolk, Virginia. One of the largest publicly traded distressed consumer debt buyers in the US, the company buys written-off credit card receivables and other debts, and subsequently collects on them. Essentially, PRA buys debt for $0.05 to $0.10 on the dollar and recovers $0.12 to $0.14.

What drove the stock down?

PRA's new CEO published results that came in well below expectations, attributing it to a combination of weak numbers, one-off events, investment expenses and delayed revenue recognition into Q2. Cash collections were down 14%, while purchases also declined sequentially. Furthermore, PRA's core US market was soft across the board.

Nonetheless, PRA remains well-positioned in a space that is likely to perform well in an unfavourable economic environment. Relative to competitors, PRA carries comparatively lower leverage and faces fewer challenges in buying bad debts. Banks are increasingly looking to sell their paper to grow earnings per share (EPS) and clean up their balance sheets. Meanwhile, PRA has been aggressively buying back 14% of its shares outstanding since 2021 and remains among the best positioned within the industry to benefit from tightening financial conditions. We maintain a positive outlook on the company's growth prospects.

NEW POSITION

We finished the quarter with a new position in **Keywords Studios** (KWS LN), an Ireland-based company dominating the fragmented market of video game outsourcing. With over 70 studios in 26 countries operating across eight different lines of business and three development divisions, Keywords scale is unmatched, three times larger than its closest competitors, yet it only holds a 6% market share. It offers a comprehensive range of services covering various developer requirements, including audio services, customer support for live games, marketing and social media management and bug testing.

While Keywords has long been highly regarded in the video game small-cap space, its valuation had been a deterrent to investment despite its strong niche positioning and favourable business model. However, toward the end of April, the company's name surfaced in Bank of America's AI loser basket, suggesting that most of Keywords' services would eventually be brought in-house by game developers due to advancements in AI technology, reducing the need for human labour. This sent the company's share price on a downward spiral. The negative momentum continued as index weight adjustments, loss cutting and quant signals further impacted the stock.

Upon closer examination, we saw that the market had misunderstood the situation, leading to indiscriminate selling of services companies like Keywords. Contrary to the perception that Keywords was unprepared for the AI revolution, the company had been proactively investing in AI technologies for at least a year before ChatGPT became a household name. It had already incorporated AI solutions into various aspects of its operations, enhancing localization services through Kantan AI, optimizing customer support via Helpshift and improving quality testing expertise with the aid of Mighty Games. Furthermore, Keywords holds a significant advantage in exposing its machine learning systems to a variety of games, languages and coding requirements. This advantage stems from its unmatched scale, making it virtually impossible for individual video game developers to replicate.

The decision to invest in Keywords instead of a game developer that owns its own intellectual property (IP) stems from several factors. The global video game market is highly susceptible to hits and misses, creating risks for developers and leading to revenue lumpiness. This is especially pronounced in the small-cap space where companies typically have limited IP and release only a few games annually. Significant ramp-up time is involved in new projects, with game developers not reaching the same development stage as the audio or functional testing teams. There may be underutilization of employees and inefficiencies. In such an environment, the outsourcing trend is increasingly prevalent across video game companies of all sizes, with the aim of optimizing development resources. Keywords plays a crucial role in this landscape, offering consistent workload to its studios by working closely with top gaming companies worldwide. Furthermore, the company benefits from building a unique breadth of expertise through exposure to a wide variety of games without the burden of managing its own IP or taking risks associated with the success or failure of a single title.

Our investment in Keywords allows us to capitalize on the growth of the video game industry without making a call on specific titles or the medium on which they are consumed. By recognizing the company's strengths, strategic positioning and the ongoing trend toward outsourcing, we believe Keywords offers an attractive opportunity with the potential for long-term success.

OTHER NEW BUYS AND SELLS

During the quarter we also added a new position in **Digi International Inc.** (DGII US), while exiting our positions in **Motorcar Parts of America** (MPAA US) and **AudioCodes Ltd.** (AUDC IS).

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

Global Alpha has been back on the road with company meetings and conferences. Across the multiple regions we cover, we have found mixed signals from management teams in various industries in the first quarter. Despite companies' continued ability to pass on price increases and overall strong labour markets, there are still concerns around the weak resurgence of the Chinese consumer, persistent inflation, the impact of rate hikes on liquidity and continued geopolitical tensions.

The flight to safety that followed the fall of Silicon Valley Bank was short lived as the risk-on attitude resumed in the second quarter. Big tech dominance on US stock market returns so far this year has resulted in almost everything non-speculative falling out of favour. Apple alone is worth more than the entirety of the Russell 2000 or the UK's 100 biggest listed companies. Nvidia's valuations have reached levels not seen since the dotcom bubble, leading it to join the $1 trillion market-cap club. This situation is reminiscent of 2020, where every speculative stock was priced for perfection.

In this environment, we are sticking to our strategy of investing in companies with little debt and strong cash flow generation, as well as those aligned with well-defined secular trends that will drive growth for years to come. We believe this volatile environment will provide active asset managers with opportunities to add value, but it is likely to be a wild ride.

We are not making significant sector or country adjustments to the portfolio based on these expectations. Instead, we are maintaining a diversified list of holdings 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 comprise 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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