

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.

INTERNATIONAL SMALL CAP

BACK TO INTERNATIONAL SMALL CAP

During the second quarter, the MSCI EAFE Small Cap Index underperformed the MSCI EAFE Large Cap Index and the MSCI Emerging Markets Index.

Within the MSCI EAFE Small Cap Index, utilities, which represents 2.9% of the Index, was the strongest-performing sector, delivering a 3.8% return. Energy was the worst-performing sector, returning -5.6% for the quarter, with an Index weight of 2.8%.

PERFORMANCE HIGHLIGHTS

Over the same timeframe, our International Small Cap composite delivered a -5.1% gross return, underperforming the MSCI EAFE Small Cap Index by 3.3% (gross).

Our top performer for the quarter was **Iwatani Corp.** (8088 JP), a prominent distributor of gases used in industrial and household applications in Japan. Iwatani is Japan's largest provider of LPG, hydrogen and helium and the only company in Japan with a fully integrated hydrogen supply network that includes manufacturing, transportation, storage and security.

Given Japan's historical lack of significant reserves of natural resources such as oil or natural gas, the country has heavily relied on imports to meet energy demands, making energy an important political topic. It is no surprise that Japan was the first country to adopt a hydrogen strategy back in 2017. It now boasts the largest hydrogen station network, with 160 stations in operation as of 2020 and targeting over 900 by 2030. Iwatani is well-positioned to reap the benefits as a primary beneficiary of this hydrogen infrastructure expansion.

So, what drove the stock up?

Iwatani's outperformance was driven by a few factors. Firstly, the Japanese government has revised its basic strategy for hydrogen, aiming to increase the annual supply to 12 million tons by 2040, six times the current level. This ambitious plan bodes well for Iwatani, given its role as a significant player in the hydrogen market. Secondly, Iwatani's release of its new mid-term plan contributed to its success. The plan outlined growth targets and strategies, with a particular

focus on hydrogen, low-carbon initiatives and overseas expansion projects. Notably, the plan also highlighted the company's commitment to improving shareholder returns.

Another top contributor last quarter was **Sega Sammy Holdings** (6460 JP), a company formed through the merger of game publisher SEGA and pachislot and pachinko machines manufacturer Sammy Corporation in 2004. Sega Sammy now owns several facility-centered businesses, including amusement centers and resorts. The share price was hit at the onset of the pandemic due to travel restrictions and lockdown measures. However, Sega Sammy owns strong and long-lasting franchises such as Total War and Sonic and has a solid history of monetizing them, providing them with a consistent back catalogue. As one of the world's top game publishers based on reviewers' ratings, Sega Sammy continues to be a prominent player in the gaming industry.

What drove the stock up?

Sega Sammy's return for the quarter was primarily driven by strong earnings, with notable 21% revenue growth led by its pachislot and pachinko machine business. Sales of new titles such as Sonic Frontiers and Persona 5 Royal were also strong. The company's announcement of its plan to release a new Sonic game, Sonic Superstars, in fall 2023 further contributed to its positive momentum, building on the success of its previous Sonic release. Finally, Sega's strategic move to acquire Rovio Entertainment, the video game maker of Angry Birds, adds diversification to its existing portfolio, with minimal overlap in terms of geographies. This acquisition aligns well with Sega's global expansion and reinforces our existing conviction in the company's strengths.

Our top detractor for the quarter was **Vitasoy International Holdings** (0345 HK). Vitasoy is a leading manufacturer and distributor of non-carbonated beverages and food based in Hong Kong. Known as the "soy expert", the company boasts a wide distribution network covering more than 200 products in over 40 countries.

Given the estimated worth of the global soy food market at over \$58 billion in 2021, with a projected CAGR of 7%, Vitasoy is well-positioned

to capitalize on the growing middle class in emerging markets and increased awareness of the health benefits of soy food. Its strong brand presence further contributes to its leading market share in the sector.

What drove the stock down?

The company's earnings fell short of estimates due to a slower-than-expected recovery in Mainland China and ongoing cost pressures. Furthermore, the resignation of its China General Manager in April 2023 led to the CEO stepping in temporarily until a suitable replacement is found. On the positive side, the China segment returned to profitability, and the company plans to expand its shelf space while implementing measures to reduce staff turnover to accelerate the business's recovery. Vitasoy is a familiar name to our team, and we are confident that its growth strategy, which centres on the Chinese consumer, remains intact.

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 initiated new positions in **Netcompany Group**, **Kelsian Group** and **Tate & Lyle PLC**.

We exited **AudioCodes Ltd.** during the quarter.

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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