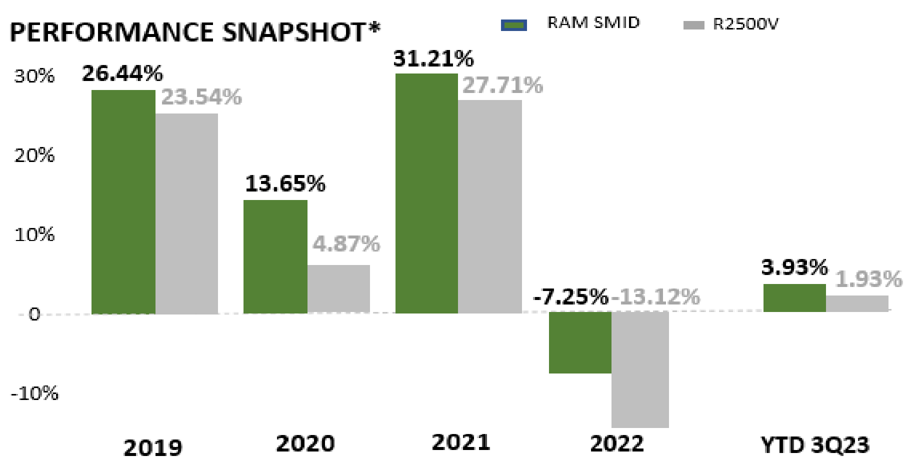
September 2023

The major market indices turned in a soft performance in 3Q23, as investors fretted about the potential implications of higher interest rates and higher oil prices. Our RAM Smid composite softened 3.09% in 3Q23, versus a 3.67% decline in the Russell 2500 Value Index (R2500V). Year-to-date 3Q23 our RAM Smid composite has climbed 3.93% versus a 1.93% gain for the R2500V index.

The larger market cap S&P500 index fell 3.12% in the quarter, and has returned 13.06% year-to-date, while the S&P 493 (defined here as the SPY ETF less its top 7 positions AAPL, MSFT, AMZN, NVDA, GOOG (and GOOGL), TSLA and META) returned -3.06% in the quarter and a softer 2.52% year-to-date.[1,2,3]



Source: Rewey Asset Management, Index returns sourced from Bloomberg 9/30/2023.

**Please note that there are material limitations inherent in any comparison between RAM Smid strategy and the R2500 Value Index. The R2500 Value Index is unmanaged and you cannot invest directly in an index. The RAM portfolio is actively managed and holds concentrated investments in the equity securities of small-mid capitalized companies.*

The Last Hike?

After hiking the Fed Funds rate by 25 basis points in July, for the 11th time since March 2022, the Fed chairman indicated that the Fed would "proceed carefully" in evaluating further increases. Although its supporting forecast materials indicate the Fed has one more 25 basis point hike penciled in for later this year, we believe the combined macro pressures of increasing mortgage rates, the resumption of student loan payments and soaring oil prices will help to curb inflationary pressures and allow the Fed to hold rates flat through year-end.[4,5]

Consumer Headwinds

The average 30-year fixed mortgage rate has soared this year to 7.74% as of September 30th, up from 6.66% at year-end 2022 and 3.27% at year-end 2021. We believe these higher rates will present a significant drag for the housing market. In our view, the very weak August report of U.S. pending home sales which fell 7.1% from July and a whopping 18.8% year-over-year shows the negative impact of higher mortgage rates.[6,7]

Accruals for student loans resumed on September 1st and monthly payments are set to resume October 1st. Moody's, in line with many economists, notes that these payments could potentially amount to $300 per borrower and shave a collective 0.3% off GDP if all payments resume.[8]

Oil prices have surged this year to end September at $90.79 per barrel, which has pushed retail gasoline prices up to $3.82 per gallon at month end, up from $3.08 per gallon at year-end 2022.[9,10]

Lower SPR Inventories

Unfortunately for the U.S. consumer, the outlook for higher oil prices paints a bleak picture. In early September, Saudi Arabia, OPEC and Russia agreed to extend their additional oil production cuts of 1.66 million barrels a day through year end 2023, bringing their total production cuts to 3.66 million barrels.[11]

The U.S. government has tried to combat higher oil and gasoline prices by releasing oil from the U.S. Strategic Petroleum Reserve, but we believe the potential benefits of these moves are waning. On September 22nd, the level of the strategic reserve had fallen to 351 million barrels, down from 656 million barrels in July 2020. These lower inventory levels limit the ability of the U.S. government sell reserves to offset higher gasoline prices.[12]

U.S. Production Not Keeping Pace

While U.S. oil production on September 22nd was recorded at 12.9 million barrels per day, just slightly below March 2020 highs of 13.1 million, we don't foresee a large near-term production response from U.S. producers in the near-to-medium term. The combined impact of tighter regulatory actions to curb U.S. oil production in many areas and a seemingly newfound love for cash and hatred of debt by independent U.S. producers likely means production will stay near current levels. We point to the Baker Hughes U.S. Oil and Gas Active Rig Count data, which shows active rigs in the U.S. falling to 623 at the end of September, down dramatically from 799 at year-end 2022. Anecdotally from our research, we note management teams are very cautious in their plans for adding rigs, even at these price levels.[13,14]

Move Early to Avoid Being Trampled by the Galloping Herd of Investors

While the potential negative impact of higher interest rates and oil prices are clearly visible today, we foresaw these moves over a year ago, and have written about the potential impact in our quarterly letters and Market Musing blogs. As such, over the last year, we have significantly reduced our composite's holdings in the housing and consumer sectors and added a new position in the oil and gas production sector. While some of these moves may have been early, we are happy with our current positioning and pleased to avoid the potential stampede of investors that might look to adjust their exposures in these sectors through year-end.

Can the Fed "Stick" a Soft-Landing?

The upside of a weaker consumer, a weaker housing market and higher oil prices is the potential for these forces to soften inflationary pressures. Inflation measured by the PCE (personal consumption expenditures excluding food and energy) softened to a 3.9% year-over-year rise in August, continuing its consistent decline from September 2022's reading of 5.47%, while the month-over-month reading rose only 0.1%, which is well within the Fed's 2% annual goal. With inflation softening and the Fed's 2024 and 2025 GDP forecast at 1.5% and 1.8%, respectively, it appears that the Fed is on track to achieve its soft-landing goal. This scenario, which would avoid the recession that the market seems to fear, would likely be very positive for the market looking forward, particularly the small and smid cap sectors that have been most negatively impacted by these recession fears.[15,16]

Portfolio Highlights

We have built our RAM Smid portfolio based on our 3-pronged investment philosophy of 1) Financial Strength, 2) The Ability to Grow and 3) Discounted valuations.

As we have held the view over the last two years that short and long rates would rise as the Fed attacked inflation, we have focused on companies with low leverage and strong interest coverage metrics. Five of our composite holdings have net cash on the balance sheet and twelve have net debt to EBITDA under 1.5x. Eight holdings are trading at or under 1x book value and nine additional holdings are trading at less than 1.5x book.[17]

It is also worth highlighting that two of our holdings have no sell-side coverage, and fifteen others have five or fewer covering analysts. We believe this anonymity provides us with the opportunity to identify companies that pass under the radar for other investors and help secure positions at attractive valuations. At quarter-end, our RAM Smid cash level averaged slightly over 7.9%. We added three new companies to the portfolio in the quarter, and sold out two positions.[18,19]

For the second quarter in a row Limbach Holdings (LMB) was our top percentage gainer, rising 27.7%. LMB's core market of HVAC system design and installation continued to show robust growth, driven by data centers, hospitals and general manufacturing facilities. LMB's strategy to switch to direct contracting with customers (ODR) is also driving significant margin and free cash flow growth for the company. While we continue to see upside for this relatively unknown company, we have trimmed our position given the 157% gain in the stock price since our initial purchases in February.[20]

Richardson Electric (RELL) was our largest percentage decliner for the second quarter in a row, falling 27.7%. After trimming on price strength in 2Q23, we further reduced our position size in August, taking the position down to a 1% weighting. Although we foresee continued short-term weakness in RELL's semiconductor CAPX end markets through year-end 2023, we remain very bullish on RELL for the longer term. We see exciting revenue and earnings growth opportunities for RELL as its ultracapacitors capture new markets in wind turbines, electric locomotives, and cellular base stations. RELL's offerings provide better energy management, including high energy lithium battery solutions, longer life cycles and lower maintenance costs vs. current solutions. We think investors could embrace not only the significant revenue growth opportunity in front of RELL, but also gravitate to its favorable ESG profile given its significant exposure to green energy solutions. We remain opportunistic to re-increase our holdings in RELL once we feel the outlook for semiconductor CAPX spending stabalizes.[21]

Mayville Engineering Company (MEC)

In the third quarter, we increased our position in Mayville Engineering Company, Inc. (MEC), rebuilding some of the position we had previously trimmed on price strength. Based in Mayville, WI, MEC is a $221 million market contract manufacturer, with services ranging from prototyping and tooling to final assembly. In our view, the 3Q23 decline in MEC share price presents a compelling opportunity for price appreciation. We believe investors have become overly negative on the economic outlook for small cap industrials in general and are overlooking the numerous company specific growth drivers that should support revenue, earnings and cash flow growth for MEC over the next 3+ years.

Starting with financial strength, MEC has a solid balance sheet and a credible outlook for robust free cash flow through at least 2026. MEC has mostly completed its roughly $54 million investment in its new Hazel Park, MI facility and closed its $96 million acquisition of Mid-States Aluminum on July 1st. Both the new facility and the acquisition should drive material increases in earnings and free cash flow going forward, with MEC estimating 2H23 free cash flow of $25-$35 million, which at the mid-point is a 13.6% free cash flow yield on its market cap. Moreover, at its September 14th investor day, MEC forecast cumulative 2024-2026 free cash flow of $200 million, a whopping 90% of its market cap, that it will use to reduce debt, repurchase shares and deploy for strategic acquisitions.

We believe recession fears overlook several company specific revenue and earnings drivers for MEC into 2024 and beyond. At its September 14th investor day, MEC indicated it believes it can grow its revenues organically at an 8%-12% CAGR over 2024-2026, with additional growth from potential M&A. MEC is benefitting from the trend of reshoring, as companies bring critical elements of their supply chain back to the United States. MEC has booked reshoring wins from new and existing customers that are currently converting to revenue, and it indicated it has a strong outlook for more wins over the near to medium term. Secondly, MEC is ramping up its new Hazel Park, MI facility, and believes it will near its $100 million revenue target for this facility on a 2024 exit rate. Annualized revenues for the facility now are roughly $70 million, supporting this outlook. Third, MEC's recently closed Mid-States Aluminum acquisition should provide immediately accretive growth, including offerings in aluminum extrusion, where MEC has noted strong customer interest.

We also see the new CEO, Jagadeesh Reddy, who joined in July 2022, as a significant positive impact on the company, as he ramps up MEC's "MBX" initiative, a kaizen based 6-sigma approach to productivity and value-based pricing. MEC has multiple Kaizens in progress and in planning, which we believe will help support MEC reaching its 14%-16% EBITDA targets by 2026, up 300-600 basis points.

We think the combination of organic and acquired revenue growth, significant margin expansion and outstanding free cash flow generation should drive a material increase in MEC's share price over the next 2-3 years. We have set a very conservative price target of $20 (up 83%) from September 30th close, based off 8x 2024 EBITDA. We believe this target is conservative when the true magnitude of MEC's potential 2H23-2026 cash flow of $230 million is considered, which represents over 104% MEC's current market cap. We have rarely seen such a free cash flow based valuation opportunity in our 33 years.[22]

Investor Neglect

Perhaps we neglect talking often enough about our philosophy of identifying stocks we think are overlooked or neglected by other investors. Put simply, we believe buying low-expectations and selling high-expectations is a powerful driver of value creation. We believe MEC represents a great example of how low expectations, or investor neglect, can create compelling investment opportunities. While MEC is a small cap stock, with a $221 million market cap, it does have five 'street' analysts following the name. Most of the street analysts remain in a wait-and-see mode on MEC, even though they see a potentially strong outlook for the stock. For example, one street analyst who rates the stock neutral with a $15 price target indicated that if MEC delivers on its investor day goals, it could see a $28 price target on the shares in two years, using only a 10x PE ratio. A $28 price level would be a 155% return on the shares. We believe this opportunity is worth our investment.[23]

Looking Forward

Over our 33 years of professional investing, we have come to expect the unexpected in stocks and the macro economy. Our investment philosophy begins with finding companies with the financial strength to weather these bumps while allowing management to deliver on their longer-term strategies.

We believe the small and smid cap market sectors always hold investment opportunities, not only due to the sheer number of companies in this universe, but also for the ability to find companies that are misunderstood and/or neglected by investors. Having a strong investment case and a long-term view creates time as an ally for value creation.

We thank you for your trust and support. As always, please do not hesitate to contact us for client service, to discuss our commentary or to simply opine on the market and stocks.

Chip

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1. Past performance is no guarantee of future results. The RAM SMID Value Composite schedule of net investment performance of Rewey Investment Management LLC (the "Schedule") represents the activity of separate customer trading accounts managed collectively (collectively the "Accounts") for the annual and cumulative periods from January 1, 2019 through September 30th, 2023. 2022-2Q23 performance unaudited. Please see full Marcum footnotes for RAM Smid composite 2019-2021 at Microsoft Word - {A44BB912-3141-4B59-AE8E-3D695C6B8BD4} (reweyassetmanagement.com). Performance graphic not to scale.
2. The Russell 2500 Value and the S&P 500 Index performance levels are sourced from Bloomberg. The Russell 2500 Value and S&P 500 indices are an unmanaged group of securities considered to be representative of the small and mid-cap stock market, and the large-cap stock market in general, respectively. Indexes are unmanaged and do not incur management fees, costs, or expenses. It is not possible to invest directly in an index. There are material differences between the RAM SMID Value Composite portfolio and the indexes used for comparison purposes. The RAM portfolio is actively managed and holds concentrated investments in the equity securities of small-mid capitalized companies. An index is generally designed to illustrate the performance of a specific asset class (i.e. small cap), but is not actively managed and the index performance does not reflect the impact of advisory fees and other investment costs.
3. SPY (S&P 500 ETF) Information sourced from Bloomberg. "SPY 493" is not an index, but a term defined in this letter to represent the SPY ETF without the impact of its top 7 holdings. This data is not guaranteed and is sourced through Bloomberg and Rewey Asset management proprietary analysis.
4. Federal Reserve September 2023 Statement: Federal Reserve Board - Federal Reserve issues FOMC statement
5,16. Federal Reserve September 2023 supporting materials "Summary of Economic Projections Summary of Economic Projections, September 20, 2023 (federalreserve.gov)
6. 30-year fixed mortgage rate data sourced from Bank Rate 30Y Mortgage Avg. via Bloomberg
7. U.S. pending home sale data sourced from National Association of Realtors via Bloomberg
8. Moody's student loan article How Student Loan Repayments Could Hurt US Economy (msn.com)
9. Oil prices reference WTI oil prices quoted as "generic first CL future" New York Mercantile Exchange via Bloomberg.
10. Average retail gasoline prices sourced from Daily Natl Avg gasoline prices from the American Auto Assn via Bloomberg.
11. Opec and Russial oil production cuts discussed Why did OPEC cut oil production? Key reasons explained | Reuters
12. U.S. DOE Strategic Petroleum Reserve Total Inventory data sourced via Bloomberg.
13. U.S. DOE Crude Oil Production data sourced from Bloomberg.
14. Baker Hughes U.S. Rotary Rig Count data sourced from Bloomberg.
15. Core PCE inflation statistics sourced from the Bureau of Economic Analysis and Bloomberg.
17,18. All portfolio discussion is based off our model RAM Smid portfolio of separately managed accounts. Company financial estimates sourced from Rewey Asset Management proprietary analysis, and Bloomberg BEST company estimates. Historical pricing and company financial data sourced from company 10Q and 10K filings, and Bloomberg. Individual portfolios may hold slight deviations in position sizes, cash levels and positions held. Portfolio statistics discussed are from June 30th, 2023. These statistics will likely change over time. Debt/EBITDA ratio comments exclude financial companies due to non-comparability.
19. Covering active sell-side analyst data sourced from Bloomberg.
20. Limbach Holdings, Inc. (LMB) quarterly performance information sourced from Bloomberg. Other LMB commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, RAM discussions with management, Bloomberg and Rewey Asset Management proprietary analysis.
21. Richardson Electronics, Ltd. (RELL) quarterly performance information sourced from Bloomberg. Other RELL commentary sourced from company earnings releases, 10Q, 10K filings, company presentations, RAM discussions with management, Bloomberg and Rewey Asset Management proprietary analysis.

22. All financial ratios, statistics, and projections discussed in the Mayville Engineering Inc. commentary are sourced from MEC 10-K, Proxy, 10Q filings, company press releases, company public conference calls and webcasts, company slide presentations, Bloomberg, MEC company webpage, RAM discussions with MEC management and Rewey Asset Management proprietary financial analysis and Rewey Asset Management industry due diligence. Historical share price information sourced from Bloomberg.
23. RAM has seen and confirmed the authenticity of this street analyst report.

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